

The coronavirus and its potential impact on your business contracts

By Jonathan W. Hugg – Contributor

As the coronavirus slowly creeps toward America and into our economic lives, it is worthwhile to pause and consider the potential impact of an epidemic on the contractual relationships that govern our businesses.

Philadelphia can learn lessons from its own epidemic history. The little remembered 1918 Spanish flu pandemic killed thousands in Philadelphia in a matter of weeks. It infected tens of thousands, paralyzed municipal government, and shut down commerce. Similarly, efforts across the globe to contain the new coronavirus have put millions of people into quarantine, grinding economic activity to a halt in afflicted areas.

It is not out of the question that if/when the coronavirus strikes in our region, the disease will affect business operations. Borrowers and tenants may stop paying, construction projects could suffer delays, deliveries may slow, cancellations could surge, travel may cease, and deadlines could be missed. There will inevitably be a rash of default-related disputes as parties, in good and bad faith, blame the epidemic for their failure to meet their contractual obligations.

Most commercial contracts use a “force majeure” clause to address unforeseen circumstances that prevent performance. “Force majeure” literally means “superior force,” a situation more powerful than the parties that they cannot reasonably anticipate, control, or avoid by due care. The lawyers usually bury force majeure clauses deep within the boilerplate of a contract. The provision will excuse performance of all or part of the agreement if one of a list of extreme events has occurred.

In the event of a coronavirus outbreak, the party attempting to invoke a force majeure clause will have the burden of establishing that the contract provision properly applies. This means demonstrating that the virus comes within the scope of the force majeure clause. A typical provision may include several relevant disaster-type situations. The broadest, and most common, is “acts of God,” which is a naturally occurring phenomenon (like a pandemic).

The clause could also possibly list “disease,” “epidemic,” “national emergency,” or “state of emergency.” An emergency likely requires a formal declaration from the government. However, a force majeure could also be something as mundane as “transportation” or “labor” disruptions, as might occur because of quarantine. The specific language of the provision will control how it applies to a contract disagreement.

The affected business will have an obligation to give notice that it cannot fully perform as its contract otherwise requires, and then should attempt to mitigate the harm. Sometimes the force majeure clause allows outright termination of a contract. It is critical closely to examine the particular words of the provision for any guidance about the process and the relief. Documenting compliance will be essential.

Public perceptions of the severity of the outbreak will likely influence how courts may respond to these disputes. Usually, the party invoking force majeure must show that a disaster or other event was completely unforeseeable at the time the parties executed the contract.

If the parties could not have anticipated the event, then they could not have allocated the risk through negotiation and incorporated it into their agreement. A judge could easily conclude that no one could have predicted the coronavirus epidemic. However, with news of the illness being so prominent, a judge might also find that there was sufficient warning that a party could have prepared and at least avoided the worst consequences. Parties entering into new contracts today may want to consider how the current disease and future epidemics could affect their agreements.

Most arguments over whether a force majeure clause will afford relief will likely turn on whether “but for” the disease, the party could have performed its contract. For example, a creditor may contend that resort to force majeure is nothing but pretext, and that the debtor would have defaulted regardless of the outbreak. A debtor may argue that all was manageable until the coronavirus, and that the creditor should be sensitive to human tragedy.

If the sudden flood of litigation and bankruptcies during the financial crisis of 2008 is any guide, courts will initially take a flexible approach and push for accommodation and settlement, but then gradually take a stricter line as epidemic fatigue sets in and caseloads mount. If, along with other public facilities, the courts even temporarily close, the resulting judicial strain will likely create further pressure to dispose of cases as expediently as possible.

This means that the specificity of contract terms may be crucial.

Unfortunately, many written contracts may lack force majeure clauses, and oral agreements will of course not have them. Parties may then turn to the doctrine of “contractual frustration” for relief. Contractual frustration is hard to prove, but also allows a court fully to excuse performance when a truly unexpected event renders it physically or commercially impossible to fulfill an agreement. Showing contractual frustration requires a complicated, fact-intensive analysis of the terms of the contract, the background of the agreement, the knowledge of the parties at the time, and their ability to perform in the actual circumstances. These are usually questions decided by juries, which may add considerable uncertainty.

Moreover, the longer the coronavirus is a threat, the harder it will be to prove that its business impact is a real surprise. It is also likely that contractual frustration may become a primary defense of smaller, less sophisticated businesses – and consumers – claiming they cannot pay their bills, rent, and loans because of the epidemic.

In the aftermath of a deadly epidemic, some may perceive that settling business disputes by relying on contractual language and lawsuits is almost disrespectful of the tragedy. However, one of the purposes of a written agreement is to impose structure on relationships so that there is already a process in place to work through these kinds of crises and disputes.

Experience shows that privately negotiated contracts afford more certainty than depending upon the government to impose a solution. It is true that past natural disasters such as hurricanes have frequently resulted in special legislation and regulations to support afflicted businesses. These have ranged from cash aid and subsidy programs to efforts to change contractual terms by statute (which may be of questionable legality).

However, in the current political climate, legislative action may be controversial and only slowly passed and implemented. Rather than hoping for government to step in, looking to our contracts may offer a more reliable way of hedging the risk from the coming coronavirus outbreak.

[Jonathan W. Hugg](mailto:jhugg@schnader.com) is a partner at Schnader Harrison Segal & Lewis LLP and co-chairs the firm’s Financial Services Litigation Group. He can be reached at jhugg@schnader.com.