Lawyer Insights

Managing COVID-19 Risk In New Agreements

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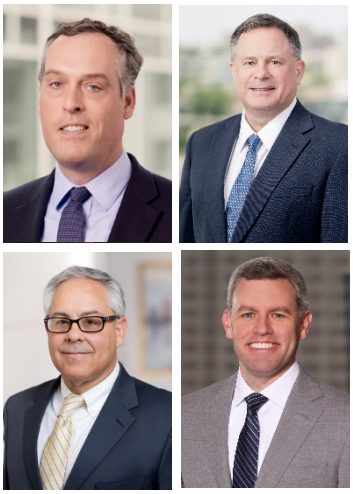

Nobody knows when the effects of COVID-19 on the economy will begin to loosen, but two things appear clear: The end will be gradual rather than a single point in time, and businesses need to have a framework for getting back to normal.

This article first identifies several legal doctrines commonly used to excuse contractual obligations: force majeure, impossibility and frustration of purpose. It then discusses how and why those doctrines need to be considered carefully to apply to COVID-19-related risks in new agreements.

Force majeure clauses define unanticipated circumstances beyond the contracting parties' control that render contractual performance too difficult, or even impossible, and will excuse or delay the duty to perform. Typically, they contain an enumerated list of calamities, such as natural disasters, strikes, or civil or military disturbances, followed by a broad catch-all phrase like "or conditions beyond the party's reasonable control."

The theory behind the clause is that at the time of contracting, neither party reasonably anticipated and priced into the agreement the risk of the force majeure event. Force majeure clauses can only be invoked when a qualifying event occurs. Because courts construe them narrowly, it is crucial to comply with any notice requirements, and document exactly how the triggering event has limited a party's ability to perform at the time of invocation.

The common law doctrine of impossibility excuses a party's contractual obligations when supervening circumstances make performance impossible or impracticable.[1] Often the decisive element is that the parties must have shared a basic assumption that the supervening event would not occur.

In the 19th century, courts insisted on strict impossibility. Under that inflexible standard, performance must have been physically or legally impossible. Today, many United States jurisdictions have adopted a less restrictive impracticability standard, reflected in Uniform Commercial Code Section 2.615 and the Restatement (Second) of Contracts Sections 261 and 272.

Closely related to impossibility, frustration of purpose applies when an unexpected change in circumstances makes one party's contract performance worthless to the other party.[2] The principal purpose of a contract must be something that is so completely the basis of the contract that, without it, the transaction between the parties would make little sense. Thus, while impossibility is primarily concerned with "the nature of the event and its effect upon performance," frustration is concerned with "the impact of the event upon the failure of consideration."[3]

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With these doctrines in mind — and before you bump elbows to consummate your next contract — here are three legal strategies to anticipate and help avoid coronavirus-related contract disputes.

First, reconsider the boilerplate force majeure clause. Depending on the provision's language and the jurisdiction, force majeure provisions may only cover unanticipated events that are not reasonably foreseeable at the time of contracting. The conditions caused by the current pandemic are now public knowledge, and there is broad scientific and governmental consensus they will persist for a number of months.

Because the effects of the pandemic arguably are reasonably foreseeable now, they may not constitute a force majeure event that would excuse or suspend a party's obligation to perform under a contract entered into after the outbreak. Instead, courts may expect parties to allocate SARS-CoV-2 (the virus) and COVID-19 (the disease) risk in other contract provisions.

In that scenario, consider a provision that expressly recognizes the current state of affairs concerning SARS-CoV-2 and COVID-19, and provides relief from performance in the event that the virus or any mutation thereof, as well as any illnesses it causes, is still a factor at the time of performance under the new contract.

Otherwise, treat the force majeure provision as a clause worthy of negotiation and contemplation, rather than imprecise boilerplate. Consider adding "epidemic or pandemic" to the list of catastrophes that have been gathered by previous generations of lawyers and contract negotiators, as well as language specifically tailored to events that could frustrate or render impossible the underlying purpose of the agreement.

For example, a supplier of widgets may want to add specific language allowing suspension or termination of performance if its input costs rise more than X% as a result of a force majeure event. Also be sure to specify whether performance is excused, or merely delayed until the end of the force majeure event, when performance is once again feasible. If the contract delays an obligation to perform, setting a deadline for when performance is due after the force majeure event ends can anticipate and avoid future disputes between parties.

Second, consider drafting the contract so that it requires parties to use best, reasonable or commercially reasonable efforts to fulfill their obligations, depending on your preference. These standards have been incorporated into Uniform Commercial Code Section 2-306, but often differ in application across jurisdictions.

Courts use a variety of factors to determine whether a party satisfied an "efforts provision," including the specific facts of the case and the totality of the parties' business relationship. It is important that any efforts provisions be drafted clearly, so that both parties have the same expectations and understanding of the contract before performance is due.

For sales of goods, for example, parties may wish to stipulate acceptable prices or quality of merchandise. For services contracts, parties may wish to stipulate conditions or thresholds that will excuse either party's performance.

And third, when drafting clauses that qualify a party's performance, account for events that are reasonably foreseeable in a pandemic. For example, the novel coronavirus could mutate to create a new

strain and resulting disease. And even if supplies are available to fulfill a goods contract, a seller may not have a sufficiently healthy workforce to manufacture or transport the order.

Other possibilities: Government authorities may regulate or restrict trade in supplies needed to treat the sick or assist with the recovery; international borders with Mexico or Canada could be closed; nonessential businesses or travel may be temporarily banned; or industry capacity could be impacted by laws like the Defense Production Act.

Notes

1. See Restatement (Second) of Contracts § 261 (1981)

2. See Restatement (Second) of Contracts § 265 (1981)

3. Seaboard Lumber Co. v. United States, 308 F.3d 1283, 1296 (Fed. Cir. 2002)

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