If You Owe The Bank…

Effects of the Global Recession on Contractual Relationships in the Maritime Industry: a U.S. Law Perspective

Presented on October 1, 2009

London International Law Seminar

Gregory W. Poulos[1]

&

Marc A. Centor

Cox, Wootton, Griffin, Hansen & Poulos, LLP

San Francisco, California

---

[1] Gregory W. Poulos is a Partner at Cox, Wootton, Griffin, Hansen & Poulos, LLP. Mr. Poulos received his undergraduate degree from the University of California at Davis in 1984, and his J.D. degree from Tulane University School of Law in New Orleans, LA in 1987. Mr. Poulos is a Proctor member of the Maritime Law Association of the United States, the Past Chair of the Pacific Admiralty Seminar and the current Senior Vice Chair of the International Bar Association Maritime and Transport Law Committee.

Marc Avram Centor is an Associate at Cox, Wootton, Griffin, Hansen & Poulos, LLP. Mr. Centor received his undergraduate degree from the University of Virginia in 2003 and his J.D. degree from University of Virginia School of Law in 2007. Mr. Centor joined CWGHP in 2009.

© Gregory W. Poulos, 2009 (all rights reserved)

I. INTRODUCTION

There is an old saying that "If you owe the bank $100, that's your problem. If you owe the bank $100 million, that's the bank's problem." This saying, or something akin to it, has been attributed to the American Oil Tycoon John Paul Getty, but has also been credited to the English Economist Lord Keynes (1883-1946) who is reported to have said: "If you owe your bank manager a thousand pounds, you are at his mercy. If you owe him a million pounds, he is at your mercy." Given my audience today, I have no doubt that it was Lord Keynes who first broached the idea and that the American tycoon simply imported it.

Whatever the original source, the concept that was being conveyed has merit, and it is worth keeping in mind as we discuss the options that are available to vessel owners and charterers as they plow through the rough economic seas that are presently being experienced.

In the past year and a half or two years, the global shipping industry has been hit hard by the economic slowdown. Freight rates fell as consumerism declined and with it the need for imports, primarily from Asia. This in turn reduced demand in Asia for raw materials. Oil prices collapsed from market highs decreasing the demand for tankers; insurance rates rose as the costs of underwriting were not subsidized by returns on investments. As a result of these problems, shipowners or charterers were unable to find fixtures for some vessels,[2] while at the same time the value of scrap metal fell making the ship scrapping option less viable. For ship builders, contracts that were in place have been jeopardized, and owners are now asking the yards to reduce prices or cancel orders all together.[3] Charterers have also tried to renegotiate hire rates and, in some cases, have simply turned back vessels to the owners or abandoned the vessels. In

[2] Apex Alphaliner puts the current size of the idle fleet at 9.9% of total slot capacity. Lloyd's List Sept. 3, 2009.

[3] www.spiegel.de/internationa/business/0,1518,594710,00.html

© Gregory W. Poulos, 2009 (all rights reserved)

other cases shippers have simply abandoned cargo at discharge ports if buyers could not be found.[4]

It is against this background that we have been asked to address the issue of whether the economic crisis has created a "force majeure" event such that vessel owners, charterers or shippers may be able to avoid contractual liabilities. While the easiest presentation would be to simply say "No" and ask the audience for questions, a more accurate response under U.S. law is "not likely…but I do have some theories." It is those theories that I would like to share with you today.

II. BACK TO THE BASICS: CONTRACT LAW IN THE UNITED STATES

One of the axioms of American law is that the parties to a contract are generally free to arrange their affairs and define their terms as they see fit. Absent special considerations such as illegality, fraud or overreaching, American Courts will enforce the terms of unambiguous contracts without resort to extrinsic evidence. Where ambiguity exists, the Courts will exam parol evidence to discern the intent of the parties. Where terms are not defined, the Courts will look to either the plain meaning of the terms or, if terms are used in a particular sense or industry, the Courts will give the word its "term of art" meaning. The Courts may also look to other rules of interpretation like the latin *ejusdem generis* (of the same kind) to discern the meaning. These rules of contract interpretation will be applied by the Courts in determining the rights of parties under contracts for ship building, charter parties or contracts of affreightment.

---

[4] The worst of the crisis may be in the wake. Recent news reports state that freight rates on many routes have stabilized or increased, and some carriers (notably CMA CGM, Maersk, Evergreen and Mitsui OSK) have reportedly raised container rates. See, Tradewinds, September 8, 2009. On the P&I front, Skuld recently reported a ten fold increase in profits during the first half of 2009. Lloyd's List September 4, 2009.

© Gregory W. Poulos, 2009 (all rights reserved)

We need to begin, therefore, with the language of the contracts themselves to determine if there is any potential for the Courts to find in favor of a party asserting rights based on an alleged economic *force majeure* event.

In ship building contracts the *force majeure* clause typically appears as part of the terms related to the shipowner's obligation to deliver the vessel. The placement of such a clause is significant. It should be noted, for example, that because of this placement, the term finds its natural home as an escape valve for the shipbuilder as opposed to the buyer. A typical force majeure clause in a US shipbuilding contract will read:

> If, at any time before actual delivery, the construction of the Vessel is delayed due to acts of the U.S. Government, foreign government, princes or rulers; war, blockade, revolution, insurrection, mobilization, civil commotion, or riots; strikes; Acts of God or the public enemy; plague or other epidemic, quarantines; freight embargoes; earthquakes, tidal waves, flood, typhoons, hurricanes or storms that result in damage to the Shipyard or Works of the Builder, or to the Vessel, or any part thereof; fire, flood, or other causes beyond the control of the Builder or its sub-contractors, as the case may be, ("Force Majeure"); then, subject to the next succeeding sentence, the time for delivery of the Vessel under this Contract shall be extended for a period of time which shall not exceed the total cumulated time of all such permissible delays.

There are two notable features of this clause. First, it is written entirely for the benefit of the builder as it gives the builder additional time to make its contractual delivery without providing any express rights to the buyer. Second, it does not contain any reference to general economic conditions except through a broad reading of the phrase "or other causes beyond the control of the Builder or its subcontractors as the case may be." Still, even this vague wording follows after the words "fire" and "flood" and therefore suggests that the clause is intended to apply to events more akin to an "act of God" than the machinations of global economics.

© Gregory W. Poulos, 2009 (all rights reserved)

Most charter parties have similar wording. This audience will be well aware that most of the form charter party contracts contain the "force majeure" wording within the "General Exceptions" clauses. Thus the Asbatankvoy provides that:

> Neither the Vessel nor Master or Owner, nor the Charterer, shall, unless otherwise in this Charter expressly provided, be responsible for any loss or damage or delay or failure in performing hereunder, arising or resulting from: - Act of God; act of war; perils of the seas; act of public enemies, pirates or assailing thieves; arrest or restrating of princes, rulers or people; or seizure under legal process provided bond is promptly furnished to release the Vessel or cargo; strike or lockout or stoppage or restraint of labor from whatever cause, either partial or general; or riot or civil commotion.[5]

The Shelltime 4 has a similarly worded "General Exceptions" clause that reads:

> Neither the vessel, her master or Owners, nor Charterers shall, unless otherwise in this charter expressly provided, be liable for any loss or damage or delay or failure in performance hereunder arising or resulting from act of God, act of war, seizure under legal process, quarantine restrictions, strikes, lock-outs, riots, restraints of labour, civil commotions or arrest or restraint of prices, ruler or people.[6]

These clauses are better than the force majeure clauses in ship building contracts, because they at least provide that the rights run to both the owner and charterer. Still, it is immediately apparent that that these fairly typical clauses make no reference to any purely economic conditions, either of the parties' or the general national or global economy.

---

5 Asbatankvoy, Clause 19.

6 Shelltime 4, Clause 27(a)

© Gregory W. Poulos, 2009 (all rights reserved)

III. FINDING A "FORCE MAJEURE"

The prevailing case law regarding *force majeure* clauses as interpreted in the United States makes economic conditions an unattractive route to contractual relief. Indeed, American courts have consistently refused to consider an unexpected change in market conditions as a force majeure. By and large, the opinions on the subject have focused on the perceived intent of the parties at the time of formation and the intended allocations of risk evident in the language of each contract. *U.S. v. Panhandle Eastern Corp.*, 693 F. Supp. 88 (D. Del. 1988) provides a good example.

In *Panhandle* the United States Maritime Administration ("Marad") filed suit to protect its interests as guarantor of ship construction financing bonds. While the case presents a very complicated fact pattern, it is sufficient for purposes of this paper that the readers understand Marad had guaranteed and paid on nearly $200 million in ship financing bonds that had been used to finance the construction of two LNG tankers. *Id*. at 91. When the bond payments were suspended by the principals, Marad was required to make good on its guarantee and brought suit to collect those sums from the principals. The sole "affirmative defense" that was ultimately asserted by the principals was that there was an economic "force majeure" that excused their performance under the relevant contracts.

The Court began its analysis by looking at the language of the underlying contracts. According to the Court, the contracts provided that:

> The contracting Parties shall be temporarily released in whole or in part, from their obligations:
>
> - in cases of force majeure or chance events *affecting the facilities used for the performance of this Contract*, such as, in particular: fire, flood, atmospheric disturbances, storm, tornado, earthquake, washout, landslide, lightning, epidemic, war, riot, civil war,

© Gregory W. Poulos, 2009 (all rights reserved)

> insurrection, acts of public enemies, act of government, strike, lockout,
>
> ***
>
> and in the following circumstances *affecting the facilities used for the performance of this Contract*:
> serious accidental damage to operations or equipment affecting the Natural Gas production facilities in the field, transportation by pipeline in Algeria, treatment, liquefaction, storage, loading operations, transportation by methane tankers, unloading, storage and regasification, as well as the main exit pipe from the regasification plant to the first branching thereon, to the extent that such pipe is used exclusively for the transportation of Natural Gas purchased from the Seller and provided that the length thereof shall not exceed 47 miles; of such nature that its consequences cannot be overcome by the taking of reasonable measures at a reasonable cost;
>
> act of a third party affecting the items specified above of such nature that such act or its consequences cannot be overcome by the taking of reasonable measures at a reasonable cost . . . .

The contract also provided that, "Pending the restoration of normal conditions, the obligations of the Parties shall continue in effect insofar as their performance shall be physically possible."

Reviewing these terms, the Court noted:

> Nowhere does Article XIII expressly state that highly adverse economic or market conditions may constitute force majeure. Rather, the clause clearly limits its applicability to occurrences which actually *affect the facilities* used for performance of the contract. Furthermore, Article XIII provides that pending restoration of normal conditions, the obligations of the parties shall continue in effect insofar as their performance is *physically possible*. Thus, Article XIII unambiguously provides for temporary release from contractual obligations only for events which affect the facilities used for performance by making performance physically impossible. This does not necessarily mean that the facilities must be physically destroyed. Thus, Article XIII contemplates such events as strikes, lockouts or epidemics, which might affect access to the facilities. *However, alleged economic hardship resulting from market fluctuations is certainly not within the ambit of Article XIII. The unwillingness or inability to make*

© Gregory W. Poulos, 2009 (all rights reserved)

> *monetary payments is not an event affecting the facilities in such a way as to make performance of the contract physically impossible*.
>
> *Panhandle*, 693 F.Supp. at 96.

The Court then went on to state the general principal that "only when a force majeure clause specifically includes the event alleged to have prevented performance, will a party be excused from performance." *Id.*(citing *Kel Kim Corp. v. Central Markets, Inc*., 70 N.Y.2d 900, 519 N.E.2d 295, 296, 524 N.Y.S.2d 384 (1987)). According to the Court, "[t]his maxim is especially true where the event relied upon to avoid performance is a market fluctuation. … American courts have routinely refused to excuse performance under such a theory, even where the force majeure clause, unlike the one in question here, presents potential ambiguities."

The *Panhandle* Court went on to discuss two previous cases from the United States Courts of Appeal which both focused on the fact that force majeure clauses are "not intended to buffer a party against the normal risks of a contract." *Id.* at 98 (citing *Northern Indiana Pub. Serv. Co. v. Carbon County Coal Co.*, 799 F.2d 265, 275 (7th Cir. 1986)). In the *Carbon County Coal* case, for example, the Northern Indiana Public Service Company tried to use a *force majeure* argument to avoid its obligations to pay for coal that it had purchased under long term fixed price and quantity contracts. The public utility argued that because market conditions had changed, it was able to buy electricity at cheaper rates than it cost to purchase the coal and produce its own electricity. After trial the jury awarded the coal company $181 million in damages against the public utility. This decision was affirmed by the Seventh Circuit Court of Appeals, which held that:

> A *force majeure* clause is not intended to buffer a party against the normal risks of a contract. The normal risk of a fixed-price contract is that the market price will change. If it rises, the buyer gains at the expense of the seller (except insofar as escalator provisions give the seller some protection); if it falls, as here, the seller

© Gregory W. Poulos, 2009 (all rights reserved)

> gains at the expense of the buyer. The whole purpose of a fixed-price contract is to allocate risk in this way. A *force majeure* clause interpreted to excuse the buyer from the consequences of the risk he expressly assumed would nullify a central term of the contract.

The court furthermore highlighted the reasoning of the Fourth Circuit's holding in *Langham-Hill Petroleum, Inc. v. Southern Fuels, Co.*, 813 F.2d 1327 (4th Cir. 1987). In the Langham-Hill case, Southern Fuels had agreed to purchase fuel oil from Langham-Hill in three installments and at certain prices. The first two installments were purchased and delivered, and then the price of fuel oil fell as a result of actions taken by Saudi Arabia. Southern Fuels then refused to take delivery of the third shipment and alleged that the drop in fuel prices caused by Saudi Arabia's actions in the global market were outside of its control and therefore amounted to a *force majeure* under the contract. The district court disagreed and awarded summary judgment to Langham-Hill. On appeal the Court of Appeals affirmed. What is significant about the decision is not only that the district court and Court of Appeals rejected the argument that a change in economics could be a *force majeure* event, but that they went further and awarded the seller (Langham-Hill) its attorneys fees based on Rule 11 of the Federal Rules of Civil Procedure. Rule 11 allows a court to award attorneys fees against a party that asserts a claim or defense that is not warranted by fact or existing law (or a good faith argument for expansion of existing law). In this case the Court of Appeals found that "[g]iven the great weight of authority in opposition to Southern's assertion of the *force majeure* clause as a defense" the district court did not abuse its discretion in awarding attorney's fees under Rule 11. This ruling should

© Gregory W. Poulos, 2009 (all rights reserved)

certainly be taken as a warning to any party seeking to assert a *force majeure* defense based on changes in economic conditions.[7]

Finally, it should be noted that most *force majeure* clauses are drafted so as to provide only a temporary respite from the contractual obligations. A hurricane, fire, flood or other *force majeure* event usually only applies to give the party asserting it additional time to meet its contractual obligations and only rarely would eliminate the obligation altogether. As a result, the usual *force majeure* clause is unlikely to provide much relief in the long terms applicable to most ship building or charter party contracts.

IV. ECONOMIC FORCE MAJEURE: A LIMITED EXCEPTION

By this point you may be wondering whether American courts ever excuse parties from contractual obligations on the basis of an economic force majeure argument. The case of *Interpetrol Bermuda Ltd. v. Kaiser Aluminum Int'l Corp.*, 719 F.2d 992 (9th Cir. 1983), offers one example of such an apparent variance. That case involved a web of interrelated contracts covering the sale of crude oil, its refinement and its resale. Trako Energy Corporation ("Trako") contracted with Occidental Crude Sales, Inc. to purchase "heavy Arabian Crude oil for shipment from the Persian Gulf to Taiwan," with Chinese Petroleum Corporation for the refinement of that oil in Taiwan, and with Kaiser for the sale of that refined oil. *Id*. at 994. Kaiser then contracted to resell the refined petroleum to Interpetrol. *Id*. Shortly after all of these deals were inked, the price of petroleum skyrocketed. *Id*. Trako and Occidental subsequently agreed on a release of their contract, whereby Occidental would sell the crude at market price and share the profits with Trako. *Id*. at 994-95. As a result, Kaiser's oil supply dried up, and it invoked the force majeure clause from its contract with Interpetrol to excuse its breach of that agreement. *Id*. at 995.

---

[7] See also, *B.F. Goodrich v. Vinyltech Corp.*, 711 F. Supp. 1513 (D. Ariz. 1989) (holding that "drastic and unexpected fall in market prices" was not a force majeure event).

© Gregory W. Poulos, 2009 (all rights reserved)

Interpetrol brought suit against Kaiser alleging breach of contract and fraud, but Kaiser filed a Motion to Dismiss which was granted by the district court. *Id*. at 995. Interpetrol appealed. *Id.* The appellate court began its analysis of Kaiser's force majeure argument by reviewing the force majeure clause between the parties. That clause, which had been confirmed in a telex, declared:

> The force majeure due to failure or delay of seller's suppliers of product and transportation shall terminate, upon notification by sellers that the vessel delivering crude to Taiwan has left loading port in the Persian Gulf which is advised to take place latter part of May. *Otherwise only standard force majeure to apply.* *Id*. at 997 (emphasis added).

As in the other cases discussed, the court focused its attention on the negotiations between the parties. Kaiser stated that it had proposed a so-called "economic force majeure" clause, but that Interpetrol countered with a compromise that economic force majeure would only apply up until the vessel loading the crude had left the Persian Gulf. *Id*.

The appellate court found no error in the district court's conclusions, namely its conclusion that economic force majeure applied before the crude left the Persian Gulf. *Id*. at 998-99. Although the force majeure clause did not explicitly state that it would apply to economically unforeseeable events, the district court reasoned that its interpretation made sense in light of evidence that Kaiser had negotiated for an economic force majeure clause and that the clause eventually agreed upon specifically differentiated between the pre-departure force majeure and the "standard force majeure" to apply from that point on. *Id*. at 998. Ultimately, although the outcome varied from the other cases above, the court's reasoning was similarly focused on contract formation and the risks evidently assumed by each party.

© Gregory W. Poulos, 2009 (all rights reserved)

V. IMPOSSIBILITY OR IMPRACTICABILITY: THE UNAVAILING TWINS

Shipowners and charterers looking for ways to avoid contractual obligations may also consider application of the twin doctrines of impossibility or impracticability. The consideration, however, should not take long; they will not help.

More than a half-century ago, in the summer of 1956, Egyptian President Gamal Abdel Nasser announced the nationalization of the Suez Canal Company and assumed control over the canal. Several months later, in response to invasions by Israel, France, and England, Egypt obstructed the canal and closed it to all traffic. The Suez Canal did not reopen until April of 1957.

Exactly one month before the Canal was closed to traffic, the United States (charterer) executed a voyage charter with Transatlantic Financing Corporation (owner) for the shipment of wheat from the United States to Iran on the SS CHRISTOS. *Transatlantic Financing Corporation v. U.S.*, 363 F.2d 312, 314 (D.C. Cir. 1966). "The charter indicated the termini of the voyage but not the route." *Id.* The closure of the Suez Canal, however, forced Transatlantic to deviate from its customary route by sailing all the way down to the Cape of Good Hope and back up into the Persian Gulf. *Id*. at 315.

Not wanting to absorb the extra cost of the deviated voyage, Transatlantic brought suit against the United States, alleging that performance of the contract was rendered impossible by the closing of the Suez Canal, and that the United States therefore owed Transatlantic under a theory of *quantum meruit* for the voyage ultimately taken by the SS CHRISTOS. *Id*.

© Gregory W. Poulos, 2009 (all rights reserved)

The Court of Appeals for the District of Columbia Circuit began its analysis by describing the doctrine of impossibility and then outlined the elements of the defense. According to the Court:

> It is now recognized that "'A thing is impossible in legal contemplation when it is not practicable; and a thing is impracticable when it can only be done at an excessive and unreasonable cost.'" The doctrine ultimately represents the ever-shifting line, drawn by courts hopefully responsive to commercial practices and mores, at which the community's interest in having contracts enforced according to their terms is outweighed by the commercial senselessness of requiring performance. When the issue is raised, the court is asked to construct a condition of performance based on the changed circumstances, a process which involves at least three reasonably definable steps. First, a contingency -- something unexpected -- must have occurred. Second, the risk of the unexpected occurrence must not have been allocated either by agreement or by custom. Finally, occurrence of the contingency must have rendered performance commercially impracticable. Unless the court finds these three requirements satisfied, the plea of impossibility must fail.

In the case of the Suez Canal closing, the Court found that the closing of the canal was an unexpected event that caused the voyage to be extended beyond the ordinary and customary route that the parties had anticipated. The Court also found, however, that the parties were aware that the canal area might become a "dangerous area" and that some risk may have been included in the setting of freight rates. It therefore determined that it might be fair to allocate that risk to the vessel owner, although ultimately it found only that it would more strongly scrutinize a claim for impossibility being asserted by the owner.

Finally, the Court turned to the question of whether the canal closure resulted in a "commercial impracticability" of performance by the owner, and here the claim failed. In finding that the performance was not "commercially impracticable" the court noted that the goods were not subject to harm due to the longer voyage, that the vessel owners were "no less

© Gregory W. Poulos, 2009 (all rights reserved)

able" than the shipper to purchase insurance to cover the contingency, and that they were ultimately "in the best position to calculate the cost of performance… and are undoubtedly sensitive to international troubles which uniquely affect the demand for and cost of their services." The Court held that, "[w]hile it may be an overstatement to say that increased cost and difficulty of performance never constitute impracticability, to justify relief there must be more of a variation between expected cost and the cost of performing by an available alternative than is present in this case where the promisor can legitimately be presumed to have accepted some degree of abnormal risk, and where impracticability is urged on the basis of added expense alone."

The doctrine of impossibility was more recently addressed by the same Circuit Court in the case of *East Capital View Community Development Corp. v. Denean*, 941 A.2d 1036 (D.C. Cir. 2008). In *Denean* an employee sued the corporation after it terminated her services because of a lack of grant funding. The corporation requested a jury instruction on the defense of impossibility, alleging that the lack of grant funding made their performance commercially impossible. The district court denied the instruction, and the jury awarded the plaintiff damages for the corporation's breach of contract. On appeal, the decision was affirmed. The case is important in the context of this paper, because the argument of financial impossibility is at the heart of the claims that might be made by a vessel owner seeking to avoid obligations under a purchase or charter party contract.

Rather than summarizing the Court's holding on the issue of economic impossibility, the Court of Appeal's phrasing and citations are the "best evidence" of how the argument would fare:

> The doctrine of impossibility relieves non-performance only in extreme circumstances. The party asserting the defense of

© Gregory W. Poulos, 2009 (all rights reserved)

> impossibility bears the burden of proving "a real impossibility and not a mere inconvenience or unexpected difficulty." Moreover, **courts will generally only excuse non-performance where performance is objectively impossible -- that is, the contract is incapable of performance by anyone** -- rather than instances where the party subjectively claims the inability to perform. Indeed, **"[i]t is generally well settled that subjective impossibility, that is, impossibility which is personal to the promisor and does not inhere in the nature of the act to be performed, does not excuse nonperformance of the contractual obligation."** The Restatement similarly recognizes the objective/subjective distinction, concluding that while a party's duty to perform is discharged if it is made objectively impracticable, "if the performance remains practicable and it is merely beyond the party's capacity to render it, he is ordinarily not discharged."
>
> **Under this analysis a party's alleged financial inability to perform a contract that it voluntarily entered would rarely, if ever, excuse non-performance; though a party may prove that it can no longer afford performance, it will be hard-pressed to prove that non-performance "exist[s] in the nature of the thing to be done."** Although this court has not directly ruled on whether financial inability to meet a contractual obligation excuses non-performance, most, if not all, other jurisdictions that have addressed this issue agree that it does not. Indeed, even insolvency is unlikely to excuse performance: "In short, it must be deemed an implied term of every contract that the promisor will not permit himself, through insolvency or acts of bankruptcy, to be disabled from making performance." *Central Trust Co. v. Chicago Auditorium Ass'n,* 240 U.S. 581, 591, 36 S. Ct. 412, 60 L. Ed. 811 (1916);
> *East Capital View Community Development Corp. v. Denean*, 941 A.2d 1036 (D.C. Cir. 2008) (internal citations omitted)[8]

I have quoted liberally from the *Denean* decision, because it summarizes so well the likely fate of any economic impossibility defense. If the shipowner's dilemma is "subjective" and based thereby on its own financial condition, even if it is related to the broader global

[8] See also, *407 East 61st Garage, Inc., v. Savoy Fifth Avenue Corp.,* 23 N.Y.2d 275, 282, 244 N.E.2d 37, 42, 296 N.Y.S.2d 338 (1968) (holding that "[T]he applicable rules do not permit a party to abrogate a contract, unilaterally, merely upon a showing that it would be financially disadvantageous to perform it; were the rules otherwise, they would place in jeopardy all commercial contracts.").

© Gregory W. Poulos, 2009 (all rights reserved)

economy, it is unlikely to succeed. A shipowner seeking to rely on this defense will need to establish that performance was objectively impossible, not just for itself, but for any shipowner.

VI. MUTUAL MISTAKE

In addition to the doctrines discussed above, mutual mistake has also been asserted by parties desirous to wrench themselves free from contracts turned sour. That doctrine allows courts to void or reform an agreement, "[w]here a mistake of both parties at the time a contract was made *as to a basic assumption on which the contract was made* has a material effect on the agreed exchange of performances[.]" Restatement (2d) of Contracts § 152 (emphasis added). The doctrine of mutual mistake worked for Aluminum Company of America ("ALCOA") in *ALCOA v. Essex Group, Inc.* 499 F. Supp. 53 (W.D. Pa. 1980).

ALCOA contracted with Essex to smelt alumina in to aluminum for a period upward of fifteen years. *Id*. at 56. The contract price for ALCOA's services was the product of a complicated formula derived with help from Alan Greenspan (nearly twenty years before his service as Chairman of the Federal Reserve) and tied to the Wholesale Price Index-Industrial Commodities ("WPI-IC"). *Id.* at 57-8. According to the court, the parties crafted this indexing scheme because ALCOA sought "to achieve a stable net income of about 4 cents per pound of aluminum converted" and Essex sought "to assure itself of a long term supply of aluminum at a favorable price." *Id*. at 58. As should be predictable by this point, the index failed to hold. After several years of moderate profits, ALCOA began to bleed profusely, largely as a result of worldwide economic conditions (i.e.: the 1973 OPEC Oil Embargo) that increased its production costs far beyond the parties' predictions. *Id*.

Faced with potential losses exceeding $75 million, ALCOA argued that "both parties were mistaken in their estimate of the suitability of the WPI-IC as an objective index of

© Gregory W. Poulos, 2009 (all rights reserved)

ALCOA's non-labor production costs, and that their mistake is legally sufficient to warrant modification or avoidance of ALCOA's promise." *Id*. at 59-60. The court agreed, finding that the parties' mistake was one of fact rather than prediction and that the "mistaken assumption [that the price index would achieve the parties' goals] was essentially a present actuarial error." *Id*. at 63. With regard to the risk allocation so closely examined in the other cases above, the court held: "Both [parties] consciously undertook a closely calculated risk rather than a limitless one." *Id*. at 70. As such, the court reformed the contract, fixing a price range whereby ALCOA's profits were contained by a ceiling but its risk of loss was effectively eliminated. *Id.* at 80.

The effect of *ALCOA* on the present day application of mutual mistake in American Courts is unclear. Surely such a drastic judicial remedy only occurs on a rare occasion, and since the *ALCOA* opinion was published in 1980, it has not been explicitly followed by a single American court. The *ALCOA* result was likely an anomaly fueled by the long term nature of the contract between ALCOA and Essex, the evidence that the parties attempted to find an accurate and equitable price index, and the enormous amounts of money at stake. As such, mutual mistake may be argued by a party eager to void or reform a losing bargain, especially in instances where solid pre-formation evidence exists that the intention of the parties was much different than the result. Unfortunately, the mere fact that one party loses large amounts of money on the deal is not likely enough to convince a court that the parties made a mutual mistake and that a basic assumption of the underlying agreement was that neither party would sustain exorbitant losses.

© Gregory W. Poulos, 2009 (all rights reserved)

VII. THE REAL OPTIONS: SOLVING THE BANKER'S PROBLEM

I began this presentation with quotes from Lord Keynes and John Paul Getty reflecting on who has the real problem in a financial transaction. Borrow enough, and it's the lenders problem when the borrower can't perform. In these economic times, that lesson may be more true in ship chartering and ship building than in any other industries. The global economic crisis has created a flood of unused tonnage on the market, and ship contracts that were placed in the lofty days of high freight rates now act like anchors holding companies still or even sinking them.

This problem, however, has created opportunities for the companies that follow Lord Keynes and Getty's theory. Shipyards don't want half finished vessels in their yards or undelivered vessels at their anchorages, and shipowners would likely prefer a small profit over no profit at all coupled with the risks of litigation. As a result, if the fine print of the contract will not allow your clients to escape their liabilities, then common sense and recognizing the needs of the adverse party may serve just as well.

VIII. CONCLUSION / TAKE HOME LESSON

The available American case law regarding economic force majeure, and the related doctrines of impossibility, impracticability, frustration and mistake, offers several lessons for maritime lawyers and businessmen. First, economic force majeure should not be relied upon as an exit strategy from undesirable deals. As demonstrated in the cases above, courts will only find an economic force majeure where there has been some indication that the parties meant to create a special exception to a standard force majeure clause. Furthermore, mere changes in market or price conditions, however drastic, are unlikely to create situations where courts consider performance of a contract to be legally impossible, impracticable or frustrated.

© Gregory W. Poulos, 2009 (all rights reserved)

Second, there is no better way to allocate for the risk of an unexpected economic downturn than to insist that the proper language be included in the written agreement between the parties. When advising a client through a transaction, discuss the risks of market changes with the client and bargain for a more favorable risk allocation when the client is willing to pay for it. Finally, when all else fails and a client is driven to litigation to escape an unfavorable deal, focus your arguments on risk allocation at the time of contract formation. Of all the doctrines and cases discussed or touched on above, they all share the common theme that the presiding court focused on what it believed was the intention of the parties. Search for any evidence that tends to show the parties did not mean to allocate the risk of a drastic economic change and highlight that evidence. By understanding the perspective through which American courts have been inclined to view problems of contract performance in economically challenging times, you can increase your chances of success, even when sailing against the tide.

© Gregory W. Poulos, 2009 (all rights reserved)