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Client Alert

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No *Force Majeure* Clause? Other Potential Options to Excuse Contractual Performance Under US Law in the Face of COVID-19

The rapid spread of the novel coronavirus disease 2019 (COVID-19) and the varied government responses thereto have caused significant disruption to commercial operations and relationships. Some companies are considering whether the outbreak constitutes a *force majeure* event, but what if your contract does not include an express *force majeure* clause? Before concluding that there is nothing that you or your contracting counterparty can do when facing disruptions as a result of COVID-19 (or a crisis event generally), take a close look at the applicable law. There may be other options available under US law to excuse non-performance of a commercial contract in the face of a crisis, though it may be difficult to prevail under these alternative theories.

Frustration/Impossibility

Most US states recognize common law doctrines such as "frustration" or "impossibility," which may be invoked to excuse contract performance under certain circumstances. But parties choosing to invoke these common law doctrines often face significant hurdles.

For example, New York law limits the doctrine of impossibility to cases where (1) performance is "objectively" impossible due to the "destruction of the means of performance" by an act of God, *force majeure* event, or the subsequent passage of law rendering performance illegal or (2) there has been a change in circumstances so fundamental that it would be unjust or contrary to public policy to hold the parties to their original agreement. Generally speaking, "impossibility" could include, for example, the death or incapacity of a person necessary to performance or the destruction of an irreplaceable good or component. Impossibility generally would not include events like the destruction of commutable inventory or inconvenience.

Texas law—like New York's—recognizes the doctrine of impossibility of performance. Texas courts will excuse a party's performance where, after a contract is entered, performance is rendered impossible "without his fault by the occurrence of an event." The doctrine requires that non-occurrence of the event was a basic assumption on which the contract was made. In other words, events that were foreseeable at the time of contract formation, and part of the mutual intent of the parties, will not excuse non-performance. Using impossibility as a basis to excuse contract obligations can be challenging, because Texas courts have interpreted "impossibility" to require more than mere difficulty, hardship, or expense. And Texas courts require the party invoking impossibility to have made "reasonable efforts to surmount the obstacle to performance," such as by providing cover.

Companies that ***have*** included a *force majeure* provisions in their contract should be aware that—in jurisdictions like New York and Texas, which construe *force majeure* clauses narrowly—the inclusion of a *force majeure* clause may preclude them from later asserting "impossibility." Courts in New York and Texas have prevented parties from invoking "impossibility" where a *force majeure* event was foreseeable at the time of formation and could have been—but was not—enumerated in the *force majeure* clause. In these jurisdictions, a court will only release the parties from their contractual obligations due to events that were "unanticipated" at the time the contract was formed, meaning that the event could not have been foreseen or guarded against in the *force majeure* clause. For this reason, it is crucial that *force majeure* provisions are carefully drafted, and the rights and obligations of both parties specifically defined therein.

California has expanded its common law impossibility defense to include impracticability. The doctrine of impracticability—which, as one might expect, is easier to demonstrate than impossibility—excuses performance where a party can demonstrate that performance may be so difficult and expensive that it becomes "impracticable," though technically possible. Circumstances rendering performance more difficult or costly than the parties originally contemplated do not necessarily rise to the level of impracticability, however. Impracticability requires a showing that performance can only be accomplished with "excessive and unreasonable" cost, which is obviously a highly fact-based showing.

Some states, like California and New York, also recognize a defense based on "frustration of purpose," which releases a party from its contractual obligations where a supervening event substantially obviates/frustrates the purpose underlying the contract. In other words, this doctrine applies when "the frustrated purpose is so completely the basis of the contract that, ***as both parties understood***, without it, the transaction would have made little sense." Like impossibility, this requires that the frustration resulted from a change in circumstances that was unforeseeable and beyond the parties' control. The key distinction is that the frustration must be ***mutual***; that is, the change in circumstances must have rendered the contract pointless for ***both*** parties.

It should be noted that, while Texas recognizes "frustration of purpose," it is in name only. At common law, the doctrine is functionally equivalent to the "impossibility" defense.

The United Nations Convention on Contracts

In signatory nations, the United Nations Convention on Contracts for the International Sale of Goods (CISG) governs contracts for the sale of commercial goods between parties in different countries (that is, unless the parties have expressly waived its applicability). Article 79 of the CISG may excuse nonperformance that results from an unforeseeable impediment beyond a party's control that it could not have overcome.

The Uniform Commercial Code

Article 2 of the Uniform Commercial Code (UCC) may also excuse performance where performance is rendered impracticable by either (1) the occurrence of an event "the nonoccurrence of which was a basic assumption on which the contract was made" or (2) good faith compliance with foreign or domestic government regulation. *See*, *e.g.*, N.Y. U.C.C. § 2-615(a); Cal. Com. Code § 2615; Tex. Bus. & Com. Code § 2.615; Fla. Stat. § 672.615. This "impracticability" standard can be less rigid and more easily demonstrated than common law "impossibility" because it does not require a showing that performance is objectively impossible. Instead, impracticability will excuse performance where performance is theoretically possible but prohibitively expensive.

US courts have held, however, that the contract's terms may alter the UCC's applicability and that the mutual intent of the parties at the time of contracting controls. For example, the parties may provide in their *force majeure* clause that performance will be excused on a showing of "hardship," or a standard that is less exacting than the "unreasonable" or "prohibitive" expense required by the UCC. Furthermore, Article 2 only governs contracts for the sale of goods. Thus, unless state law otherwise recognizes impracticability as a defense at common law (*e.g.*, in California), performance of contracts for services or real property will not be excused based on commercial impracticability.

Material Adverse Change/Effect

Some contracts expressly allocate risk based on events that could result in a material adverse change (MAC) or material adverse effect (MAE) on the business or its prospects. The occurrence of a MAC or MAE may give the invoking party the right to avoid performance or even terminate the contract. Examples of MACs or MAEs include, but are not limited to: (a) breach or default under a related contract; (b) threatened litigation or arbitration; or (c) situations that would materially impact the operations or financial performance of the company. With respect to COVID-19 or another crisis event, a MAC or MAE might include travel restrictions, supply chain disruptions or shortages, lock-downs and quarantines, all of which have the potential to materially affect a company's commercial operations or long-term prospects, at least while the crisis is ongoing.

What Should Companies Consider if their Contract Lacks a Force Majeure Clause?

Companies should take proactive steps to mitigate their risk triggered by a potential *force majeure* event, even if their commercial agreements lack an express *force majeure* clause. As noted above, the existence (or absence) of a *force majeure* clause is not the end of the inquiry. As explained here and in prior posts, there may be other avenues for a company (or its counterparty) to seek relief from contractual obligations due to a *force majeure* event, including remedies at common law, under the CISG or Article 2 of the UCC. If your commercial agreement has no *force majeure* provision, consider taking the following steps:

1. Carefully review the options available under the US state law governing your contract. Evaluate whether the non-performing party will have to demonstrate impossibility of performance or mere impracticability. Likewise, if frustration is a recognized doctrine in the relevant state, consider whether the purpose underlying the agreement has been frustrated for both parties.

2. For companies considering invoking common law "impossibility," evaluate whether performance is objectively impossible. Can a party perform its contractual obligations or will performance merely be difficult or expensive? There may be a valid impossibility defense if, for example, a person necessary to performance has died or become incapacitated or quarantined, or if performance has been rendered illegal by government containment procedures or other regulations.

3. If you are a supplier of goods, consider your contingency plans in the event that your supply chain is disrupted by COVID-19. Under the laws of most US states, you will be required to source goods from alternate suppliers to deliver on your contractual obligations, which can be costly. Be sure to weigh the economic impact of obtaining cover against the expense of defending a breach of contract claim. Additionally, consider whether the cost of obtaining cover is "unreasonable" enough to avail you of the "impracticability" defense under the UCC (or potentially state common law).

4. Consider whether a party is seeking relief from a commercial contract for the sale of goods, or a contract for services or real property. If the former, the dispute is likely covered by the UCC, which may be less rigid than the common law. For international contracts for the sale of goods, evaluate whether the CISG applies and, if so, whether the crisis could be considered an unforeseeable event that cannot be overcome.

5. Retain counsel to draft (or at least review for you) a *force majeure* clause to include in future contracts (and in amendments to existing contracts, where possible). The *force majeure* language should specifically define the triggering *force majeure* events and the rights and obligations of both parties. Particularly for companies operating in jurisdictions that narrowly construe *force majeure* clauses, such as New York and Texas, the contours of the *force majeure* clause and the triggering events should be carefully defined.

Please contact us if you have any questions.

Jennifer Ancona Semko
Partner, Washington, DC
jennifer.semko
@bakermckenzie.com

Mark Goodman
Partner, San Francisco
mark.goodman
@bakermckenzie.com

Mark McCrone
Associate, Washington, DC
mark.mccrone
@bakermckenzie.com

Marisa Bakker
Associate, Washington, DC
marisa.bakker
@bakermckenzie.com

Maria McMahon
Associate, Washington, DC
maria.mcmahon
@bakermckenzie.com