FINANCE

ALERT | MARCH 17, 2020

HANDLING CONTRACTUAL DISPUTES LINKED TO COVID-19

By M. Christine Carty, Jonathan Hugg and Janet Tasigianis

COVID-19 is causing business disruption throughout the world.

Companies that obtain parts or finished goods from overseas in many industries already face delivery delays or cancellations due to factory closures caused by COVID-19. These lock-downs are causing disruptions in product manufacture, shipment, and delivery. Numerous large meetings and events have been cancelled in the U.S. and multi-national corporations based in the U.S. and elsewhere have imposed broad travel restrictions to prevent the spread of COVID-19. Further, various forms of "regional" shutdowns have started in the U.S. to control COVID-19.

These eventualities are expected to cause loss of revenue and/or inability to perform agreements by companies directly and indirectly impacted. There inevitably will be a rash of default-related disputes as parties, in good and bad faith, blame COVID-19 for their failure to meet contractual obligations. This Alert focuses on the potential defenses to claims of contract breach due to delays or non-performance.

Contract Remedies for Delay or Non-Performance

Companies may wish to examine their contracts and consult with counsel concerning available remedies and relief from performance. Most commercial contracts contain a *force majeure* clause to excuse performance if one of a list of the extreme events occurs which could prevent or delay performance. As a creature of contract, the scope of the circumstances that will excuse performance will be limited to the language of the particular *force majeure* clause and the interpretation of those clauses under the applicable state law. Courts generally construe *force majeure* clauses narrowly.

In the case of COVID-19, the party attempting to invoke a *force majeure* clause will have the burden of establishing that the contract provision applies to the circumstances at issue and, in addition, the scope of the *force majeure* clause. This means demonstrating that the delay or non-performance is attributable to the COVID-19 virus and also that COVID-19 comes within the scope of the specific language of the *force majeure* clause in the contract at issue. A typical provision may list several disaster-type situations, including government orders, strikes, and physical disasters, such as floods, hurricanes, and the like. The broadest, and most common phrase included is "acts of God." The language generally means a naturally occurring event, one that is free of human intervention. In order to find protection under the *force majeure* clause, a company may argue that a pandemic or epidemic constitutes a naturally occurring event. Whether such an argument will succeed may depend on whether the phrase "acts of God" stands alone or is preceded by other language, such as "natural calamity, such as an earthquake, flood, fire, or other act of God."

Some *force majeure* clauses contain language to the effect that an "order of a government" constitutes *force majeure*. For example, businesses that obtain their finished goods or parts from entities in China may wish to consider invoking this language to excuse performance due to the Chinese government's orders to numerous

factories to close completely for a time. Indeed, the China Council for the Promotion of International Trade ("CCPIT"), an arm of the Chinese government, has been issuing *force majeure* certificates to factories that request them. Presumably, the purpose of such certificates is to protect the affected Chinese companies from claims of breach of contract by their counterparties. As similar government-ordered closures occur in the U.S. or elsewhere, businesses with such language in their agreements may be able to invoke *force majeure* as a defense to breach of contract claims.

Sometimes, *force majeure* clauses refer to "disease," "epidemics," or "state of emergency" as excusing performance or may contain even broader language, such as "any cause that is beyond the reasonable control" of a party. Parties are likely to be more successful in arguing *force majeure* if the clause specifically refers to the catastrophic event at hand; for example, in this case, a "disease," "epidemic," "outbreak," or other similar language that describes the COVID-19 virus. A *force majeure* also could be something as mundane as "transportation" or "labor" disruptions, as might occur because of quarantine.

Any party seeking to invoke *force majeure* will have an obligation to give notice as required in the applicable clause and, most likely, be required to show that it attempted to mitigate the delay or non-performance. Sometimes the *force majeure* clause allows the outright termination of a contract.

Because of the variety of *force majeure* clauses and the potential impact of mitigation requirements under applicable state law, clients who are considering invoking *force majeure* should consider conducting a careful review of all contracts related to the dispute and consulting with counsel about the appropriate steps that should be taken to achieve maximum protection under the contracts and the applicable state law.

Equitable Remedies for Delay or Non-Performance

Unfortunately, written contracts may lack *force majeure* clauses, and oral agreements will not have them. In those circumstances, courts will not imply *force majeure* into the contracts and parties may have to turn to the equitable doctrines of "impracticability" or "contractual frustration" for relief.

Commercial impracticability excuses performance or delays in performance if a supervening event materially changes the inherent nature of a party's obligations to become substantially more difficult, complex or challenging, so that the performance costs become excessive. Frustration of purpose is a limited excuse that applies when, due to a supervening event, a party's fundamental purpose in entering into the transaction is destroyed or obviated. Performance is not impossible, but one party's fundamental reason for doing the deal no longer exists. Both impracticability and frustration are difficult to prove, and rarely accepted by the courts, but their attraction is that they allow a court to fully excuse performance when a truly unexpected event renders it physically or commercially impracticable or impossible to fulfill an agreement.

Proving impracticability or frustration requires a complicated, fact-intensive analysis – under the correct state law – of the terms of the contract, including a *force majeure* clause if present, the background of the agreement, the knowledge and intent of the parties at the time of execution, their ability to perform in the specific circumstances at issue, and the nature of the supervening event and its relationship to the subject of the agreement. If a party is considering invoking an equitable remedy due to difficulties in performing or obtaining performance from a counterparty, a careful review may be conducted with counsel as to whether either impracticability or frustration applies.

Governmental Relief for Businesses Impacted by COVID-19

In addition to considering contractual and equitable principles to relieve performance, affected companies may wish to consider government resources to mitigate the costs and impact of COVID-19. As of the date of this Alert, federal, state, and local governments are developing or offering tax and other relief programs to companies affected by COVID-19. Companies should check government resources on a frequent basis for programs such as the following:

- New York City: "Financial Assistance for Businesses Impacted by Covid-19," https://www1.nyc.gov/site/sbs/businesses/covid19-business-financial-assistance.page

- California State, Employment Development Department:

    - General Resources https://www.edd.ca.gov/about_edd/coronavirus-2019.htm

    - Unemployment Insurance Work Sharing Program https://www.edd.ca.gov/unemployment/Work_Sharing_Program.htm

- San Francisco: Office of Economic and Workforce Development, "Assistance & Guidance for Businesses and Workers Impacted by COVID-19" https://oewd.org/assistance-guidance-businesses-and-workers-impacted-covid-19

- Washington State: Department of Health, "Resource List for Washington State Businesses and Workers Impacted by COVID-19 Coronavirus," https://www.governor.wa.gov/issues/issues/covid-19-resources/covid-19-resources-businesses-and-workers, http://www.doh.wa.gov/Emergencies/Coronavirus

- Seattle: Seattle Office of Economic Development, "2020 Small Business Stabilization Fund Application," http://www.seattle.gov/office-of-economic-development/small-business/small-business-programs-/stabilization-fund-

Takeaways

Since litigation is expensive and uncertain and since either contractual or equitable remedies for performance delays or interruptions likely will depend on notice to the counterparties and efforts to mitigate, **businesses may wish to engage with counterparties promptly to collaborate on mitigation, including possible amendments to the agreements**. As a practical matter, such businesses will benefit from an early and detailed tracking of the specific defaults and delays and the consequences arising from each, and a granular analysis of mitigation options to facilitate constructive negotiations with counterparties. Detailed information may well identify options to the affected business and the counterparties. Businesses may benefit from the advice of counsel in documenting these efforts and preparing presentations to counterparties in the event that negotiations fail.

In addition, Federal, state, and local relief efforts for businesses should be closely examined as they are nascent and evolving. Applications for relief under such programs should be prepared with the advice of counsel to insure compliance with regulatory requirements.

This Alert was based on information available at the time of publishing. It is subject to change. You should consult government websites and publications for the most up-to-date information. ◆

This summary of legal issues is published for informational purposes only. It does not dispense legal advice or create an attorney-client relationship with those who read it. Readers should obtain professional legal advice before taking any legal action.

For more information about Schnader's Financial Services Litigation Group or to speak with a member of the firm, please contact:

Stephen A. Fogdall
Co-Chair, Financial Services Litigation Group
215-751-2581
sfogdall@schnader.com

Jonathan W. Hugg
Co-Chair, Financial Services Litigation Group
215-751-2527
jhugg@schnader.com

M. Christine Carty
Partner
212-973-8012
ccarty@schnader.com

Janet Tasigianis
212-973-8174
jtasigianis@schnader.com

www.schnader.com

** See: www.schnader.com/jakarta*