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Insights: Alerts

COVID-19: Contract Defenses

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Please note: The below information may require updating, including additional clarification, as the COVID-19 pandemic is dynamic and continues to develop. Please monitor this site and/or your email for updates.

The new coronavirus ("COVID-19") has prompted the World Health Organization to declare a pandemic, for President Trump to declare a National Emergency, for Italy to quarantine the entire country and for many other countries throughout the world to initiate aggressive containment and mitigation measures. The spread of COVID-19 and the increasing testing and mitigation measures are disrupting business activities and impacting the ability of parties to meet contractual obligations. Public health is the immediate overriding concern. Many businesses are canceling business trips, business meetings and instructing its workforce to work remotely. Cities are imposing ordering businesses to close and construction sites to shutter. Each of these actions are prudent public health measures. Nonetheless, each decision will impact ongoing commercial relationships and contracts.

The risks to a business include a) employment issues (loss of workforce due to illness), and productivity issues because workers have family care obligations or through making ad hoc remote work practices; b) operational disruptions to the supply chain; c) reduced customer demand; and d) reputational harm if the response to evolving events is insufficient. The Legal Alert focuses on several contract related issues to consider during the COVID-19 crisis and its aftermath.

Contracting parties are now facing supply delays, travel bans, quarantines and interruptions, and uncertainty that are impairing and frustrating the business purpose of their contracts. In evaluating the legal implications of the COVID-19 health emergency, there is no single answer. Each contract needs to be evaluated independently. The governing law of the contract as well as the risk allocation provisions and other contract terms will determine whether a contracting party may have a valid claim for time extensions, damages, or have performance excused.

In contracts governed by the laws of a state in the United States, defenses for non-performance asserted when an unexpected event, such as an epidemic, impairs contractual performance include the common law defense of supervening impracticability or frustration of purpose (Restatement (Second of Contracts) §§ 261 and 265), Change in Law or Prevention by Government Regulation or Order (Restatement (Second) of Contracts § 264), and a contractual *force majeure* defense.

The recent decision in *Rembrandt Enters., Inc. v. Dahmes Stainless, Inc.*, C.A. No. C15-4248-LTS, 2017 WL

3929308 (N.D. Iowa Sept. 7, 2017) addresses these issues and is worth reviewing. The key facts are that Rembrandt is a large scale producer of eggs that had a business opportunity to expand production facilities. As part of this business objective, Rembrandt entered into a contract with Dahmes to purchase egg-drying equipment. Before delivery, the Avian Flu epidemic inflicted poultry in Iowa and Minnesota. Rembrandt cut its production in half and declared a *force majeure* event under its egg supply contracts. Rembrandt also halted construction of its expanded facilities and cancelled the equipment contract. In the lawsuit, Rembrandt argued cancellation was appropriate under the defense of frustration of purpose; Dahmes filed a breach of contract claim. The court denied most of the cross-motions for summary judgment and set the case for trial.

Frustration of Purpose Defense:

- The parties' principal purpose in making the contract is frustrated (construction of the expanded egg processing facility as described in the contract);
- Without the party's fault (Avian flu outbreak was beyond Rembrandt's control);
- By the occurrence of an event, the non-occurrence of which was a basic assumption on which the contract was made (the dryer was to be installed in an expanded processing facility that no longer was being constructed).

Responses to a Frustration of Purpose Defense:

- Dahmes disputed the claim in part by arguing that the principal purpose of the contract was for it to sell equipment to Rembrandt. Nothing about that purpose has changed because the economics of egg production changed.
- Dahmes also argued the *force majeure* clause supplanted the common law claim of frustration of purpose.
- *Force majeure* did not excuse the buyer's performance.
- Strict compliance with the *force majeure* notice provisions was required.

Force Majeure Claims

The breadth of a *force majeure* clause was addressed in *Intern. Automotive Showcase, Inc. v. SMG, C.A.,* No. CV030477177S, 2004 WL 1833312 (D. Conn., July 21, 2004). The parties entered into a use license for the New Haven Coliseum for the plaintiff's automobile show. SMG was an agent of the New Haven Coliseum and a party to the license. The Coliseum Authority opted to close the facility and no longer host events after the Use License was executed. The show was canceled and IAS sued. SMG succeeded on its motion for summary judgment on its *force majeure* defense since it had no control over the decision to close the Coliseum. The *force majeure* had common language listing Acts of God, fires, floods and the like. The court held the clause sufficiently broad to cover the circumstances as applied to SMG. The court alternatively held the doctrine of supervening impossibility also applied.

- *Force majeure* is a defense by a party who has not performed its obligations under a contract. The

non-performing party bears the burden of proving the defense.

- An event outside the control of the party's must have occurred that prevented completion of the work.
- The event has to be the type of event identified as a *force majeure* event.
- The non-performing party must have taken action to try to perform but was unable to complete performance.
- Changes in economic feasibility typically are not *force majeure* events.

Change In Law/Prevention By Government Order or Regulation

The spread of COVID-19 has caused the WHO to declare a pandemic and for national governments, including the United States, to declare national emergencies. These declarations and their containment measures have included quarantines, travel restrictions, school closures, and encouraging people to stay home. Many contracts include provisions allocating risks caused by a Change in Law. Contracts should be reviewed to confirm whether a Change in Law provision is included and whether the actions by a foreign, national, state/province and local governments are addressed by the provision. Courts are likely to enforce the parties' risk allocation resulting from an applicable contract provision. There also is a common law defense that excuses performance prevented by a change in law or by a government regulation or order. Restatement (Second) of Contracts § 264. This rule applies when there is a supervening change in a law (defined broadly to include statutes, regulations, orders and ordinances) that was not expected that renders performance of the contract impracticable.

- The new government rules must render performance impracticable rather than merely inconvenient. As COVID-19 containment measures evolve and expand in scope, the impacts on a contract also will change. For example, a travel ban may modify how a contract was intended to be performed without preventing performance. For other contracts, an inability to travel may render performance impracticable.
- The change in law has to have been unexpected. Contracts executed after the virus was known and spreading may receive different treatment than contracts executed long before the pandemic.
- The reason why performance has become impracticable is through no fault of the non-performing party. Actions the non-performing party could have taken to allow performance but did not will not excuse performance.

Equitable Relief and Mitigation

A court may grant relief as a matter of equity under the principles stated in Restatement (Second) of Contracts § 272 ("Relief Including Restitution"). A court may order restitution or other relief to avoid an unjust outcome based on the supervening impracticability. This relief addresses changes in position by either contracting party, such as partial performance, before the events causing impracticability arose.

Also, the party seeking relief has a responsibility to mitigate its losses. The ability to do may depend on whether the impracticability of contract performance caused by COVID-19 is temporary or permanently has frustrated the purpose of the contract. It also may depend on whether alternative performance is available.

Government Contracts

Government contracts (federal, state and local) include a separate set of rules, regulations and practices that may differ from private party commercial contracts. It is important to review each government contract to determine the applicability and scope of *force majeure* clauses, and to comply with all notice requirements. Contractors should also seek to understand whether any of their government contracts require government orders to be given priority over commercial orders such as for certain Department of Defense contracts. If contract performance is impacted by Coronavirus events, document the cost impact and provide notice to the Government as soon as practicable. Contractors should also develop a program to be alerted to supply chain issues that may impact performance even if they are not directly impacted.

Practice Tips For Contracts

Review the contract and determine the following:

- What law governs and what does the contract state is its purpose;
- Is the stated purpose frustrated by the interruptions caused by the COVID-19 containment and mitigation actions;
- Is the frustration temporary or more permanent to the performance and purposes of the contract?
- Is alternative performance available?
- Does the contract have a *force majeure* clause and if so, are epidemics included as a *force majeure* event?
- What are the notice requirements of the *force majeure* clause?
- What are the mitigation requirements of *force majeure* clause?

Insurance

Different insurance policies may address the business risks discussed above (employment, contracts and reputation). The coverage may be different for workers and events occurring outside the United States and events occurring within the United States. A comprehensive risk management strategy should include a review of all potentially applicable local and global insurance policies to determine whether coverage for losses and damages caused by COVID-19 are available. An insured should examine whether it has potential coverage for business interruption losses under its property policies. An insured may have other liability policies in place to address injury or damage to employees or third parties. For example, to the extent that a company's employment policies or its directors' or officers' actions in response to COVID-19 are being questioned, an insured should consider whether or not those policies or actions have triggered any D&O, Employment Practices Liability (EPL), or other professional liability coverages. If there is a possibility of coverage for even a portion of your COVID-19 losses, an insured should submit a notification under all conceivably applicable policies. Failure to notify an insurer promptly of a claim or event in some jurisdictions can have serious consequences on an insured's ultimate ability to recover otherwise covered losses.

Practice Tips For Insurance

- Identify ongoing and future impacts to the business;
- Review all potentially applicable insurance policies; and
- Submit timely notice of events and claims under any and all potentially applicable policies.

Conclusion

COVID-19 is an ongoing health crisis that has significant legal and business implications. It is important to stay on top of all of the legal and business implications and to consult counsel promptly to ensure rights are not waived.

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