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Insights

Litigation & Arbitration Group

Russian Invasion of Ukraine: Potential Litigation Issues

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Contact

Dan Perry, Partner
+1 212.530.5083
dperry@milbank.com

Melanie Westover Yanez, Special Counsel
+1 202 835 7560
mwyanez@milbank.com

Stephen Benz, Associate
+1 202 835 7548
sbenz1@milbank.com

The Russian military's invasion into Ukraine and the resulting economic sanctions imposed by various nations against certain Russian entities and individuals have, among other things, created volatility and uncertainty in the economic markets. This economic uncertainty has forced many companies, lenders and investors to seek guidance on their legal rights with respect to certain contractual obligations, especially in these key areas:

- **Force Majeure Clauses**
- **Frustration of Purpose Doctrine**
- **Impossibility and Impracticability Defenses**
- **Discharge of Contracts Requiring Performance That Is No Longer Legal**
- **Material Adverse Event Provisions**
- **Know Your Customer and Anti-Money Laundering Requirements**

This alert provides a broad overview of these legal issues. The analysis of any particular contract, transaction or dispute, however, is necessarily fact-specific and will depend on, among other things, the specific contract language and conduct of the parties in each instance, as well as the governing law applicable to that contract, transaction or dispute. In addition, we understand that each institution must address the legal issues while taking into account commercial decisions, including avoiding reputational harm. As the situation continues to develop, the legal landscape as well as commercial practices will continue to change and evolve.

FORCE MAJEURE CLAUSES

The concept of force majeure excuses a contractual party from performing under the contract when there is an occurrence of an unexpected event beyond the control of the party, and the event prevents that party, either temporarily or permanently, from performing.

I. Force Majeure Clauses Generally

As with most contractual disputes, the starting point of the analysis will be the terms of the agreement. Force majeure clauses often enumerate specific events such as floods, hurricanes or war

that could potentially excuse performance under the contract. The clauses are narrowly interpreted and confined to the enumerated events or those of the same kind or nature as the particular matters mentioned. When an occurrence is not specifically enumerated in the contract, but the contract contains a general force majeure provision, the catchall provision is "not to be given expansive meaning." *Kel Kim Corp. v. Cent. Markets, Inc.*, 519 N.E.2d 295, 297 (N.Y. 1987) (*citing* 18 Williston, Contracts § 1968 (3d ed. 1978)).

Some courts have held that the event must not only be included in the force majeure clause; it must be unforeseeable as well. Other courts (including Delaware courts) have refused to impose an unforeseeability requirement where one cannot be found in the parties' agreement.

In addition, many force majeure clauses (and New York law) require that parties make diligent efforts to overcome the unexpected event and mitigate its effects. Likewise, the counterparty against whom the force majeure clause is being invoked has a general duty to mitigate damages and will generally be required to mitigate any loss caused by the force majeure event.

II. Frequently Litigated Issues with Force Majeure Clauses

Issues that are frequently litigated with respect to force majeure clauses include:

A. whether the event in question fits within the language of the force majeure clause;

B. whether the parties could have foreseen the event;

C. whether the event has prevented the party from performing;

D. whether the party attempting to invoke the force majeure clause could have avoided and/or overcome the event and its consequences through reasonable diligence;

E. whether the party attempting to invoke the force majeure clause complied with applicable notice requirements; and

F. whether a force majeure event allows termination of the contract or is merely a temporary defense.

A. Whether the event in question constitutes force majeure under the contract

With respect to the first issue, whether the Russian invasion of Ukraine can potentially qualify as a force majeure event will depend on the specific language of the force majeure clause and the particular non-performance at issue. Wars and armed conflict are routinely included in force majeure clauses. Courts also generally have accepted war as a force majeure event.

Indeed, the Ukrainian Chamber of Commerce and Industry (the "Ukrainian CCI") issued a statement certifying that an event of force majeure has occurred and is continuing. Specifically, the Ukrainian ICC identified the "military aggression of the Russian Federation against Ukraine, which led to the imposition of martial law" on February 24, 2022 as circumstances that "until their official ending, are extraordinary, unavoidable and objective circumstances" that rendered fulfillment of obligations impossible.

Even if war is included as a contractual event of force majeure, the non-performing party must establish that its nonperformance was due to the war. For example, contracting parties located away from the fighting and not involved in international trade may have a difficult time asserting that the war is an event of force majeure excusing nonperformance, even if the war has indirectly affected their performance through, for example, increased gas prices. In particular, economic hardship typically does not constitute force majeure unless the clause contains some language pointing to a change in economic conditions. These clauses are rare, however. After the 2008 financial crisis, for example, courts consistently held that market forces do not constitute force majeure. Thus, it is unlikely that (without more) any economic downturn due to the Russian invasion or economic sanctions can be used as an excuse for nonperformance.

B. Whether the event was foreseeable

Certain jurisdictions, including New York, also require that the event at issue must have been unforeseeable. Other jurisdictions, such as Delaware, do not require a showing of unforeseeability.

Whether a court will treat a war as unforeseeable will vary from situation to situation. For example, in *Madereinse do Brasil v. Stulman-Embrick Lumber Company*, the Second Circuit refused to allow a Brazilian company to invoke force majeure as a result of World War II, reasoning that "[t]he war in Europe had been under way for more than a year, and Pearl Harbor was still in the future. Neither the United States nor any of the South American countries entered the war for a year or more after the making of the contract. Hence the lack of ships in January, 1941, was a foreseeable risk which plaintiff willingly took upon itself; and it cannot under such circumstances plead the defense of 'force majeure.'" 147 F.2d 399, 403 (2d Cir. 1945), cert. denied, 325 U.S. 861. Likewise, in *Connecticut National Bank v. TWA*, the Southern District of New York noted that even if a force majeure clause was present in the parties' contract (it was not), that clause would have been inapplicable to the First Gulf War because "TWA cannot argue that the threat of war in the Middle East is something of which it was unaware. The people of that region have been at war for thousands of years and recent history has been no different. The threat of terrorism is also nothing new. TWA is not entitled to relief from meeting its obligations since all the factors it points to were well within the foreseeable when it entered the Agreement." 762 F. Supp. 76, 81 (S.D.N.Y. 1991).

In the case of the Russian invasion of Ukraine, this factor may be particularly salient. Some case law holds that when war conditions are previously known to two sophisticated parties entering into an agreement, the war conditions themselves will not excuse performance by way of force majeure. Here, Russian separatist factions, often with the logistical and military support from Russian troops, have been engaged in sporadic conflict with the Ukrainian military in certain regions of Ukraine since Russia's annexation of Crimea in 2014. Moreover, Russia had been engaged in a build-up of military forces along the Ukrainian border since early 2021. Thus, a party may argue that the escalation of the conflict by Russia was a foreseeable event, and in fact, publicly predicted by U.S. officials. On the other hand, a party could argue that the scope and impact of the 2022 Russian invasion is distinguishable because the Russian invasion is broader in scope and size than could have been foreseen.

C. Whether the event has prevented the party from performing

Even if an event in question fits within the delineated events that could potentially excuse performance under the force majeure clause, the nonperforming party still must establish that the event in question actually prevented, hindered and/or delayed its performance under the contract. In the context of war, the war conditions themselves need to be the event that is impeding performance under the contract in order for nonperformance to be excused. It is not enough that a war is simply ongoing.

D. Whether the event could have been overcome or avoided through reasonable diligence

Even if the war in Ukraine could potentially qualify as a force majeure event, some courts will require the party attempting to invoke the force majeure clause to demonstrate that it could not avoid, overcome, or mitigate the event or its effects through reasonable diligence. Whether the party can make this showing will depend on the specific facts of the case. Further, the party attempting to invoke the clause must prove that they are without fault and did not act negligently.

E. Whether the party invoking the clause complied with applicable notice requirements

Contracts often contain notice provisions that require a party to provide timely notice to the other party of the occurrence of a force majeure event that will impact/prevent that party's performance under the contract. Such notice provides the non-defaulting party with the opportunity to take all reasonable steps available to overcome and/or mitigate the consequences of the force majeure event.

To the extent that a party fails to provide such timely notice, it can be deemed a waiver of that party's right to invoke the force majeure clause. Older New York cases noted that the requirement that a party give notice of a force majeure event will not be deemed a condition precedent to invoking a force majeure excuse unless the language of the agreement clearly creates such a condition. More recent

New York cases, however, have been more inclined to view notice requirements as a condition precedent to invoking force majeure. Thus, if notice is not provided properly, the nonperforming party may waive the ability to assert the force majeure defense.

Even if the notice provision is not a condition precedent, courts will construe the provision as an obligation of the invoking party. In such case, only a material breach of the notice provision will affect the right to invoke force majeure. A breach will not be material if the party made a reasonable attempt to notify the other party as soon as possible and no harm or prejudice is alleged by the non-breaching party.

For contracts involving the sale of goods, the Uniform Commercial Code requires that the party in receipt of a force majeure notice respond within thirty days, or the contract will lapse with respect to any affected deliveries. For contracts incorporating the Convention on the International Sale of Goods ("CISG"), article 79 of the CISG requires a party invoking force majeure to provide notice and holds a party liable for damages for failing to provide notice.

F. Whether the force majeure defense is temporary or allows a party to terminate the contract

Another issue that may be litigated is the duration a party can assert the defense, and whether a force majeure defense allows for termination of the contract overall. Generally, "[u]nless the force majeure destroys the subject matter of the contract or one of the parties, it is never permanent in a literal sense." *Commonwealth Edison Co. v. Allied-General Nuclear Services*, 731 F.Supp. 850, 861 (N.D. Ill. 1990). As a result, a force majeure defense is usually only a temporary defense. This principle is also true of contracts under the CISG, which provides that a force majeure defense only applies for the duration of the force majeure event. But "if the conditions preventing performance persist throughout the life of the contract, they are permanent enough to excuse liability." *Id.* Finally, some force majeure clauses may also allow the party against whom force majeure is invoked to cancel the contract after a certain period of time has passed since the invocation of force majeure.

III. Contracts Lacking Force Majeure Clauses: Impossibility, Frustration of Purpose, and Illegal Performance

Even when contracts lack force majeure clauses, the Russian invasion and the events resulting therefrom may give rise to other common law or statutory defenses that would excuse performance. Three common law defenses—impossibility, frustration of purpose, and illegality—are considered below. Additionally, we consider force majeure-like defenses that could be asserted under the California Civil Code (for contracts governed by California law) and the CISG and UCC (for sales contracts).

A. Impossibility

The common law remedy of impossibility of performance may excuse nonperformance. The impossibility doctrine applies if: (1) an intervening event occurred; (2) the parties' agreement assumed such an event would not occur; and (3) the unexpected event made contractual performance impossible or extremely impracticable. Per the Restatement (Second) of Contracts, "extreme impracticability of performance may properly be regarded as having the same effect as strict impossibility of performance." 17A Am. Jur. 2d *Contracts* § 643 (2020). Performance is impossible when "it can only be done at an excessive and unreasonable cost, for which the parties had not bargained." *Id.*

New York courts require that performance be objectively impossible. Other jurisdictions, such as Delaware, have found that performance is impossible when it is extremely impracticable because performance of the contract can only be done at excessive and unreasonable cost for which the parties had not bargained for. If the event was foreseeable or predicted, performance will not be excused.

B. Frustration of Purpose

Another doctrine that may excuse performance is frustration of purpose. This doctrine is applicable when the underlying purpose of the contract cannot be performed due to a wholly unforeseen event that is beyond what was bargained for. Frustration of purpose is applicable if: (1) an event substantially frustrates a party's principal purpose; (2) the nonoccurrence of the event was a basic

assumption of the contract; and (3) the event was not the fault of the party asserting the defense. While this doctrine is similar to impracticability, frustration of purpose places more focus on the purpose of the contract that has been negated. Courts interpret the term "purpose" broadly making it more difficult for parties to show that the purpose of the contract was obviated. Finally, frustration of purpose must be complete and total; mere unprofitability or hardship will not qualify.

C. Illegal Performance As a Result of Economic Sanctions

As a result of the economic sanctions imposed on certain Russian entities and individuals, a party may find that it is now illegal to continue performing under a contract. Under common law, "when the contract was originally legal, but because of a change in purpose of the parties or a change in the law, performance of the acts prescribed in the contract by one of the parties has become illegal, any subsequent performance of such acts is against public policy and the party who has undertaken to perform them is excused from doing so." 8 Williston on Contracts § 19:36 (4th ed. 2021).

For a party to invoke such a defense, however, the party must show that continued action would be violative of the law (here, the economic sanctions imposed by various governmental organizations). For example, in *Engel Industries, Inc. v. First American Bank, N.A.*, 798 F. Supp. 9 (D.D.C. 1992), at issue was a contract for the sale of medical equipment that ultimately would be sold to an Iraqi government agency. After the contract was executed, the First Gulf War began, and President Bush imposed a freeze on all Iraqi assets in the United States pursuant to an executive order. The defendants argued that the contract should be discharged because they could no longer perform the contract without contravening the president's executive orders. The district court rejected this defense because the U.S. Department of Treasury's Office of Foreign Assets Control ("OFAC") issued an opinion determining that the contract at issue would not violate the president's executive order, a determination to which the district court deferred.

Parties who think that the performance of a contract might violate U.S. economic sanctions orders can submit a request for interpretive guidance to OFAC with respect to the transaction, and similar requests for guidance can be made to foreign governmental organizations. There are, however, significant pros and cons to such an action, and any such action should be taken only after consultation with counsel.

D. California Civil Code

If a contract does not have a force majeure clause but is governed by California law, a party may seek to invoke the California Civil Code as a defense, in addition to the common law defenses of impossibility. Specifically, Cal. Civ. Code § 3526, provides that "[n]o man is responsible for that which no man can control." Additionally, Cal. Civ. Code § 3531 states that "[t]he law never requires impossibilities," and Cal Civ. Code § 1511 provides that performance of an obligation is excused "[w]hen it is prevented or delayed by an irresistible, superhuman cause . . . unless the parties have expressly agreed to the contrary." Thus, California law provides statutory defenses that a party could invoke in the event that a contract does not have a force majeure clause.

E. Contracts Governed by the UCC and CISG

The UCC and the CISG provide force majeure-type protection for contracting parties. Under article 79 of the CISG, "a party is not liable for a failure to perform any of his obligations if he proves that the failure was due to an impediment beyond his control and that he could not reasonably be expected to have taken the impediment into account at the time of the conclusion of the contract or to have avoided or overcome it or its consequences." Consequently, if an international contract references or is governed by the CISG, a party may be able to invoke this temporary defense of non-performance. Likewise, article 2-615 of the UCC notes that "[d]elay in delivery or non-delivery in whole or in part by a seller ... is not a breach of his duty under a contract for sale if performance as agreed has been made impracticable by the occurrence of a contingency the non-occurrence of which was a basic assumption on which the contract was made or by compliance in good faith with any applicable foreign or domestic governmental regulation or order whether or not it later proves to be invalid."

IV. MAE AND MAC CLAUSES

Material Adverse Event and Material Adverse Change clauses (herein, referred to as MAC clauses) generally protect a party from performance obligations when there has been an event or change that has or would reasonably be expected to have a materially adverse event on the party. In the M&A context, an MAC clause may provide that if a party has suffered a MAC within the meaning of the agreement, the counterparty can cancel the deal without penalty. In the lending context, a condition of the lender's funding obligation may be that the borrower has not experienced an MAC.

The current practice is for parties to allocate categories of MAC risk by negotiating a default MAC clause, exceptions to the MAC clause, and exclusions from those exceptions. The typical MAC clause allocates general market or industry risk to the buyer/lender, and company-specific risks to the target/borrower. The exceptions and exclusions are unique to each contract. Such clauses often list specific events (*e.g.*, floods, fires and earthquakes) and/or categories of events (*e.g.*, natural disasters, war, terrorism, and government-imposed states of emergency) that can potentially excuse contractual performance under the agreement.

MAC clauses are subject to the same rules of contractual interpretation as any other contract provision. Courts construe them narrowly and are unlikely to infer that a MAC clause includes any protections that are not explicitly enumerated. The heavy burden to demonstrate that a change in circumstances excuses contractual performance falls on the party seeking to invoke the MAC clause.

MAC clauses are highly negotiated, and each clause may present its own unique set of protections and carve-outs. In examining the interplay between the primary definition of a MAC, its exceptions and exclusions from those exceptions, courts will first determine whether the change of circumstances constitutes an MAC. If so, it will then proceed to determine whether an exception or carve-out applies. The determination of whether circumstances constitute a MAC is fact-intensive and there is no standard test or set of factors that courts apply in the analysis. Not coincidentally, most court decisions on MAC clauses were issued following post-trial briefing with the benefit of discovery and factual and expert testimony.

V. Know-Your-Customer Requirements

The U.S. Department of Justice ("DOJ") has launched a new interagency taskforce, Task Force KleptoCapture, to assist in enforcing the economic sanctions that the U.S. government has placed on various Russian entities and individuals. The DOJ has signaled that one way in which this new taskforce will enforce the sanctions is through "the prosecution of those who try to evade know-your-customer [("KYC")] and anti-money laundering [("AML")] measures." As a result, it is important more now than ever that financial institutions ensure full compliance with such KYC and AML measures. Moreover, the Financial Crimes Enforcement Network ("FinCEN") has released guidance to financial institutions regarding certain "red flags" that may suggest attempts by sanctioned entities or individuals to work around the economic sanctions. Financial institutions are encouraged to review these alerts and take measures to identify transactions which might raise red flags. Some red flags that FinCEN has identified are:

- Use of corporate vehicles (*i.e.* legal entities, such as shell companies, and legal arrangements) to obscure (i) ownership, (ii) source of funds, or (iii) countries involved, particularly sanctioned jurisdictions.
- Use of shell companies to conduct international wire transfers, often involving financial institutions in jurisdictions distinct from company registration.
- Use of third parties to shield the identity of sanctioned persons seeking to hide the origin or ownership of funds, for example, to hide the purchase or sale of real estate.
- Accounts in jurisdictions or with financial institutions that are experiencing a sudden rise in value being transferred to their respective areas or institutions, without a clear economic or business rationale.

- Jurisdictions previously associated with Russian financial flows that are identified as having a notable recent increase in new company formations.

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Practice/Group Contacts

New York	55 Hudson Yards, New York, NY 10001-2163		
Daniel Perry	dperry@milbank.com	+1 212.530.5083	
Washington, DC	1850 K Street, NW, Washington, DC 20006		
Melanie Westover Yanez	mwyanez@milbank.com	+1 202.835.7560	
Stephen Benz	sbenz1@milbank.com	+1 202.835.7548	

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