Contract Defenses in the Age of COVID-19

All of your businesses of whatever type are being affected by the COVID-19 pandemic and the resultant shut-downs, work stoppages, and government imposed restrictions. And all of your businesses are facing, or will soon be facing, two intractable problems:

- Individuals or companies that you do business with want to use the pandemic as an excuse not to perform under a contract, commercial lease, or purchase or service agreement;

- You have performance obligations with counterparties that have literally become impossible to perform, or the pandemic has caused such severe economic hardships by governmental fiat or otherwise, that performance by you is simply impracticable.

Under either scenario, it is imperative that you understand the contours of the various legal defenses that can be asserted as a defense to contract performance. The following is our effort to give you a basic understanding of these defenses. It is broken up into three types of defenses that can be raised under the current situation:

- Force Majeure;
- Material Adverse Change Clauses; and
- Commercial Impossibility or Impracticability

As each of these defenses is very fact driven, we are here to discuss with you their applicability to your business. And as always, we are here to help in any way we can during these most difficult times.

Force Majeure

Early common law did not excuse contractual performance even when an extreme event such as an invasion, the passage of a law, or a natural disaster prevented the undertaking. *Force majeure* clauses were created to fill that gap, and relieve a party of liability for failure to perform upon the occurrence of identified events or effects "that can be neither anticipated nor controlled" and that: (a) are beyond the control of the parties; and (b) impose extreme hardship, expense, or difficulty rendering performance impossible. *N. Ind. Pub. Serv. Co. v. Carbon Cnty. Coal Co.*, 799 F.2d 265, 276 (7th Cir. 1986) (Illinois law); *Butler v. Nepple*, 354 P.2d 239, 245 (Cal. 1960) (California law); *Goldstein v. Orensanz Events LLC*, 146 A.D.3d 492, 493 (N.Y. App. Div. 2017) (New York law). The effect of a force majeure clause is similar to the modern common law doctrine of impossibility of performance and the Uniform Commercial Code rules on

impracticability of performance. U.C.C. § 2-615; *Commonwealth Edison Co. v. Allied-Gen. Nuclear Servs*., 731 F. Supp. 850, 855 (N.D. Ill. 1990).

A *force majeure* clause may not be implied in a contract; they must be express and are construed narrowly. *Kel Kim Corp. v. Cent. Markets, Inc.*, 519 N.E.2d 70 N.Y.2d 295 (N.Y. Ct. App. 1987). Thus, in most jurisdictions, only specifically-listed events will trigger the clause. And if the clause includes a catch-all like "and other events that prevent performance that are beyond the control of the non-performing party," it will be interpreted pursuant to the doctrine of *ejusdem generis*, so it will include only the same general kind or class of events as those specifically listed. *Team Mktg. USA Corp. v. Power Pact, LLC*, 41 A.D.3d 939, 942-43 (N.Y. Sup. Ct. App. 2007). Also, the oft-used phrase "acts of God" is generally interpreted to mean an event "occasioned exclusively by natural causes, such as could not be prevented by human care, skill, and foresight," and where the alleged act is the sole and proximate cause of one's injury. *Wald v. Pgh., Cin., Chi. & St. Louis R.R.*, 44 N.E. 888, 889 (Ill. 1896). Examples include sudden illness or death and violent snowstorms. *Evans v. Brown*, 925 N.E.2d 1265, 1273 (Ill. App. Ct. 2010); *Cormack v. New York, N.H. & H.R. Co.*, 90 N.E. 56, 59 (N.Y. Ct. App. 1909).

The party seeking to invoke the benefit of *force majeure* must demonstrate that a triggering event has occurred due to no fault of their own, and that they are unable to fulfill their contractual obligation despite their best efforts. If they can meet this standard, then the *force majeure* clause will apply, but it only excuses liability in accordance with its terms. For instance, it may apply to some, but not all, of a parties' duties. *E.g.*, *San Mateo Cmty. Coll. Dist. v. Half Moon Bay Ltd.*, 76 Cal.Rptr.2d 287, 294 (Cal. Ct. App. 1998), *as modified* (July 1, 1998). And some clauses may only allow a delay in performance, whereas others may excuse performance entirely or even provide grounds to cancel the contract.

Whether a *force majeure* clause applies to the current COVID-19 circumstances must be decided based on its specific terms. Most clearly, if the clause includes a "pandemic" or similar language, it should be applicable. There is also a good argument that COVID-19 is an "act of God." Further, even if a *force majeure* clause does not include language that can be triggered by the pandemic itself, it may include the pandemic's consequences. For instance, a clause that includes "government orders" may cover when a business that cannot perform because it has been ordered to shut down as a non-essential business. Or, if the clause identifies foreign supply disruptions as a *force majeure*, and a party cannot obtain supplies sufficient to perform due to coronavirus conditions in a foreign country (like port shutdowns), that may also qualify.

Material Adverse Change Clauses

Commercial agreements often include a clause that allows one party to terminate or modify its obligations to the other in the event of a "material adverse change" or "material adverse effect." These "MAC" clauses are often found in merger and acquisition agreements and commercial financing agreements. Generally, these provisions allocate risk in the event of a material adverse change in circumstances between the time a contract is signed and when performance is required, such as when the contemplated acquisition must close or the loan must be funded.

MAC clauses are usually highly negotiated and therefore vary greatly from contract to contract. However, in general, a MAC clause in a merger and acquisition agreement will provide that the buyer is not required to close on the acquisition in the event of a material adverse change in the value or financial condition of the target. A MAC clause in a commercial loan will provide that the lender need not close on the loan or make further advances in the event of a material adverse change in the business operations, assets, liabilities or financial condition of the borrower. Generally, a MAC clause will define the triggering event as one that would reasonably be expected to have a material adverse change on the business, assets or operations of the subject party, but expressly *exclude* broad categories of general financial risks, as well as natural disasters and acts of God. Typically, there is no express definition of the specific event that will constitute a material adverse event or a dollar value threshold concerning materiality. As a result, it is left to the courts to determine whether a material adverse change has occurred, and there is no bright line test.

In virtually all jurisdictions, including Illinois, Delaware, New York and California, invoking a MAC clause is difficult. It is the burden of the party seeking to invoke the clause to establish that the provision has indeed been triggered, which is a fact intensive inquiry. *E.g.*, *Solutia Inc. v. FMC Corp.*, 456 F. Supp. 2d 429, 442 (S.D.N.Y. 2006) (determining whether a MAC has occurred "requires an assessment of all the facts and circumstances surrounding the situation"); *Israel v. Nat'l Canada Corp.*, 658 N.E.2d 1184, 1191 (Ill. App. Ct. 1995) ("The issue of whether a material adverse change in [plaintiff's] financial condition occurred is a question of fact and will not be disturbed on review unless the finding is against the manifest weight of the evidence."). Courts will look to the terms of the parties' written contract to determine their intent in determining whether a MAC clause has been invoked properly.

Further, under a seminal case on MAC clauses, the party seeking to invoke the clause must establish that the adverse change is (1) so severe that the party has lost the benefit of its bargain; and (2) the condition will last a significant duration, better measured in years than months. *See Akorn, Inc. v. Fresenius Kabi AG*, No. 2018-0300-JTL, 2018 WL 4719347, at *53 (Del. Ch. Oct. 1, 2018). Proving a material adverse change relies heavily on fact witness testimony and almost always requires expert witnesses to opine on issues of materiality and valuation. Because these disputes are fact intensive and rely on experts, they are usually poor candidates to be resolved on summary judgment. A full blown trial is often required, and outcomes are exceedingly difficult to predict.

Whether the COVID19 pandemic is a material adverse change under a commercial contract requires a careful review of the terms of the agreement. Indeed, in *Akorn*, the parties expressly agreed that a "pandemic" did *not* qualify as a material adverse change. *See* 2018 WL 4719347, at *51. The question also relies heavily on the severity and duration of the event. With respect to COVID19, both the severity and, in particular, the duration are still unknown.

Alternative Defenses in the Absence of *Force Majeure* or Material Adverse Change ("MAC") Clauses

Even if a contract does not contain a *force majeure* or MAC clause, or the clause is inapplicable under the circumstances, parties might still be excused from performing under common or

statutory law. The following summarizes the circumstances and their applicability to the COVID-19 virus.

A. The Defense of Impossibility/Impracticability of Performance

At common law, in jurisdictions like Illinois, New York, California, and Delaware, as well as many others, impossibility or impracticability of performance may excuse performance under a contract.[1] In general, "impossibility" of performance excuses performance only when the performance is rendered *objectively* (rather than subjectively) impossible either because the subject matter of the contract is destroyed or performance is rendered impossible by operation of law. In addition, the impossibility must be the result of an unanticipated event that could not have been foreseen or guarded against in the contract.

The law of "impracticability" of performance generally provides that:

> Where, after a contract is made, a party's performance is made impracticable without his fault by the occurrence of an event the non-occurrence of which was a basic assumption on which the contract was made, his duty to render that performance is discharged, unless the language or the circumstances indicate the contrary.[2]

However, for performance to be impracticable, the event must be unforeseeable, and the party seeking to avoid performance is expected to make all reasonable efforts to overcome any obstacles to performance.[3] Circumstances that make performance merely unprofitable, difficult, or inconvenient are typically insufficient to relieve a party of its duty to perform.[4] Financial hardship or economic difficulty alone will almost never excuse performance.[5] Natural disasters,

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[1] Delaware courts now generally apply the more generous impracticability standard only; with the exception of cases governed by the Uniform Commercial Code ("UCC"), New York and Illinois courts typically apply the impossibility standard, although Illinois courts sometimes demonstrate more flexibility; California's common law impossibility defense has expanded to include impracticability.

[2] Restatement (Second) of Contracts § 261 (1981) (hereafter "Restatement").

[3] *E.g.*, *YPI 180 N. LaSalle Owner, LLC v. 180 N. LaSalle II, LLC*, 933 N.E.2d 860, 866 (Ill. App. Ct. 2010) (must be unforeseeable); *Mountaire Farms, Inc. v. Williams*, No. C.A. 03C-10-002-RFS, 2005 WL 1177569, at *6 (Del. Super. Ct. Apr. 25, 2005) (same); Restatement § 261 cmt d (must use reasonable efforts to overcome condition).

[4] Restatement § 261 cmt d.

[5] *E.g.*, *Bank of Am., N.A. v. Shelbourne Dev. Group, Inc.*, No. 09 C 4963, 2011 WL 829390, at *5 (N.D. Ill. Mar. 3, 2011); *Lloyd v. Murphy*, 153 P.2d 47, 51 (Cal. 1944); *but see Kennedy v. Reece*, 37 Cal. Rptr. 708, 712 (Cal. Ct. App. 1964) (determining that the doctrine of impracticability excuses performance where a party can show that performance will be so difficult and unreasonably expensive that it becomes impracticable).

acts of God, crop failures, insurrections, and wars, can give rise to impossibility defenses.[6] So too can government laws, regulations, directives, and orders.[7]

Similarly, for contracts dealing with the purchase and sale of goods covered by the UCC, Section 2-615 of the UCC provides that a seller is excused from performing under a contract when "performance as agreed has been made impracticable by the occurrence of a contingency the non-occurrence of which was a basic assumption on which the contract was made or by compliance in good faith with any applicable foreign or domestic governmental regulation or order whether or not it later proves to be invalid."[8]

And, when a seller provides notice of impracticability under Section 2-615, the buyer might be permitted to terminate the contract under Section 2-616 of the UCC. As one Illinois court concluded, "a party seeking to excuse his performance must show that the loss will be so severe and unreasonable that failure to excuse performance would result in grave injustice."[9] Again, and as with the defense at common law, financial hardship alone is usually not enough to excuse performance.[10]

At common law or under the UCC, the defenses of impossibility/impracticability are very narrowly applied by courts. Generally speaking, once a party to a contract has made a promise, that party must either perform or pay damages for nonperformance, even when unforeseen circumstances make performance burdensome. Courts recognize that the purpose of entering into a contract is to allocate the risks that might affect performance, and therefore, performance is excused only under extreme circumstances.[11] Further, these defenses typically require a fact-specific inquiry by the court. Therefore, just like material adverse change clauses, in many cases the court will be unable to resolve the dispute on summary judgment, and a trial will be required.

Regarding the pandemic, it is possible that these defenses could apply, particularly if courts determine the pandemic was not foreseeable at the time of contracting. For example, the governments of many jurisdictions have implemented various directives ordering people to stay home and non-essential businesses to close -- to devastating financial effect on many individuals and businesses. However, it remains to be seen how long these circumstances will last and what impact they might have. Typically, extraordinary conditions that are temporary will only

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[6] Restatement § 261 (1981) cmt d.

[7] *Rosenberger v. United Cmty. Bancshares, Inc.*, 73 N.E.3d 642, 650 (Ill. App. Ct. 2017) (citing Restatement § 264 (1981)); *Commonwealth Edison Co. v. Allied-Gen. Nuclear Servs.*, 731 F. Supp. 850, 855 (N.D. Ill. 1990).

[8] 810 ILCS 5/2-615; NY UCC § 2-615; Cal. Com. Code § 2615; DE ST TI 6 § 2-615.

Moreover, Comment 9 to Section 2-615 indicates that its provisions are equally applicable to buyers so long as they comply with all of the statutory requirements. *E.g.*, *N. Ill. Gas Co. v. Energy Co-op., Inc.*, 461 N.E.2d 1049, 1060 (Ill. App. Ct. 1984).

[9] *N. Ill. Gas Co. v. Energy Co-op., Inc.*, 461 N.E.2d 1049, 1061 (Ill. App. Ct. 1984).

[10] 810 ILCS 5/2-615 cmt. 4; NY UCC § 2-615 cmt. 4; DE ST TI 6 § 2-615 cmt. 4.

[11] *Kel Kim Corp. v. Cent. Markets, Inc.*, 519 N.E.2d 295, 296 (N.Y. App. Div. 1987).

suspend a party's duty to perform, while the condition creating the defense exists, but will not discharge that duty after the cessation of the condition.[12]

B. The Defense of Frustration of Purpose

Illinois, New York, California, and Delaware, among others, also recognize the related defense of frustration of purpose or commercial frustration. Generally, the doctrine provides that a party is discharged from its duties to render performance "where, after a contract is made, the party's principal purpose is substantially frustrated without its fault by the occurrence of an event, the non-occurrence of which was a basic assumption on which the contract was made."[13]

For the defense to be viable, the frustrated purpose must completely destroy the basis of the contract that both parties understood that without it, the agreement would not have been made.[14] If an event is reasonably foreseeable and the agreement nonetheless fails to provide protection, the defense of commercial frustration is not available.[15]

Like impossibility and impracticability of performance, the defense of frustration of purpose is narrowly applied by courts, and similarly, financial hardship is typically not enough to successfully invoke the defense.[16]

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[12] Restatement § 269.

[13] Restatement § 265; *see also LECG, LLC v. Unni*, No. C-13-0639 EMC, 2014 WL 2186734, *7 (N.D. Cal. May 23, 2014), *aff'd*, 667 F. App'x 614 (9th Cir. 2016), providing that under California law, the frustration of purpose must apply to all contracting parties, not just one.

[14] *Crown IT Servs., Inc. v. Olsen*, 11 A.D.3d 263, 265 (N.Y. App. Div. 2004); *Ill.-Am. Water Co. v. City of Peoria*, 774 N.E.2d 383, 390 (Ill. App. Ct. 2002) ("commercial frustration will render a contract unenforceable if a party's performance under the contract is rendered meaningless due to an unforeseen change in circumstances"); *Cutter Labs., Inc. v. Twining*, 34 Cal. Rptr. 317, 324 (Cal. App. Ct. 1963) (the value of the performance must be destroyed substantially).

[15] *Ill.-Am. Water Co.*, 774 N.E.2d at 390-91; *Roberts*, 370 N.E.2d at 273; *Mitchell v. Ceazan Tires, Ltd.*, 153 P.2d 53, 54 (Cal. 1944); *In re: Ampal-Am. Israel Corp.*, No. 15-CV-7949 (JSR), 2016 WL 859352, at *3 (S.D.N.Y. Feb. 28, 2016), *aff'd sub nom*. *In re Ampal-Am. Israel Corp.*, 677 F. App'x 5 (2d Cir. 2017) (concluding that the event must "amount to a virtually cataclysmic, wholly unforeseeable event").

[16] *Sunshine Imp. & Exp. Corp. v. Luxury Car Concierge, Inc.*, No. 13 C 8925, 2015 WL 2193808, at *5 (N.D. Ill. May 7, 2015); *A+E Television Networks, LLC v. Wish Factory Inc.*, No. 15-CV-1189 (DAB), 2016 WL 8136110, at *13 (S.D.N.Y. Mar. 11, 2016).