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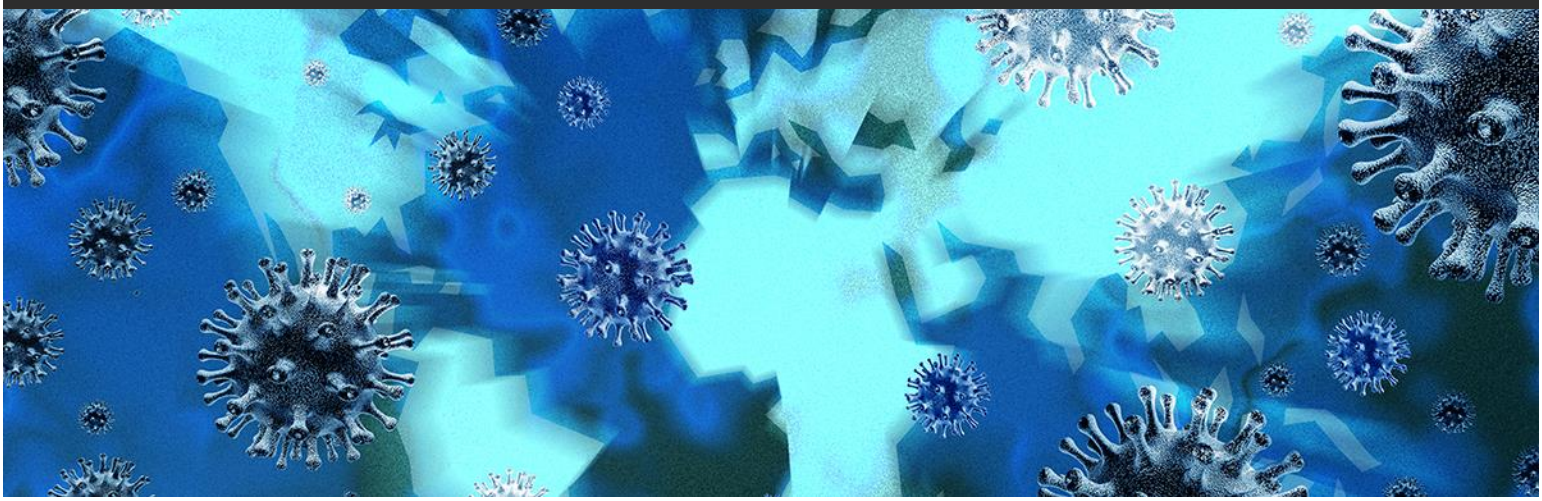
Alert | Health Emergency Preparedness Task Force: Coronavirus Disease 2019



March 2020

Risk Allocation for Economic Losses from Coronavirus Disease 2019

Coronavirus Disease 2019 (COVID-19) is causing unprecedented disruptions to the U.S. economy. Government officials and health professionals are predicting that these disruptions could continue through September. Businesses are having to face the challenges of operating remotely; many are cancelling non-essential travel – hampering long-planned meetings and conventions. Global supply chains are impeded as countries work to contain COVID-19's spread.

While economic considerations are secondary to the protection of human health, they should not be ignored. Companies often allocate the risk for unanticipated business interruptions through their contracts and insurance policies. Whether you are considering recovery options or are defending against breach of contract claims, there are some important legal concepts to consider.

Force Majeure

We covered force majeure in a March 3 GT Alert, "Coronavirus and Force Majeure Contract Clauses."

Force majeure is a common feature of contracts under common law legal systems. If you are evaluating a claim, or a counter-party is claiming that they may suspend performance or terminate the contract based on an event of force majeure, consider the following questions:

1. Is there a contractual force majeure provision?

2. What performance under the contract does the provision apply to?
3. Has a listed event of force majeure occurred (in whole or in part)?
4. Was the event beyond the reasonable control of the claiming party or without fault of the claiming party?
5. Was the event unanticipated or reasonably unforeseeable?
6. What specific factors prevent or materially delay/impact performance?
7. If the contract is governed by a civil law system, do any civil code provisions address force majeure?
8. Has your local jurisdiction implemented restrictions on travel, large gatherings, or imposed quarantines?

Resolution of these questions with respect to COVID-19 will be fact-specific and highly dependent on contractual wording. Decreased demand, higher production costs, or other purely economic factors typically do not constitute an event of force majeure. There must be a performance that has been prevented by a qualifying force majeure event. It has not yet been determined if government imposed closures, labor shortages, or lack of parts or components due to the virus will qualify.

Frustration of Purpose

In the United States and other common law jurisdictions, the doctrine of frustration of purpose is a cousin to the concept of force majeure, but does not require specific contractual language. The doctrine of frustration of purpose applies when a party's principal purpose in entering a contract is substantially frustrated (without the fault of the party making the claim) by the occurrence of an event the parties had assumed would not occur at the time the contract was made.

Perhaps the most famous case involving the concept of frustration of purpose is *Krell v. Henry*. In that 1903 English case, an apartment was rented for the purpose of watching the king's coronation. When the king fell ill and the coronation did not occur as planned, the tenant sought to cancel his performance under the contract. The landlord objected, stating that the obligation to rent the apartment was a binding obligation, whether or not the coronation occurred. The court agreed with the tenant, finding that where a contract had been made for a specific purpose and that purpose could not be carried out due to an unforeseen event without the fault of the tenant, the tenant should be relieved of the contract. Notably, the purpose at issue must be known to the counter-party but may not need to be stated in the contract itself. In *Krell*, all parties knew that the apartment was ideally suited for the purpose of viewing the coronation, and the purpose had been discussed at the time the lease was made.

Whether this doctrine applies to business interruptions due to COVID-19 will depend on a close factual examination of the circumstances as well as the contract itself. The law governing the contract will also need to be examined to determine whether frustration of purpose is conceptually available. There are numerous theoretical applications of this concept. For example, where a specific order for goods or services is tied to a particular event and the contract identifies the quantity, the product, and the timing of delivery but does not state the purpose of the purchase however it is fairly evident to both parties, the contract may have been frustrated.

Like force majeure, frustration of purpose is often not the preferred method for breaking a contract because the circumstances where these concepts may apply are fairly narrow. However, given the unprecedented nature of the current COVID-19 situation, an uptick in these types of claims seems likely.

Impossibility vs. Impracticability

Under early common law, the doctrine of impossibility excused the nonperformance of duties under a contract, based on a change in circumstances that makes performance of the contract literally impossible (i.e., the destruction of a theater makes the performance within the venue impossible). However, modern contract law along with and the Uniform Commercial Code (U.C.C.) have evolved the view of the impossibility doctrine as more of impracticability, meaning that now, literal impossibility may no longer be required.

Impracticability has been argued in many ways. At the core of many arguments is that the party should be excused of his or her responsibilities because performance has been made exceptionally and unreasonably burdensome, or impracticable by a catastrophic unforeseen event (i.e., such extraordinary performance to comply with the terms of the contract was not contemplated by the parties at the time the contract was made), and that such event was not caused by the party seeking to be excused. The catastrophic event must be unforeseeable (but not unimaginable), meaning that it was so unlikely that a reasonable party would not have drafted provisions in the contract when it was written to address it.

Compliance With All Laws Clauses

"Compliance with all laws" clauses are typically contained in contracts and provide that "each party agrees to comply with all laws, statutes, rules and regulations" relating to their duties under the contract. While this type of language is typically not considered a "big deal," because people often think, "of course, I will follow the law," such provisions may be beneficial when: (i) determining what the law requires in terms of performance of a party; (ii) or excusing future performance if doing so would be illegal or impermissible under any laws, statutes, rules, and regulations (e.g., laws prohibiting the sale of certain products or regulations preventing large group gatherings due to safety and health concerns). As such, parties should also consider the local, city, state, county, and federal laws that may dictate performance in conjunction with the parties' contractual obligations.

Looking Ahead

- Understand and evaluate your individual facts and circumstances.
- Monitor the situation – in real time. The current situation is fluid, meaning facts and circumstances can change quickly, and often do.
- Know what your contracts say, and understand the implications of your decisions. Review before you act.
- Look at the local laws (federal, state, and city) to determine if they affect how you proceed with your performance.
- Keep detailed records that include the scope of the interruption to your business, and detail the factors that you may rely upon for potentially excusing your performance.
- Review your insurance coverages.
- Consider whether there are alternative means to perform contractual obligations.

- Consider business solutions to legal issues, such as a mutual agreement to move your event or obligation to a time after the crisis is over, or a negotiated resolution.

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