

Unexpected Events from Covid to Supply Chain Disruption: Implications for US Contract, Securities and Antitrust Law

Japanese companies doing business in the US have been faced with what has come to seem a continual, cascading stream of unexpected events disrupting supply chains and interfering with contract performance and business expectations. This update discusses how US case law, as illustrated by recent decisions, is likely to deal with such unexpected events in the key areas of contract, securities and antitrust law.

When Do Covid or Supply Chain Disruption Justify Non-Performance of a Contract?

The wave of US litigation that some expected from Covid never came. Covid gave rise to litigation concerning business interruption insurance coverage – which was usually denied – and commercial rent – which usually had to be paid. But little new law was made in most areas of contract interpretation.

The few exceptions, where Covid has led to significant litigation concerning commercial contracts and in the M&A context, are worth noting. Covid remains with us and continues to impose commercial and personal harm. But new, often unanticipated, threats to contract performance continue to materialize, from Russia's invasion of the Ukraine to labor shortages, supply chain disruption, and breakdowns in distribution systems. As long as circumstances continue to arise that may not have been in the conscious contemplation of the parties when contracting, questions will be raised about whether force majeure clauses or other contract terms provide relief to the disadvantaged party – to which the limited, but growing, Covid case law may provide some answers.

Contract Litigation. In a March 23, 2022 decision, the Second Circuit affirmed the trial court's interpretation of a catchall force majeure clause applying to circumstances beyond the parties' "reasonable control" as excusing non-performance due to Covid. A painting had been consigned for sale by the Phillips auction house in an auction planned for the spring of 2020.¹ When New York State issued an order requiring non-essential businesses to cease in-person operations, the auction house cancelled the sale and returned the painting. The owner of the painting sued for breach of contract. The parties' agreement had a force majeure clause, which read: "in the event that the auction is postponed for circumstances beyond our or your reasonable control, including, without limitation, as a result of natural disaster, fire, flood, general strike, war, armed conflict, terrorist attack or nuclear or chemical contamination, [Phillips] may terminate this Agreement." The Court reasoned that the phrase "without limitation" must mean that the clause applied to events in addition to and similar to those enumerated. Covid was the

¹ *JN Contemporary Art LLC v. Phillips Auctioneers LLC*, 29 F.4th 118 (2d Cir. 2022).

same type of event, as it caused large-scale societal disruption and was beyond the parties' control. The Court affirmed dismissal of the claim against the auction house.

M&A Litigation. Covid has also led to litigation in the context of M&A transactions. In general, Covid has not been found to be a material adverse effect that could permit termination of an acquisition agreement. However, in at least one case, measures taken by a target company as a result of Covid have been found to breach the company's pre-closing covenants, and hence to justify abandoning the transaction. A subsidiary of South Korea's Mirae Asset Financial Group had agreed to purchase fifteen US luxury hotels from AB Stable, a subsidiary of China's Anbang Insurance Group, for \$5.8 billion.² A typical deal provision required Anbang to run the hotels between signing and closing "only in the ordinary course of business, consistent with past practice in all material respects." In response to Covid, Anbang closed two hotels, curtailed operations at others, reduced hotel operations to skeleton staffing, laid off employees, and put spending on non-essential capital improvements on hold. On December 7, 2021, the Delaware Supreme Court affirmed the Chancery Court's finding that Anbang had breached its obligation to operate "in the ordinary course of business." The Court rejected the argument that the hotels were being operated as would be "ordinary" in a pandemic, or as was "ordinary" compared to the general response of the hospitality industry to Covid. Instead, the Court interpreted the clause as requiring Anbang to operate consistent with its own past practice. As the changes to hotel operations resulting from Covid were well beyond the scope of ordinary business operations, the Court concluded that the ordinary course clause had been breached and that Mirae was excused from its obligation to purchase.

The ordinary course clause has not, however, provided a means to exit every transaction affected by Covid. In another post-Covid decision, the Chancery Court rejected a buyer's attempt to walk away from an acquisition based on the claim that the seller's response to Covid violated the ordinary course clause. The seller, a cake-decorating company, had drawn down on its revolving credit facility and temporarily reduced spending on marketing, capital improvements and wages in response to Covid's suppression of demand.³ The Court held that these business decisions were consistent with the company's reaction to past downturns, and hence were in the ordinary course. A more fundamental deviation from past practice would be required to violate an ordinary course obligation.

Supply Chain Disruption Securities Litigation: Covid and Beyond

Securities lawsuits based on production delays have been one of the notable trends in recent US securities litigation. Such lawsuits began with Covid, but increasingly arise from events that have a limited connection to the pandemic. Cases initially arose when

² *AB Stable VIII LLC v. MAPS Hotels and Resorts One LLC*, C.A. No. 2020-0310 (Del. 2021).

³ *Snow Phipps Group, LLC v. KCake Acquisition Inc.*, C.A. No. 2020-0282 (Del. Ch. April 30, 2021).

companies made representations about their resiliency or preparedness for Covid that plaintiffs claimed were fraudulent. Newer cases are based on second-level effects of Covid. Supply chain disruption and labor shortages are setting back many businesses and causing them to miss financial projections. When stock price drops occur and plaintiffs claim that financial results are inconsistent with companies' representations, securities cases can follow. Two recent cases illustrate how supply chain delays can give rise to securities litigation.

Romeo Power manufactures battery packs for electric trucks and cars. Battery cells are a crucial component in Romeo's product. In October of 2020, at a time that it had entered into an agreement to merge with a SPAC, Romeo told investors that it had the capacity and supply to meet user demand, that it had key partnerships with battery cell manufacturers, and that it was not dependent on "any level of the value chain." On March 30, 2021, Romeo announced revenue projections for 2021 as much as 87% lower than it had provided a few months earlier. The company explained that production was constrained by a shortage in battery cells. Its stock fell 20% and on April 16, 2021, a securities suit followed.⁴

Cerence develops artificial intelligence virtual assistant software for sale to automobile manufacturers. It earns revenues from licensing fees and cloud-based services when its software is installed in automobiles. Cerence told investors in an earnings call on November 22, 2021 that its revenue projections had taken into consideration "current risks and uncertainties of the semiconductor device shortages that are impacting auto production." On February 7, 2022, its new CEO announced lower first-quarter revenues than anticipated, lowered 2022 revenue projections and retracted 2024 projections, blaming chip shortages that had led to a slow-down in the automotive industry. Cerence's stock price dropped by 30% and on February 25, 2022, a securities suit was filed.⁵

While Covid may be receding, the risk from over-burdened supply chains has not. As the global economy continues to respond to new sources of production and distribution delays, further supply chain-related securities claims are likely to follow.

Collaborative Responses to Supply Chain Disruption: Addressing the Antitrust Risks

Even as the public health threat from Covid appears to recede, the supply chain problems Covid exposed have not gone away. Distribution systems continue to break down. Increasing political risk makes sources of supply unreliable. Car manufacturers have run out of capacitors, liquor distillers out of bottles, and department stores out of stock. Around the world, companies are responding. Manufacturers and retailers are seeking

⁴ See *In re Romeo Power Inc. Securities Litigation*, 1:21cv3362 (S.D.N.Y.) (pending).

⁵ See *City of Miami Fire Fighters' and Police Officers' Retirement Trust v. Cerence Inc.*, 1:22cv10321 (D. Mass.) (pending).

multiple sources of supply, increasing inventory, shrinking supply chains, and nearshoring or onshoring production. Instead of “just in time,” companies are thinking “just in case.”

In response to the new supply and distribution environment, companies have considered various forms of cooperation and joint conduct with competitors and other industry participants. Companies have joined with competitors to build back-up networks, share data to make supplier networks more transparent, and build new distribution capacity.

In 2021, major German car companies including Mercedes-Benz and BMW and their biggest suppliers formed Catena-x, an automotive alliance dedicated to creating an “industrial ecosystem” promoting data sharing and standardization. Participants intend to increase the resilience and flexibility of supply chains and efficiency in procurement by creating “greater transparency” among members. The Consumer Goods Forum, which includes retailers and consumer goods manufacturers such as Alibaba, Amazon, Nestle and Shisedo, is similarly dedicated to “managing and sharing product information across the entire value chain.” The Forum is pursuing projects to enable sharing of forecasting and transaction data between its partners.

These collaborations may be a forward-thinking response to the new reality of supply chain instability and distribution network malfunction. But they also raise antitrust risk. While many antitrust regimes and authorities will be relevant for international competitor cooperation, most such collaborations will find it appropriate to consider potential liability under US antitrust law.

US law recognizes that while competitor collaborations often have pro-competitive benefits, they also have the potential for antitrust harm that outweighs any potential benefit. Competitor collaborations may provide an opportunity for participants to agree on anti-competitive terms. The opportunity for contacts between competitors presented by trade associations and joint ventures have been viewed as “plus factors” in determining whether conduct was independently motivated or jointly agreed. Collaboration on purchasing can create monopsony power or facilitate collusion by standardizing costs.

Information sharing itself can constitute anti-competitive conduct. Information sharing can increase the likelihood of collusion on price or output. Sharing information on current operating costs and operations or future business plans is particularly likely to raise antitrust concern. Information sharing can also provide the means to detect and punish deviation from anti-competitive agreements. The antitrust issues raised by competitor collaboration can give rise under US law to private litigation or public regulatory enforcement action.

Antitrust risk needs to be thoughtfully addressed by any company considering collaborating with competitors to address supply chain disruption. While US antitrust

law is not the only source of concern, US legal consequences should be taken into account during any collaboration among companies involved in US imports or affecting US commerce.

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