

Force Majeure Damages

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by

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presented to the
79th Annual Meeting of the

Academy of Legal Studies in Business www.alsb.org

Ottawa, Ontario, Canada

August 17 - 21, 2004

INTRODUCTION

A *Force Majeure* Clause anticipates specific needs for a breach (e.g., Act of God renders performance impossible). However, the *Force Majeure* Clause goes further and the parties expressly agree that breach attributable to those listed causes is excused, that is, not a breach because it is beyond the scope of their contract.

The interplay of these specified sources of breach and excuse alter the ordinary contours of damages. A *Force Majeure* Clause transforms previously compensatory damages into consequential damages. Compensatory damages ordinarily are recoverable. Meanwhile, consequential damages rarely are recoverable and ordinarily are expressly disclaimed. The parties need to thoughtfully tailor the objective scope of the *Force Majeure* Clause, least it offer

either far less or far more excuse than the parties' subjectively intended.

A *Force Majeure* Clause seeks to define the limits of the parties' reasonable expectations, beyond which their contractual duties are discharged. A *Force Majeure* Clause is part of the collection of boilerplate clauses (e.g., choice of law) of any commercial contract. Boilerplate language often is inserted as a pre-cast building block of the contract and often gets far less attention than it ought. For example, the interplay of the choice of law clause with the *Force Majeure* clause might either magnify or extinguish the *Force Majeure* Clause.

This paper will avoid entanglements with three broad fields of law that are natural companions of a *Force Majeure* Clause: international law, arbitration law, and the Uniform Commercial Code. In each instance the aversion springs from the same cause, but with a different manifestation: context sensitive application of the law. In international law the broad rubric of a *Force Majeure* Clause yields to variations in surrounding treaties and customs between the trading partners. Even more so a *Force Majeure* Clause viewed through the lens of an arbitration clause can morph in unrecognizable ways. Lastly, the very purpose of the UCC is at variance with a *Force Majeure* Clause. UCC 1-106 calls for liberal administration of remedies as if full performance had been had; in stark contrast, a *Force Majeure* Clause discharges the contract. As a *Force Majeure* Clause, UCC 1-106 acts as welcoming all surprises rather than as rejecting listed surprises. Accordingly, international law, arbitration law, and the Uniform Commercial Code, even though each is a natural companion of a *Force Majeure* Clause, are beyond the scope of this paper.

This paper will focus on the interplay of a *Force Majeure* Clause and lost profits. The focus of this paper will be on domestic contract law between commercial sophisticates. For those contracts, profit is a direct and immediate fruit of the contract, and thus far less likely to be

a collateral transaction without remedy. Further, while a *Force Majeure* Clause seeks to discharge the parties' contractual duties, and thus one would suspect a preclusion of damages, this paper will focus on those settings where damages are owed even though the *Force Majeure* Clause is given effect.

The limitation to the context of contracting commercial sophisticates is to maximize the information available to the parties at the time of contract. That information includes the output from negotiation skills, risk management skills, and forecasting skills, to name but a few. This information provides a far firmer foundation than a *Force Majeure* Clause embedded in an adhesion contract between a consumer and a small retail merchant using a form contract off of the web. Both the parties' magnitude of sophistication and their equality of sophistication strengthen the enforceability of the *Force Majeure* Clause.

To key on discharge with damages might seem at cross purposes. It is not. One function of the *Force Majeure* Clause is to terminate a parties' continuing obligation to perform. This is a common goal of contract law.

Most contracts do not generate litigation. However, most contracts are breached and could be litigated. Contract performance can be arrayed across a continuum from complete performance, then to substantial performance, and finally to material breach. Anything less than complete performance is a breach, thus substantial performance is a breach. Ordinarily, the performance received on a contractual duty is substantial performance. Substantial performance is a breach that triggers legal liability for damages. However, the same trigger of damages triggers discharge of the duty to continue to perform on the contract.

Accordingly, it is not odd to focus on *Force Majeure* Clauses and to focus on damages owed when the duty to perform is terminated.

PROOF OF LOST PROFITS

When proving lost profits the courts require that *the fact* of lost profits must be proved to a reasonable certainty. In contrast, *the amount* of lost profits need only be proved reasonably. This is an application of the general rule that the defendant takes the plaintiff as the defendant found the plaintiff.

Lost profits ordinarily are a form of consequential damages. To be recoverable as a remedy for breach of contract the consequential damages needed to be within the contemplation of the parties at the time of contract.

The most cited case is *Hadley v. Baxendale*, 9 Exch. 341, 156 Eng. Rep. 145 (1854). While most cited it often is misapplied. Additionally, it ought not to be as frequently cited in the USA as it is, for two reasons. First, *Hadley v. Baxendale* is foreign law, albeit British law, but arising after the ratification of the USA *Constitution*. Second, it was not the case of first impression: that honor goes to *Masterton v. Mayor of Brooklyn*, 7 Hill (N.Y.) 61 (1845). However, the courts clearly favor the flexibility of *Hadley v. Baxendale* and the policy of *Hadley v. Baxendale* over those offered by *Masterson v. Mayor of Brooklyn*.

The *Hadley v. Baxendale* test is a three part test for recovery of lost profits because those lost profits were within the contemplation of the parties at the time of contract. The three parts are alternative paths to proving that contemplation. Each path keys on a different observer's view of the future. First, what today is routinely described in tort law as proximate cause (i.e., reasonably foreseeable [note: not necessarily foreseen]) may prove the parties' contemplation. That is, standing the shoes of the parties what reasonably would the parties have foreseen? Second, contemplation may be proved by objective foreseeability. That is, at the time of contract what would a reasonable person (not the parties) standing at the location of the parties have

foreseen? Third, contemplation can be proved with subjective foreseeability, aka special circumstances. That is given the special circumstances of the parties' location, subjectively, what did the parties' foresee. It is quite possible for the parties to have in fact foreseen a consequence that it was not reasonable for the parties to have foreseen nor could a reasonable person so situated have reasonably foreseen.

A *Force Majeure* Clause is an example of a special circumstance, that is, an example of the parties' objective behavior demonstrating that the parties did subjectively foresee. In a *Force Majeure* Clause the parties expressly attempt to foresee the future of contract performance and expressly state which forces are beyond the reasonable control of the parties.

Note, an item might be both expressly excluded from the *Force Majeure* Clause and be beyond the control of the parties. However, in that instance, the parties are engaged in risk allocation as a form of risk management.

Masterson v. Mayor of Brooklyn takes a different tact than *Hadley v. Baxendale*. *Masterson v. Mayor of Brooklyn* recommends use of presumed foreseeability. That is, lost profits are presumed foreseeable as part of a commercial contract. The breaching party is exposed to liability for lost profits unless disclaimed.

But note, in *Masterson v. Mayor of Brooklyn* the plaintiff is a private party and the defendant is the government; while in *Hadley v. Baxendale* both parties were private parties and both were commercial sophisticates (i.e., mill owner and transportation provider). Thus, while *Masterson v. Mayor of Brooklyn* is nine years the senior of *Hadley v. Baxendale*, the latter provides a more generic application of contract law.

Lost profits are, quite possibly, the most frequently sought form of consequential damages. How might the court know what the parties' reasonably foresaw, what a reasonable

person in the position of the parties would have reasonably foreseen, or what the parties' subjectively foresaw (i.e., special circumstances)? That question is answered by *Globe Refining Co. v. Landa Cotton Oil Co.*, 190 U.S. 540 (1903). In *Globe Refining Co. v. Landa Cotton Oil Co.* the parties' tacit agreement controls the question of liability for lost profits. In addition to the contract itself, negotiations before and after provide guidance to the court in mapping the objective intent of the parties.

Accordingly, the mere proposal of a *Force Majeure* Clause, even if it is summarily rejected by the other party serves a distinct purpose in the risk management associated with contract litigation.

CONTENTS OF A *FORCE MAJEURE* CLAUSE

The contemplation of the parties' sets the limits of their contract. In essence, the parties' must identify which transactions are central to their contract and which transactions are collateral. For central transactions damages will be owed in the event of breach. Most often, damages that would be legally owned can be disclaimed. The routine disclaimer of consequential damages is an example. Disclaimer is not the sole means of risk management. Risk management might prompt the parties to specifically assign liability and/or might prompt the parties to estimate the magnitude of liability (e.g., liquidated damages). Collateral transactions are the province of unaccepted consequential damages and of risks beyond the control of the parties. Thus, unlike risks that are central to the contract, risk that are within their contract and will be borne by a party, collateral transactions ought to expressly stated, excluded, and disclaimed.

That is the role of the *Force Majeure* Clause and its specification of the forces that are beyond their contemplation. The *Force Majeure* Clause is a list of foreseen potentialities that the

parties agree are beyond their contract and beyond their liability.

Lists can be constructed in different ways. A common list construction technique includes the "but not limited to" phrase. This phrase, ordinarily, will be inferred if the list is introduced with "for example" or some similar phrase. If a *Force Majeure* Clause states: "A party's duty to perform is discharged in that performance is thwarted by a force beyond the reasonable control of that party; for example, an Act of God, strike, riot, or war.", then the words "for example" clearly call out for additions forces of a similar nature. Far less frequent and far more dangerous in a *Force Majeure* Clause context is the "but not limited to, nor necessarily similar to" phrase. The expansive consequence of "nor necessarily similar to" can be great.

Generically, a *Force Majeure* Clause requires timely notice of a party claiming this means of discharge. Accordingly, exercise of a *Force Majeure* Clause is similar to an anticipatory breach excused. The timely notice is a condition precedent to the discharge.

The *Force Majeure* Clause serves as a contractual specification of remedy. As such, in sounds in the realm of liquidated damages and ought to trigger the procedural protections ordinarily in play with liquidated damages clauses. For example, exculpatory clauses often prompt a judicial finding of unconscionability and the same can be predicted for a *Force Majeure* Clause when a party seeks discharge even though that party has reasonable control over the risk provoking the claim under the *Force Majeure* Clause.

OPERATION OF A *FORCE MAJEURE* CLAUSE

A *Force Majeure* Clause replaces the common law's implied limits on the contemplation of the parties. Almost always parties to contracts should displace the generic common law limits with their personally tailored specification of the limits of the contemplation of the parties.

There are three basic sources of discharge by common law: frustration of purpose,

impracticability, and impossibility. None of these three is likely to please both parties when it triggers discharge. Frustration of purpose is the easiest to prove while impossibility is, well, very difficult.

Frustration of purpose exists if performance is practical (i.e., both physically feasible and financially feasible), but court ordered performance would be to order waste via gross inefficiency since the benefit has been extinguished. The classic example is found in the coronation cases seeking enforcement of room rentals to view a cancelled parade. The room still exists, the rent still can be paid, but why bother? Thus, the court orders the payment of damages and discharges the duty to perform.

The next two common law discharges are meant to be harsh, and by their very harshness to prompt the contracting parties to expressly address impracticality and impossibility via the *Force Majeure Clause*.

Impracticability exists when performance physically feasible but performance in today's conditions is far beyond the conditions contemplated by the contracting parties. How far beyond? Generically, impracticality will not be available for avoiding performance until the price change is beyond a three fold change. If the price rises a *mere* 250%, then conditions are not beyond the conditions contemplated. Harsh indeed. Impossibility calls for a price change of more than ten fold. Impossibility exist is no reasonable person can perform.

Oddly, contracts between commercial sophisticates do not routinely list the market as a force beyond the control of the parties, and such contracts rarely identify a bandwidth for expected price variation.

Unlike mutual mistake and its remedy of rescission *ab initio* to restore the status quo, where there was no contract; with impossibility, impracticability, or frustration of purpose there

was a contract and its duties are now discharged. The prime remedy is restitution so as to prevent unjust enrichment. But note, impossibility arising subsequent to a breach does not undo prior breach even if that impossibility will alter the measure of damages. Alternatively, if that prior breach is an anticipatory breach of contract, since an anticipatory breach arrives with residual power to revoke the breach via a notice of revocation that arrives before the non-breaching party's detrimental reliance upon the anticipatory breach.

When the parties' contract is silent and the contract is defeated by subsequent events there are two basic rules for allocating the losses: the English Rule and the American Rule. Neither fits well all circumstances, but each has its advantages.

The English Rule is simple to state and easy for the court to enforce. The English Rule is that the loss is allowed to fall where it may. Since the parties' did not protect themselves, the court will not substitute its judgment for that of the parties and the court will leave them where it found them. Typically, one party is delighted with this outcome. However, since the parties did not specify what to do when the unexpected arrived, it is difficult for the court to call that fortunate party, while enriched, a recipient of unjust enrichment.

The American Rule enforces restitution of benefit received so that both parties are closer to a net position of no unjust enrichment. However, a party's mere reliance expenses are insufficient to trigger restitution. The reliance expenses must be clearly central to the transaction. The restitution will include money plus interest versus fair market value. Of course, particularly because the market has changed dramatically, there will be a contest over whether the appropriate measure of price is the contract rate or is the market rate. Additionally, unjust enrichment must be attentive to the risk of loss for value received but then destroyed.

When the common law provides the discharge for frustration of purpose, impracticability,

or impossibility, notice often is an express condition precedent. The same is true in the ordinary boilerplate of a *Force Majeure* Clause. The notice triggers the non-breaching party's duty to mitigate as well as discharges the breaching party's duty for future performance. Both the triggering of the duty to mitigate and the discharge of the duty to perform constrain the measure of damages.

Failure to provide the required notice is a separate breach. Recall that performance can be complete performance (i.e., discharge with no damages), substantial performance (i.e., damages with damages owed), or material breach (i.e., no discharge and with damages). An express condition, such as a notice requirement, transforms the quality of performance for equating with substantial performance. An express condition makes any performance less than complete performance a material breach.

LOST PROFITS UNDER A *FORCE MAJEURE* CLAUSE

If a *Force Majeure* Clause is in place, and if it is applicable, and if a party provides the requisite notice, then, typically, lost profit damages will not be available. Other forms of damages might be available, but not lost profits. As risk allocation technique the *Force Majeure* Clause ought to have a companion clause wherein the parties specify the remedy for this specific contingency. That is, define the damages recoverable upon activation of the *Force Majeure* Clause. Otherwise, a generic approach might be applied by the court when a specific approach is desired by the parties. Lost profit damages will be available even if a *Force Majeure* Clause is in place if the breaching party inappropriately claims discharge via the *Force Majeure* Clause or the breaching party fails to provide the required notice.

The parties' specification of recoverable damages triggered by a *Force Majeure* Clause would need to satisfy the requirements of a liquidated damages clause. A liquidated damages

clause is valid if, at the time of contract, the parties' reasonably believe that, at the time of loss, the loss will be difficult to estimate, *and*, at the time of contract, the parties make a reasonable estimate of the losses at the time of loss. Failure to satisfy these requirements often renders a purported liquidated damages clause unenforceable as a penalty. The parties ought to include in their reasonable estimate of losses at the time of loss all reliance expenses including profit.

The preceding two paragraphs describe the simple interactions of a *Force Majeure* Clause and lost profits. More complex is a continuing contract, for example an installment contract spanning multiple years. In a continuing contract, suspension of or termination of the duty to perform via a *Force Majeure* Clause discharge of the duty to perform might trigger unexpectedly swift violation of the metrics of other contract provisions (e.g., cumulative delays; total cost sharing).

In closing, the contemplation of the parties test used by the law will likely be a sham if the *Force Majeure* Clause is no more than thoughtless boilerplate, and thoughtless boilerplate might be far more dangerous than the default common law protection. The *Force Majeure* Clause deserves the keen attention of the parties. They grasp the business risks being managed by the contract: their lawyers do not. This is an instance where the parties clearly must lead their counsel.

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ABSTRACT: A *Force Majeure* Clause anticipates specific needs for anticipatory breach, but provides an excuse of breach attributable to those listed causes. The interplay of anticipatory breach and excuse alter the ordinary contours of damages. The *Force Majeure* Clause transforms previously compensatory damages into consequential damages, which ordinarily are expressly disclaimed. The parties need to thoughtfully tailor the objective scope of the *Force Majeure* Clause, least it offer either far less or far more excuse than subjectively intended.

OUTLINE

I. SCOPE OF PAPER

- A. Lost profit damages with an effective *Force Majeure* Clause.
 - 1. commercial sophisticates
 - 2. discharge with damages
- B. Exclude
 - 1. international
 - 2. arbitration
 - 3. UCC
 - a. liberal administration of remedies
 - b. as if full performance

II. PROOF OF LOST PROFITS

- A. *Fact* of lost profits must be proved to a reasonable certainty.
- B. *Amount* of lost profits need only be proved reasonably.
- C. *Hadley v. Baxendale*, 9 Exch. 341, 156 Eng. Rep. 145 (1854).
 - 1. proximate cause
 - 2. objective foreseeability
 - 3. special circumstances: subjective foreseeability
 - a. e.g., *Force Majeure* Clause
- D. *Masterton v. Mayor of Brooklyn*, 7 Hill (N.Y.) 61 (1845).
 - 1. presumed foreseeability
- E. *Globe Refining Co. v. Landa Cotton Oil Co.*, 190 U.S. 540 (1903).
 - 1. tacit agreement of the parties
 - a. in addition to the contract itself, negotiations before and after

III. CONTENTS OF A *FORCE MAJEURE* CLAUSE

- A. Parties' contemplation of the limits of their contract.
 - 1. Which transactions are collateral?
 - 2. Which damages are unaccepted consequential damages?
 - 3. Which risks are beyond the control of the parties?
 - 4. Which risks are within their contract and will be borne by which party?
- B. Specification of the forces that are beyond their contemplation.
 - 1. list
 - a. e.g., strike, riot, war, Acts of God
 - 2. list, but not limited to.
 - 3. list, but neither limited to, nor necessarily similar to,
- C. Notice as a condition precedent.
- D. Specification of remedy.
 - 1. e.g., liquidated damages

IV. OPERATION OF A *FORCE MAJEURE* CLAUSE

- A. Replaces common law implied limits on the contemplation of the parties.
 - 1. impossibility: no reasonable person can perform (e.g., price = 10X)
 - 2. impracticability: performance feasible but not as contemplated (e.g., price = 3X)
 - 3. frustration of purpose: performance practical but benefit extinguished (e.g., coronation cases)
- B. Common law remedies
 - 1. Unlike mutual mistake and its remedy of rescission *ab initio* to restore the *status quo*, where there was no contract; with impossibility, impracticability, or frustration of purpose there was a contract and its duties are now discharged.
 - 2. Restitution prevents unjust enrichment.
 - a. Impossibility subsequent to breach does not undo breach
 - i. But note, anticipatory breach and the power to revoke notice.
 - 3. English Rule: loss falls where it may
 - 4. American Rule: restitution of benefit received
 - a. Mere reliance expenses insufficient to trigger restitution
 - b. money plus interest versus fair market value
 - i. contract rate versus market rate
 - ii. risk of loss for value received but then destroyed
- C. Notice often is an express condition precedent.
 - 1. Notice triggers duty to mitigate.
- D. Discharge of duty for future performance.
 - 1. An express condition alters what is material breach and what is substantial performance.

V. LOST PROFITS UNDER A *FORCE MAJEURE* CLAUSE

- A. Typically, none: the duty to perform is discharged via resort to the clause.
- B. As risk allocation, parties might specify remedy for this specific contingency, or might do so for any failure to perform without specifying that the failure must be a breach.
 - 1. e.g., liquidated damages
 - 2. e.g., all reliance expenses including profit.
- C. In a continuing contract, suspension of duty via the *Force Majeure* Clause might trigger unexpectedly swift violation of the metrics of other contract provisions (e.g., cumulative delays; total cost sharing).
- D. Contemplation of the parties might be a sham if the *Force Majeure* Clause is no more than thoughtless boilerplate, and might be far more dangerous than the default common law protection.