The Role of Economics in Evaluating Contractual Performance Defenses

Emerging Disputes on COVID-Related *Force Majeure* Claims

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INTRODUCTION

The "COVID-19" pandemic and ensuing economic crisis have added significant stress to the economics and performance of transactions in the energy industry. These transactions – including fuel and power purchase agreements, projects to install new infrastructure, and acquisitions of existing assets – are covered by a variety of contracts.

Some of these contracts will require complex renegotiations in light of the crisis, while others will require financial reorganization. In some instances, one of the parties may claim *force majeure* or another common law remedy to obtain relief from contractual performance commitments. Similar claims have already started to appear in the energy industry.[1] More are likely on the horizon. Proper economic analyses can enhance the robustness of negotiation and litigation positions relating to the validity of a claimed event that affects contractual performance.

The pandemic is only the latest disruption in a quickly changing energy marketplace that has already put economic strain on many contracts. Law firms have addressed the legal requirements for a party to assert or defend itself against *force majeure* claims or other common law bases for nonperformance under its existing contracts.[2] Contracts allocate risks and rewards to support long-term investment and performance from the parties. For unrelated

FOOTNOTES

1 For example, recently Total invoked *force majeure* on its power purchase contracts with EDF, and wind turbine / solar PV component suppliers declared *force majeure*.

2 See, e.g., Perkins Coie LLP, "Practical Guidance on Interpreting Force Majeure Provisions in the Wake of the COVID-19 Outbreak", 24 March 2020 (https://www.perkinscoie.com/en/news-insights/practical-guidance-on-interpreting-force-majeure-provisions-in-the-wake-of-the-covid-19-outbreak.html); Sidley Austin LLP, "Energy Contracts: Inoculating Against Five Misconceptions Regarding COVID-19 Force Majeure Claims", 16 March 2020 (https://www.sidley.com/en/insights/newsupdates/2020/03/inoculating-against-five-misconceptions-regarding-covid19-force-majeure); and Thompson & Knight, "Oil and Gas Leases – Shutting in a Well", 29 April 2020 (https://www.tklaw.com/news-insights/insights/client-alert-oil-and-gas-leases-shutting-in-a-well).

parties to enter into a contract, their expected value created by the contract must outweigh the cost of committing to its terms. The parties understand that the value of any contract will fluctuate during its life. However, the ongoing COVID-19 pandemic has created unique, impactful circumstances that may substantially affect the ability to perform and produce value under some contracts.

Naturally, law firms have focused on specific legal requisites, such as the need for the language in a *force majeure* clause to explicitly address the circumstances used as the basis for relief.

In comparison, this article focuses on the types of economic analyses that can often assist in determining the nature and impacts of such claims, as well as to prove or disprove causation, and identify mitigation options once the legal requirements for declaring *force majeure* are met. These economic tests can include:

- Evaluating causation between the COVID-19 pandemic or other events and associated nonperformance
- Quantifying what impacts the claimed events had on the financial losses and credit ratings of the party seeking relief from obligations, and on the economic damages imposed on the counterparty from nonperformance
- Proving that the contract party seeking relief from obligations did (or did not) use available mitigation options to reduce the adverse impacts of the claimed events.

THE ROLE FOR ECONOMICS IN CONTRACTUAL PERFORMANCE

Economic analyses can be instrumental in determining a valid basis for asserting or defending many *force majeure* claims and assessing performance-related defenses. The traditional roles of economics in contract cases relate to assessing liability or damages, such as by defining the rights and value created and the amounts of various remedies (e.g., expectancy vs. reliance damages). Economic experts serve an obvious role in assessing damages from breach of contract and in bankruptcy proceedings. But economic expertise can also serve much broader purposes.

Economics can be useful to assess whether performance-related defenses apply. For example, claims of *force majeure* require a causal link between the force majeure event and explanations of nonperformance. A party must show that the *force majeure* event was the determining factor in restricting performance under the contract and that nonperformance reasonably could not be mitigated. Other common law defenses, such as Frustration of Purpose, Impossibility, or Commercial Impracticability, may apply and would require similar economic evaluation. Any assertion or defense of *force majeure* claims (or other common law defenses) can be evaluated within the following economic framework:

1. **Causation**
   The event must have a demonstrable, direct, causal link to the nonperformance. An economic analysis first will evaluate the economic conditions affecting performance. A clear comparison of market conditions before, during, and (if relevant) after the event is key to linking the *force majeure* or another event to the change in market conditions. An expert can separate the impacts of the specified performance-impinging events from other adverse market developments (some of which could have been predicted or hedged). In some instances, the analyses can prove (or disprove) that the events were the tipping point that pushed an uneconomic contract into an impossible situation to sustain financially. The expert can then estimate the contribution of the claimed force majeure or other event versus other factors affecting nonperformance.

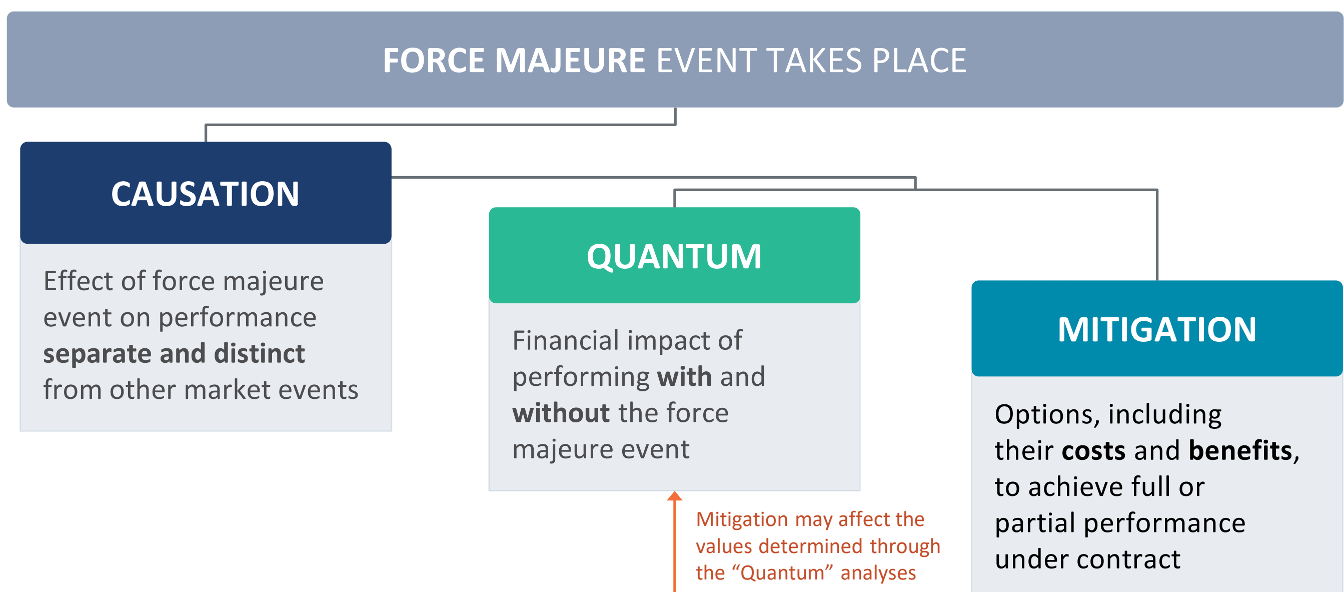
2. Quantum

Quantifying the economics with and without the claimed event under the contract's terms can be used to estimate the economic damages from non-performance and to understand the expected financial impacts to the party seeking relief from obligations. These factors can distinguish the availability of force majeure from bankruptcy. There is substantial overlap here with the typical role of economic experts in measuring damages for breach of contract claims. The difference in economic outcomes between actual performance and the performance that would have occurred "but for" the disputed event can be measured in detail. This places paramount importance on defining the unrealized but-for state of the world. Furthermore, an economic expert could provide a clear explanation of the impact that performing under the contract would have on the financials and credit ratings of the party seeking relief from obligations. This analysis could be helpful for defining differences between the outcomes produced from force majeure or other common law contract defenses and bankruptcy.

3. Mitigation

Proving that the contracting party seeking relief from obligations did (or did not) maximize the available mitigation options to reduce the adverse impacts of the claimed event is also relevant to an economic evaluation of *force majeure* or other nonperformance claims. Mitigation strategies may include establishing reasonable hedges available before the event, the cost of those hedges, or the costs of the next best alternative option that would facilitate performance under the contract. This may affect the values determined through the quantum analyses, but evaluation of the costs and benefits of any mitigation efforts is important.

Economic Framework for Evaluation Contract Performance



CASE STUDIES

Below are two hypothetical case studies that exemplify the role of economics in evaluating the appropriateness of *force majeure* claims and other contractual remedies.

1. Performance Regarding a Long-Term Supply Contract

Consider a power plant owner that bought the plant when electricity prices were high. The plant creates a byproduct that is produced only when the plant generates power. Given the plant's historically-high capacity factors, the owner signed a long-term contract to supply the byproduct to a buyer in quantities tied to those high-power production levels.

Power prices declined over time due to the build-out of more efficient resources, but the plant remained able to meet its supply commitments for the byproduct. However, the COVID-19 pandemic caused a sharp drop in power prices, driving down the plant's generation output to near zero. Does the power plant owner have recourse to justify nonperformance?

Conducting an economic analysis of the power market can help to make this determination. While the contract does not protect the power plant owner from incurring losses, it is clear that neither party intended for the contract to financially ruin the other party.

If analysis can show that the pandemic-driven drop in demand for power from the plant was the "tipping point" that would lead to such ruin (again, an issue of relative economics before and after the event), this can show causation and be used to calculate the quantum. This may support a claim of *force majeure* (if the contract's terms provide for it), as well as other performance defenses provided under the common law.

2. Supply-Chain Disruptions to EPC Agreements

Renewable energy development in the US relies on a global supply chain. Plant shut-downs, port closures, shipping delays, and workforce restrictions will cause wide-ranging impacts on renewable energy developers' ability to meet their construction timelines.[3] As shutdowns and delays disrupt the supply chain, many parties may turn to the *force majeure* provisions in their EPC agreements as a means of adjusting the timelines. But many questions will arise in the process.

For example, which of the various potential disruptions along the supply chain caused the ultimate nonperformance under the contract? What alternative manufacturing or shipping options were available? What were the proposed costs for those alternative options? And in the situations where the supplier could still meet some customer orders, how did it prioritize those deliveries to ensure that it was not unfairly opportunistic in the contracts it delayed? Economic analyses along each of these questions would help in determining the reasonableness of a disputed f*orce majeure* claim.

FOOTNOTES

3 See U.S. Energy Information Administration, "COVID-19 mitigation has delayed construction of some electric generators", 15 July 2020 (https://www.eia.gov/todayinenergy/detail.php?id=44376).

CONCLUSION

The above case studies are a glimpse into the role economic analyses can serve in *force majeure* or other contract defense disputes. The byproduct supply contract and supply-chain disruptions to EPC agreements are just two examples of demand shock that can lead to *force majeure* claims. Others could include coal or natural gas purchase contracts with minimum take-or-pay obligations, power purchase agreements, or well shut-ins on oil leases.

Similarly, the significant change in the energy landscape may give rise to disputes in ongoing mergers and acquisitions that have certain force majeure or termination clauses. The economic analyses discussed in this article are relevant across a variety of contract disputes that may arise from this pandemic-related disruption and future not-yet-known disruptions

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