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Unpacking Force Majeure Contract Clauses and Supply-Chain Disruptions

Written by: Wendy A. Clarke and Jason R. Adams, Kelley Drye & Warren LLP

For more than 18 months, the COVID-19 pandemic has disrupted global supply chains across all industries. Notwithstanding improving outlooks, the pandemic continues to be viewed as a significant risk to...

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Managing Leading a High-Performing Credit-to-Cash Team

By: Keith Cowart, FIS

There are two questions I often come across regarding leading credit-to-cash teams. One, how do you improve the team you are working with? And two, how do you effectively lead a team that is already...

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Small Business Reorganization Act in Practice: Issues and Strategies for Creditors in Small Business Bankruptcies

By: George P. Angelich, Esq., Justin A. Kesselman, Esq., Patrick Feeney, Esq., Arent Fox LLP

In 2019, Congress passed the Small Business Reorganization Act of 2019 ("SBRA"), which created a new option for small businesses seeking the benefits of Chapter 11 of the Bankruptcy Code. Subchapter V of Chapter 11 (11 U.S.C. §§ 1181-1195) ("Subchapter V") a faster, more streamlined process for restructuring that is ...

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Are Your AR Processes Modernized?

By: Mitchell Rose, Billtrust

"Old fashioned" is not how most of us want our AR operation described, especially in today's environment where adapting to slower mail service and remote work in the pandemic's wake has been a loud call-to-action to automate and build a digital relationship with...

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Unpacking *Force Majeure* Contract Clauses and Supply-Chain Disruptions

By: Wendy A. Clarke, Special Counsel and Jason R. Adams, Partner, Kelley Drye & Warren LLP

Introduction

For more than 18 months, the COVID-19 pandemic has disrupted global supply chains across all industries. Notwithstanding improving outlooks, the pandemic continues to be viewed as a significant risk to growth with recent surveys showing a majority of reporting companies continue to experience supply chain disruption.¹ In June, the Biden administration announced initiatives to bolster America's supply chains, with six industrial sector reports due by February 2022.

In addition to supply shortages, companies are dealing with supplier efforts to invoke *force majeure* contract provisions to avoid paying damages for their failure to supply. While commercial contracts often contain such provisions, few parties have a full grasp of their application. Many wrongfully leap to the conclusion that the characterization of COVID-19 as a pandemic automatically excuses performance.²

This article provides an overview of *force majeure* provisions and the legal requirements to excuse performance thereunder, including recent decisions addressing COVID-19. As discussed, parties seeking to rely on *force majeure* provisions must show the pandemic was both contemplated by the parties and directly impeded performance. Suppliers that fail to do so face significant legal obstacles to excuse performance and avoid liability. This article concludes with a discussion of issues to consider in assessing ongoing supply chain risks.

Force Majeure Provisions and General Legal Requirements

A contractual *force majeure* provision identifies conditions under which a contract counterparty will be relieved of liability for non-performance based on events that are beyond their control.³ *Force majeure* provisions are particularly relevant for long-term supply contracts for (i) textiles, foodstuffs, mechanical equipment and similar goods; (ii) commodities; (iii) transportation services; and (iv) energy supply. While such provisions can include any conditions negotiated by the parties, they historically include generalized trigger events such as strikes, war, natural disaster, governmental interference or acts of God. Less common until recently was the inclusion of pandemics or epidemics as triggering conditions.

In assessing whether a *force majeure* provision will excuse performance, courts historically look at three issues:

Is the event set forth in the contract? - Failure to specifically identify the event is a hurdle to *force majeure* application.⁴ Efforts to fit an event within generalized catchall phrases are carefully scrutinized within the context of other specifically identified events.⁵ For example, the 2008 financial crisis was held not to qualify under a *force majeure* clause that included a catchall for causes beyond the parties' control.⁶

Was performance directly impaired by the event? - The party must show the event directly prevented, hindered, delayed or impeded performance in accordance with the contract language.⁷ While the *force majeure*

1 Knut Alicke, Richa Gupta & Vera Trautwein, Resetting supply chains for the next normal, MCKINSEY & COMPANY: OUR INSIGHTS (July 21, 2020), <https://www.mckinsey.com/business-functions/operations/our-insights/resetting-supply-chains-for-the-next-normal>; Economic conditions outlook, June 2021, MCKINSEY & COMPANY: OUR INSIGHTS (June 29, 2021), <https://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/economic-conditions-outlook-june-2021>.

2 See, Tedros Adhanom Ghebreyesus, Director-General, World Health Org., Opening Remarks at the Media Briefing on COVID-19 (Mar. 11, 2020), <https://www.who.int/dg/speeches/detail/who-director-general-s-opening-remarks-at-the-media-briefing-on-covid-19---11-march-2020> ("We have . . . made the assessment that COVID-19 can be characterized as a pandemic.").

3 *Facto v. Pantagis*, 390 N.J. Super. 227, 231 (2007) (A *force majeure* clause provides a means by which the parties may anticipate in advance a condition that will make performance impracticable).

4 *Kel Kim Corp. v. Cent. Mkts., Inc.*, 70 N.Y.2d 900, 902 (1987) (*force majeure* clauses should be construed narrowly to excuse nonperformance "only if the *force majeure* clause specifically includes the event that actually prevents a party's performance").

5 *Id.* at 903 (*force majeure* catchall clauses are subject to the principle of interpretation "that the general words are not to be given expansive meaning; they are confined to things of the same kind or nature as the particular matters mentioned").

6 See *Route 6 Outparcels, LLC v. Ruby Tuesday, Inc.*, 931 N.Y.S.2d 436 (3d Dep't 2011) (while the court conceded the defendant had no control of the world economy, the defendant's response and decisions on deployment of its resources remained in the defendant's power and control).

7 See, e.g., *In re Cablevision Consumer Litig.*, 864 F. Supp. 2d 258, 264 (E.D.N.Y. 2012) (*force majeure* clauses "will generally only excuse a party's nonperformance that has been rendered impossible by an unforeseen event"); *Hess Corp. v. ENI Petroleum US, LLC*, 435 N.J. Super. 39, 47-49 (2014) (im-

event need not be the sole cause, courts carefully scrutinize the facts to ensure a strong causal link.⁸

Was nonperformance foreseeable and could it have been mitigated? - *Force majeure* should not apply if the party could have foreseen and mitigated its nonperformance.⁹ Some courts have held that true impossibility of performance must be demonstrated rather than mere impracticability or economic difficulty.¹⁰

COVID-19 Case Law

Prior to COVID-19, few cases addressed *force majeure* in the context of health crises. Those that did focused on the express contractual language and the foreseeability of epidemics. For example, a 1922 decision dealing with the influenza epidemic found a school district was not excused from paying a teacher's salary notwithstanding a board of health mandate closing schools because such event was not explicitly provided for by contract.¹¹

Courts, however, have reached differing results with respect to COVID-19. These decisions have primarily turned on the unique facts of each situation with a focus on (i) express contract language; (ii) the extent to which the pandemic or governmental directives impeded performance; (iii) whether alternative means of performance are available; and (iv) whether the conduct of the parties caused nonperformance. Parties seeking to invoke COVID-19 as a *force majeure* event have been held to a high evidentiary standard.¹² Courts continue to require a strong causal link and something more than an economic decline or other business failings attenuated with the pandemic.¹³

The handful of New York COVID-19 cases to be decided demonstrates mixed results:

- *A/R Retail v. Hugo Boss Retail* – COVID-19 found not to excuse tenant performance under a lease. While the lease contained catchall triggers including governmental orders or regulations, the court determined the lease contemplated the risk of government-ordered restrictions/closures and explicitly did not excuse payment in connection therewith.¹⁴
- *JN Contemporary Art v Phillips Auctioneers* - COVID-19 found to prevent seller's claim for damages against auctioneer who cancelled auction. The court determined that while the *force majeure* clause did not mention pandemics specifically, COVID-19 fit within catchall provisions addressing natural disasters and was similar to the listed examples, like floods or fires.¹⁵
- *Gap Inc. v Ponte Gadea New York* – COVID-19 found not to excuse tenant performance under a lease. Tenant unsuccessfully argued the pandemic and government restrictions amounted to a casualty as contemplated by the contract. Since the lease contemplated governmental preemption, the court concluded the COVID-19 shutdowns were not unforeseeable.¹⁶

possibility of providing gas from the one source did not render performance impossible when gas was available from other sources); *Aukema v. Chesapeake Appalachia, LLC*, 904 F. Supp. 2d 199, 210 (N.D.N.Y. 2012) (mere impracticality or unanticipated difficulty is not enough to excuse performance).

⁸ See *OWBR LLC v. Clear Channel Communications, Inc.*, 266 F. Supp. 2d 1214 (D. Haw. 2003) (event coordinator's cancellation of event because of economic downturn following September 11 was too attenuated to qualify as force majeure because coordinator failed to demonstrate that terrorism prevented travel in February 2002).

⁹ See, e.g., *Watson Labs. v. Rhone-Poulenc Rorer*, 178 F. Supp. 2d 1099, 1111–14 (C.D. Cal. 2001) (applying a foreseeability requirement where parties relied on the boilerplate language of "regulatory, governmental...action" rather than a specifically listed contractual event); *Phillips Puerto Rico Core, Inc.*, 782 F.2d 314, 319 (2d Cir. 1985) ("the non-performing party must demonstrate its efforts to perform its contractual duties despite the occurrence of the event that it claims constituted force majeure").

¹⁰ See, e.g., *Aukema v. Chesapeake Appalachia, LLC*, 904 F. Supp. 2d 199, 210 (N.D.N.Y. 2012) (mere impracticality or unanticipated difficulty is not enough to excuse performance).

¹¹ *Phelps v. School Dist. No. 109*, 134 N.E. 193 (Ill. 1922) (ruling against suspension of a teacher's salary when the school was ordered to be closed for some time on account of an influenza epidemic because "if the school had desired to avoid liability in the event such a contingency arose and caused the school to be closed it could have accomplished that result by so stipulating in the contract").

¹² *Palm Springs Mile Associates, Ltd. v. Kirkland Store's, Inc.*, 2020 WL 5411353 (S.D. Fla. September 9, 2020) (dispositive motion denied where factual questions controlled whether government restrictions prevented payment of rent).

¹³ See e.g., *Future Street Ltd. v. Big Belly Solar, LLC*, 2020 WL 4431764 (D. Mass. July 31, 2020) (even assuming the pandemic qualifies as a force majeure under the agreement, Future Street failed to show its nonperformance was actually caused by the pandemic or that performance was rendered impracticable).

¹⁴ *A/R Retail LLC v. Hugo Boss Retail, Inc.*, No. 158385/2020, 2021 WL 2020879 (N.Y. Sup. Ct. May 19, 2021).

¹⁵ *JN Contemporary Art LLC v Phillips Auctioneers LLC*, 507 F Supp. 3d 490 (SDNY 2020).

¹⁶ *Gap Inc. v Ponte Gadea New York LLC*, 20 CV 4541-LTS-KHP, 2021 WL 861121 (SDNY Mar. 8, 2021).

Several bankruptcy courts have also addressed whether COVID-19 constitutes a *force majeure* event that excused bankrupt tenants from paying rent and reached differing results.

- *In re Hitz Restaurant Group* – Illinois Stay at Home Order found to excuse performance under lease. The tenant argued the shutdown prevented restaurant dine-in services, which triggered the *force majeure* clause covering nonperformance based on laws, governmental action or orders. The court held the *force majeure* clause was triggered because the state’s order constituted governmental action that was the proximate cause of the restaurant’s inability to pay rent.¹⁷
- *In re CEC Entertainment* – COVID-19 found not to excuse performance under leases. The court strictly interpreted the *force majeure* terms in the leases, holding that such provisions did not provide a contractual basis to excuse performance because the leases did not explicitly provide that an inability to pay was an event that would excuse performance.¹⁸
- *In re Cinemex* – COVID-19 found to excuse performance under lease. The court held that governmental shut down orders satisfied provision which included governmental actions. The court, however, declined to excuse nonperformance once the tenant was authorized to operate at 50% capacity because their choice not to reopen for primarily economic reasons did not provide a sufficient basis for relief.

Issues to Consider Under Your Existing Supply Chain Contracts

Given the fact-intensive inquiry, parties must consider the following questions in assessing whether performance can be excused under existing *force majeure* contractual provisions:

- Are pandemics or governmental orders explicit triggering events?
- Is the pandemic the direct cause of nonperformance?
- How does suspended performance affect payment obligations?
- Are termination rights modified for extended suspension of performance?
- Are remedies limited, such as prohibiting the recovery of certain types of damages?

Steps You Can Take to Mitigate Risk

Identify the Exact Nature of the Supply Problems and Document Them. Up-to-date knowledge of the facts is crucial and the ability to prove those facts may determine success in any subsequent legal proceedings.

For businesses that are facing supply problems, do not accept an unspecific *force majeure* declaration. Rather, ask for details about how your supplier is affected. Do not take a position before knowing the relevant facts.

As a supplier you will need to understand the facts behind why you are unable to perform. Is it due to government-ordered shutdowns or quarantines, staff illness, staff staying home out of fear or other reasons? Identifying the exact nature of the problem is critically important and you should secure evidence proving the cause of your specific problem.

Manage Contract Disputes Proactively to Resolve Them Efficiently. Managing contract disputes proactively will increase your chances of resolving them efficiently and successfully. While you should engage with your suppliers and customers in a cooperative and reasonable manner, you must also take steps to protect your legal and evidentiary position in the event a dispute escalates. Check your contract’s dispute resolution clause to identify what court or tribunal would decide a dispute and how that adjudicator would likely assess the situation.

Assess Risk Allocation Under Your Supply Chain Contract. The scope and requirements of *force majeure* vary from contract to contract. Careful legal analysis of your specific situation is indispensable and will depend on the exact nature of the supply problems, the specific terms of your contract, and the governing law.

¹⁷ *In re Hitz Restaurant Group*, 616 B.R. 374 (Bankr. N.D. Ill. June 3, 2020).

¹⁸ *In re CEC Entertainment, Inc.*, 652 B.R. 344 (Bankr. S.D. Tex. Dec. 14, 2020).

If you find yourself facing a *force majeure* defense by your supplier and, as a result, cannot supply your own customers, you need to assess the risk allocation under each contract separately to develop the best risk management strategy.

Provide Notice. Provide appropriate notice that complies with the terms of your contract. Ensure you reach the appropriate parties and use the means called for in your contract. Otherwise, your ability to raise a *force majeure* defense could be limited or a counterparty's duty to mitigate, if any, might not be triggered due to a delay in or a defective notice.

If you receive a *force majeure* declaration from a supplier, carefully frame your response to protect your legal position and, if you must then issue a *force majeure* declaration to your own customers, avoid any language that could prejudice your position in a future dispute with your supplier.

Make Efforts to Overcome Supply Problems. Many contracts and governing laws exclude a *force majeure* defense if you can overcome the consequences of the *force majeure* event. Often, you cannot rely on a *force majeure* defense to avoid significantly higher costs of supplying alternative goods, unless you are entitled to invoke hardship (which might be a rare opportunity in various jurisdictions).

If you receive a *force majeure* declaration that you consider invalid, you may have some obligations to take steps to mitigate your damages. Be sure to document all your efforts to overcome the supply problems, particularly if they are unsuccessful.

About the Authors



Wendy Clarke focuses her practice on corporate, finance and securities law. Wendy represents global companies, private equity funds and other entities in connection with mergers and acquisitions, dispositions, syndicated financings and other commercial transactions, as well as general corporate governance matters. Wendy also counsels brokerdealers in connection with regulatory, securities enforcement and transactional matters.



Jason Adams has more than 20 years of experience helping clients navigate the world of large commercial bankruptcies. Today, his practice focuses primarily on creditors' rights, debt restructuring, distressed M&A and bankruptcy litigation. Jason has substantial experience in the retail, restaurant, technology, industrial and financial services industries. He consistently strives to bring practical and streamlined solutions to his clients' challenges in both an efficient and cost-effective way.