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Contract Disputes Arising from the Ukraine Conflict: Issues, Defenses and Lessons for the Future

August 4, 2022

Announcer:
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Julian:
Hello and welcome to Tech Talks. I'm your host, Julian Dibbell. I am a senior associate in Mayer Brown's Technology & IP Transactions practice. I'm joined today by Jim Ferguson and Valerie Vanryckeghem. Jim is a partner in Mayer Brown's Litigation and Intellectual Property practices in our Chicago office. Valerie is a senior associate in Mayer Brown's London office in the firm's Intellectual Property & IT Group.

Our topic today, the conflict in Ukraine and its impact on commercial operations and what contracts have to do with that. Particularly, we're talking about what contractual or other protections may be available to business contract parties that find themselves in a situation where a party is no longer able or willing to perform its contractual obligations.

Today we are going to hear from two practitioners in international outsourcing transactions about the common issues organizations are facing as a result of this conflict, and what legal remedies are available to those types of organizations and how proper drafting of contractual protections may help businesses that are seeking to exit or be excused from performing an existing relation.

Setting the scene – Factual scenarios

Julian:
Jim, why don't you start by explaining briefly what kinds of issues businesses may be facing as a result of the Ukraine conflict?

Jim:
Thanks Julian, and hello everyone. You're absolutely right, Julian, that the Ukraine conflict has led to a growing number of contractual disputes, and I think a good place to begin our discussion today is by

grouping these disputes into three major categories based on their causes. The first category consists of disputes resulting from the decision that many Western companies made to withdraw from doing business in Russia. The second category consists of disputes resulting from non-performance—contractual non-performance—because of the sanctions imposed on Russia by Western governments. And a third category of disputes result from contractual non-performance because of the actual hostilities (in other words, the "acts of war") between Ukraine and Russia.

Failure to Perform Following Voluntary Withdrawal from Russia

If we look at this first category, the voluntary withdrawal from Russia, in some cases, companies have ceased performance on contracts after deciding to withdraw from Russia because of reputational concerns or because the invasion was simply incompatible with their core values. In these cases, the companies' decision to withdraw from Russia has led them to suspend or withdraw from certain contracts. In fact, Valerie, I believe you encountered this issue in a recent project you worked on?

Valerie:
That's right, Jim. Actually, a client of the firm with facilities in Russia had contracted with a service provider to provide certain services on-site at the premises of our client in Russia. And this service provider decided—as a consequence of the conflict in Ukraine—that it no longer wished to be associated with Russia in any way. And so, this service provider decided to withdraw completely from Russian territory, which meant that it would no longer provide the contracted services at our client's facilities in Russia.

And as you can see right here, this issue is problematic for both the service provider and the customer, because they are both trying to limit reputational damage: (1) the service provider by retreating from the region and no longer providing services in Russia (2) but also our client, who is very aware that it may face public backlash if it attempts to hold the service provider to its contractual engagements in Russia.

Jim:
Yes, that's a great illustration of how complex these situations can be.

Failure to Perform Due to Sanctions Imposed by Western governments

Let's turn now to the second category of cases, which consists of companies who have failed to perform contractual obligations because of sanctions imposed by Western governments. We had a recent example involving a supplier who failed to deliver contractually required goods because of EU sanctions barring access to European ports by any ship that last docked at a Russian port. In these cases involving sanctions, a key issue is going to be whether the sanction directly prevented the party from performing its contractual obligations or simply made performance more onerous or costly.

Failure to Perform Due to "Acts of War" Between Ukraine and Russia

The third category of cases focuses on the actual "acts of war" between Ukraine and Russia. In this category, companies fail to perform their contractual obligations as a direct result of the hostilities—the "acts of war"—between the two combatants. As an example, some suppliers might not be able to deliver certain contractually required hardware because of the Russian blockade in the Black Sea. Or, another example, an IT service provider based in Ukraine might not be able to perform its contractual obligations because its

major facility has been destroyed during the war. As with sanctions, in these cases involving "acts of war," the key issue is going to be whether the hostilities directly prevented contractual performance or simply made performance more onerous or costly.

Defenses Based on Contract Provisions

Julian:
Ok, interesting. So Valerie, are there contractual defenses or protections available to the parties involved in these types of disputes, and what are they?

Valerie:
Yes, of course, Julian, there are. Regardless of the governing law, we see that parties usually choose to include provisions in their contract, at least in relation to force majeure, which we all know about.

Force Majeure

Scope

These clauses are really creatures of contract, and so, their scope depends largely on the specific wording that is used in the agreement. But, at its core, it's important to know that a force majeure provision seeks to limit a party's liability in case there are certain unforeseeable events that are beyond the control of this non-performing party and that prevent or impede the performance by this party. And so, in order to invoke a force majeure defense, the non-performing party should really be able to demonstrate that there is a triggering event that qualifies as a force majeure event as defined in that clause; that this event directly prevented the performance of certain contractual obligations; and that the non-performing party took all reasonable steps to mitigate damages.

The Ukraine Conflict

Now, looking at force majeure clauses in the light of the conflict in Ukraine, a party that is unable to perform as a result of the conflict may very well be able to show that either the war itself or government sanctions qualify as a force majeure event, because most force majeure clauses specify or explicitly include "acts of war" or "acts of government" as examples of force majeure events. Now, that being said—and this is where there might be an issue—if the parties negotiated the contract **after** the invasion began, then the non-performing party may face challenges in showing that the event was "**unforeseeable.**" Another major issue in the case of many Ukraine-related contract disputes is likely to be **causation**—meaning, did the alleged "force majeure" event directly cause the failure to perform? For example, even when "acts of war" are explicitly listed as a force majeure event, it may be hard for a service provider to rely on it if the "acts of war" occurring in Ukraine have not *caused* a service provider to be unable to perform certain contracted services on-site in Russia.

And now, in most jurisdictions, the courts also do not regard "economic hardship" (or reputational injury) as sufficient grounds for a force majeure defense. And so, if an IT service provider claims that it has become *impossible* to perform its contracted services in Russia because the risk of reputational damage is too high, it's likely that this service provider will face difficulties in showing that the alleged "force majeure" event

(*i.e.*, the Russian invasion of Ukraine) has *directly prevented* it from performing its contractual obligations because it is merely the fear of reputational damage that is causing this service provider to attempt to stop providing services. Now, similarly, if an IT service provider or even a hardware vendor has ceased performance because sanctions or "acts of war" have made performance of its obligations *simply more costly or more onerous*, again, their force majeure defense may not succeed.

So, really the question is, if a non-performing party could have provided the contracted services from one of its other establishments—not directly within the conflict zone in Ukraine—*or* eventually have repurposed another establishment for such services (albeit at a higher price), then it may not have a strong force majeure case based on the war. *By contrast, though*, if either sanctions or the war in Ukraine have directly prevented a party from contractual performance, this party would have a much stronger force majeure defense. For example, if a data center used by a service provider to provide certain services has been destroyed by a missile, it would likely have a strong force majeure defense, of course.

Julian:
That's a great overview of how a force majeure might intersect with these issues and a great masterclass in the basics of force majeure. Thank you, Valerie. So that's the obvious one, force majeure. Are there any other contractual defenses that might be available or come into play in these types of situations, Jim?

Price Adjustment Clauses

Jim:
The answer Julian, of course, is yes. And the further answer is it depends on the contract, because some contracts also have a so-called price adjustment clause which contains some mechanism to adjust the price to prevent a contract from becoming too financially onerous for one of the parties. They are intended to reflect changing market conditions—particularly over the course of a long-term contract. For example, the Ukraine conflict has led to an increase in the cost of raw materials, energy, transportation, and many other vital items, all of which may cause the contract to become more financially onerous for the service provider. And, as we noted earlier, government-imposed sanctions and acts of war may also increase the cost of performance. If a contract does include a price adjustment clause, then the ability of a service provider to invoke it will depend on the language of the clause, including whether the specified factors necessary to trigger a price adjustment have occurred; whether the service provider has complied with the contractually required process for invoking the provision; and whether the customer, under the contract, has any right to veto the adjustment.

Material Adverse Event Clauses

In addition to force majeure clauses and price adjustment clauses, some contracts may have what is known as a Material Adverse Event (MAE) clause, which is designed to protect against the risk that an unforeseen event may have a materially adverse effect on one of parties. If the contract includes such a clause, then the party's ability to invoke it will once again depend on the language in the clause, including, most importantly, whether the unforeseen event satisfies the contractual definition of "material"; and also whether the party has complied with the contractually required process for invoking the MAE clause, including any required notice or mitigation efforts.

One other thing we would look at in connection with MAE clauses is whether the clause specifies the specific consequences of a Material Adverse Event. For example, the clause may require the non-performing party to take immediate steps to mitigate the impact of an MAE event, or it may give one or both parties a right to suspend or even terminate the contract altogether. These provisions, Material Adverse Event in particular, generally work to reduce the risk allocated to the service provider. But Valerie, I know you have been involved in projects where the MAE provision actually provided comfort to the customer. Do I have that right?

Valerie:
Yes, that's right, Jim. I guess you might even say that there has been some sort of a learning curve on the customer side as well. And so, in large-scale outsourcing and SaaS (Software as a Service) projects where the services are crucial to ensure business continuity on the side of the customer, we see that customers do want to be informed immediately of certain pre-defined events that the customer has qualified as "Material Adverse Events." Often designed to even include events that *could* have a material adverse impact on the customer. And also, these customers then want to be able to take action. For example, to veto the use of a certain subcontractor, or the use of a datacenter at an unacceptable location, or to force the parties around the table to find a solution. And, if all else fails, to terminate the contract or part thereof.

Another field in which our team has seen some sort of a learning curve is, of course, the financial sector. Many jurisdictions now have regulations or guidelines in place for outsourcing in the financial sector and Europe specifically has the outsourcing guidelines of the European Banking Authority. Under those guidelines, financial institutions are required to include MAE provisions in their outsourcing arrangements to ensure that they stay informed on Material Adverse Events such as, for example, the financial situation of their supplier, any mergers, divestments that the supplier might have, and the use of subcontractors by their supplier, just to name a few. And so these guidelines require financial institutions to be able to take action and to include an explicit right of termination for certain of these Material Adverse Events.

Now looking at this scenario in light of the conflict in Ukraine, if a financial institution has, for example, engaged an IT service provider who uses a subcontractor in Ukraine, and as a result of the war, this service provider proposes to change its subcontractor to a new subcontractor in a country that does not have an adequate level of protection for personal data, then the financial institution would need to be informed of this, and would have a right to veto the use of this new subcontractor and ultimately—if no solution is found—would have a right to terminate the contract or the relevant part of it.

Defenses Based on General Principles of Civil and Common Law

Julian:
Ok, well, so, there's a fairly robust—if somewhat complicated—set of contractual defenses that may be available in these situations. What if no actual contractual defenses are available? Are there defenses or protections possible based on common law principles or civil law, as the case may be?

Valerie:
Yes, there certainly are, Julian. In addition to the contract-based defenses, there are a number of defenses rooted in general principles of civil or common law. Looking at the civil law jurisdictions first, it is useful to remember that many civil law jurisdictions (especially those with a civil code that is based on the code

napoleon, such as France, Belgium, or Netherlands) recognize that force majeure is a general principle of law.

Force Majeure (civil law)

And of course, the importance of this is that contracts that have any of these jurisdictions as their governing law, these contracts may still include the remedy of force majeure, *even when* the contract does not explicitly include a force majeure provision. So that's one thing to be aware of.

Economic Hardship or "*Imprévision*" (Civil Law)

There is also the principle of Economic Hardship, or "*Imprévision*" in civil law jurisdictions. The remedy of economic hardship is not available in all civil law jurisdictions. Not all of them recognize this principle; I think France does, but Belgium, for example, actually does not. And so Economic Hardship is similar to force majeure in that it is also based on a change of circumstances that was *unforeseeable at the time of the conclusion of the contract*. So, as with force majeure, the circumstances would need to be *new or reasonably unknown* to the party seeking to rely on Economic Hardship. And reasonably unknown, for that to be determined, the judge could take into account, of course, the professional background, for example, of this party. But, contrary to force majeure, for Economic Hardship, it is sufficient that the unforeseeable circumstances render the performance of the contract *excessively onerous* for this party who had not accepted to bear such risk. In fact, you could say it is rooted in the civil law concept of "good faith" and the requirement in many civil law jurisdictions for parties to a contract to at all times behave and exercise their rights "in good faith." And so, in the case of Economic Hardship, the assumption is that if the situation is *so excessive*, then it would no longer be "acting in good faith" if the other party would still demand the performance of the contract without any adjustments. If we take France as an example, as the process and consequences may be different, of course, in other civil law jurisdictions; but a service provider whose performance of the contract has become excessively onerous as a result of the conflict in Ukraine, *would then be allowed* to demand the renegotiation of the contract. If the other party refuses such renegotiation or the parties fail to reach an agreement, then the parties may either agree to terminate the agreement on the date and subject to the conditions they determine, or they might mutually ask a judge to decide on the revision of the contract or its termination on a date and subject to the conditions that the judge sets. And so *this is* unique to civil law jurisdictions, because—in a way—it allows a judge to substitute the parties and *for the judge* to decide what the contractual terms will be going forward.

Jim:
You're absolutely right on that point, Valerie. In common law jurisdictions, courts generally do not get involved in re-drafting the parties' contracts. But there are two closely related common law defenses that might apply to these kinds of contractual disputes—one is Frustration and the other is Impossibility or Impracticability.

The Frustration Principle

The frustration principle excuses non-performance when an unforeseeable occurrence outside the parties' control destroys the very purpose of the contract. An example we might imagine is a customer who contracts with an IT service provider to host a data center in Kiev and a missile destroys the data center.

This means the very reason for the contract, which was to host a data center in Kiev, has been destroyed or frustrated.

Impossibility/Impracticability

In the case of the impossibility/impracticability doctrine, it excuses non-performance when an unforeseeable occurrence outside the parties' control renders the parties' performance either impracticable or impossible. One thing to note is that all of these defenses, both in civil law and in common law, require that the event be unforeseeable—reasonably unforeseeable—at the time of contract. But in the case of the Impossibility or Impracticability doctrine and the Frustration doctrine, these are common law doctrines, and the governing law of the contract may impact the application of these principles to the specific case. Most importantly, in many jurisdictions—common law jurisdictions—the courts will strictly apply the principle of impossibility, holding that performance must be absolutely impossible, while other courts are willing to consider market conditions and economic costs in determining whether performance is impossible.

Drafting Risk Allocation Provisions

Julian:
We've been looking at various scenarios and defenses where we've got a contract sitting in the drawer and something goes wrong … a party is suddenly, as a result of the Ukraine conflict, unwilling or unable to perform … we turn to the contract to see if there's a defense there. If not, we look to what possible non-contractual defenses there might be. What about going forward? So what lessons have we learned from this from thinking through the Ukraine invasion and its impact that help us draft risk allocation provisions in future contracts?

Valerie:
First, the fundamental question will be whether the drafter wants to adopt provisions that are more favorable to the customer side or more favorable to the side of the service provider, right? So, if you are drafting a force majeure clause and you are seeking to draft in favor of the customer, then the contract should include a force majeure provision that broadly excludes risks that are known already at the time of contract or foreseeable at the time of contracting, specifically excludes economic hardship or burden as a force majeure defense and also potentially specifically excludes events relating to the Ukraine conflict as a force majeure defense. You may also want to consider requiring the service provider that it is able to show that it could not have avoided (or overcome) the effects of the force majeure event. Or, you might also require the service provider to use all commercially reasonable efforts to continue performance while pursuing ways to mitigate the damage done by non-performance. And finally, of course, you would want to include some language that the customer has the right to engage an alternative service provider to step in if that is a possibility and provides that only a customer has the right to terminate the contract in the event of a force majeure event.

Now, if you are drafting in favor to the service provider or a supplier, then the contract should include a force majeure clause that includes a broad definition of a force majeure event, ideally including some catch-all language along the lines of "any event beyond the reasonable control of the non-performing party" and you may also want to ensure that the clause applies when the force majeure event prevents performance, but also when it impairs *or* delays performance or even simply results in partial performance only.

Jim:
Thanks, Valerie. Many of those same principles would also apply if you were drafting price adjustment or material adverse event provisions, and your approach will certainly differ on whether you're drafting in favor of the customer or the service provider. If, for example, you wanted to draft risk allocation provisions that are more favorable to the customer, the first question is whether you want to include any price adjustment or material adverse event provisions at all, since these provisions are often designed to reduce the risk allocated to the service provider.

If you do elect to draft a price adjustment provision that's favorable to the customer, then it should include language that limits the number of price adjustments that can occur within a year and installs an initial period during which no price adjustments can occur (for example, the first two years). It should also link the price adjustments to an objective and reliable index, and it should require the service provider to document increased costs and undertake all reasonable steps to keep costs down.

On the other hand, if you wanted to draft a risk allocation provision that is more favorable to the service provider, the contract should include a price adjustment clause that permits the service provider to invoke the clause at any time (for example, each time there is an increase of more than x% in the price of energy) and also permits the service provider to automatically bill the customer the increased price without any prior approval needed by the customer.

Similarly, with respect to material adverse event provisions, if you want to draft provisions that are more favorable to the customer, the contract should include language that explicitly describes the material adverse events that the customer is concerned about, as well as a catch-all phrase to capture anything that could have an impact on the customer's operations. The language should also require the service provider to formulate a mitigation plan to be approved by the customer, and it should permit the customer to terminate the agreement if no commercially reasonable solution can be implemented.

On the other hand, if you wanted to draft a provision that is more favorable to the service provider, the contract should include material adverse event language that explicitly describes the material adverse events that the service provider is concerned about, as well as a catch-all phrase to capture anything that could have an impact on the provision of services by the service provider. It should also require the parties to undertake good faith renegotiation and agreement on the key terms, such as the charges and deadlines if a material adverse event occurs. And, finally, it should permit the service provider to suspend the performance of the agreement until a commercially reasonable solution is found.

Closing

Julian:
Thank you, Jim, and thanks, Valerie. Great overview and insights.

Listeners, if you have any questions about today's episode – or if you have an idea for an episode you'd like to hear about anything related to technology & IP transactions and the law – please email us at TechTransactions@mayerbrown.com. Thanks for listening.

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