# Contract Performance and Frustration in Coronavirus's New Normal

## Performing the Impossible and Impractical in Key Jurisdictions

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# Speakers

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# Goal

To provide a framework to analyze how the COVID-19 pandemic might affect contract performance, especially where agreements are silent and common law principles will apply

*Note: We are not providing legal advice in this seminar. For that, please contact an individual Venable lawyer.*

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# Roadmap for today

- Which state law applies?
- Major branch: Does the contract address force majeure or not?
  - If it DOES, exercise is to construe the language and intent
    - Ex. MAC/MAE in M&A deals
  - If it DOES NOT, common law principles of impracticability, impossibility, and frustration may apply
    - Most of today's presentation
  - In MIXED CASES – Some mention of force majeure but not with full clarity as to performance at issue, interesting analysis
    - One argument will be that by addressing it, the parties definitively meant NOT to apply the excuse of force majeure
- Is this pandemic a "force majeure" event?
- If so, what is the effect? Is the contract just terminated? Can a judge/arbitrator fashion other relief, such as recession?
- Q&A – You will be able to submit questions

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# Sidebar: Contracts currently under negotiation or being drafted

- You should consider and address COVID-19 and its downstream effects
- It is certainly no longer an “unforeseen” event
- Specifically set forth whether COVID-19 secondary effects will excuse or delay performance

# General principles of contract law

## Contract Performance and Frustration Given New Normal

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# *Force Majeure*

- Allows parties to allocate risk and decide what will or will not excuse performance
- Equivalent to an affirmative defense
- Must be beyond the party's control and not due to its fault or negligence
- Must fit within one of the categories in the contract
- Contract may have additional requirements, such as notice

# Common Law Doctrines: Impossibility, Impracticability, and Frustration

- May apply to excuse performance even if the contract has no force majeure clause
- Impossibility largely replaced by impracticability
- Frustration of purpose/commercial frustration is similar to impracticability – often both can be invoked
- Either party may have a claim for relief, including restitution, if frustration or impracticability apply

# Restatement (Second) of Contracts

## Impracticability

- Event occurs making performance impracticable
- Parties assumed in making the contract that the event wouldn't occur
- No fault by the non-performing party
- Duty to perform is excused, unless contract language or circumstances indicate otherwise

## Frustration

- Event occurs that substantially frustrates a principal purpose of the contract
- Parties assumed in making the contract that the event wouldn't occur
- No fault by the non-performing party
- Duty to perform is excused, unless contract language or circumstances indicate otherwise

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# Delaware – Impracticability

- Unforeseen event
- Performance is not commercially practicable
  - Extreme and unreasonable difficulty, expense, injury, or loss to a party
  - But impossibility is not required
- Non-performing party did not agree to perform in spite of impracticability

# Delaware – Frustration

- Principal purpose is substantially frustrated
  - May still be possible to perform
  - But performance doesn't make sense anymore
- Unforeseen event
- Non-performing party is not at fault

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# California Law

## Impracticability and Frustration

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# California – Impracticability

- Traditional Doctrine Impossibility
- Current Doctrine Impracticability
- A thing is impossible in legal contemplation when it is not practicable
- A thing is impracticable when it can only be done at an excessive and unreasonable cost
- Impracticability does not require literal impossibility

*Habitat Tr. for Wildlife, Inc. v. City of Rancho Cucamonga*, 175 Cal. App. 4th 1306, 1336 (2009)

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# California – Frustration

- Assumes performance is still possible
- Requires unanticipated supervening circumstance
- Purpose of contract frustrated by the supervening circumstance
- Value of the contract destroyed by the supervening circumstance

*Habitat Tr. for Wildlife, Inc. v. City of Rancho Cucamonga*, 175 Cal. App. 4th 1306, 1336 (2009)

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# Real Estate

## Contract Considerations

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# Real Estate Agreements

- Purchase and Sale Agreements
- Loan Documents
- Leases

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# Contract Provisions/Principles

- Force Majeure Provisions
- Eminent Domain/Government Action
- Frustration of Purpose
- Impracticability
- Impossibility
- Equity

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# Restatement (Second) of Property, Landlord & Tenant Law

- **Government Action**: Restatement suggests that a tenant may terminate a lease if the use of the leased property as intended by the parties is frustrated by government action apart from a taking by eminent domain, and if the governmental action was ***not reasonably foreseeable*** by the tenant at the time the lease was made. § 9.3
  - The doctrine is applied sparingly and usually only when "the continuation of the burdens of the lease would impose ***extreme hardship*** on the tenant that the intended use of the leased property is frustrated." *Id.* § 9.3 cmt. b.
  - If the tenant can use the property for other purposes than originally intended, the doctrine does not apply. *Id.*
- **Illegal Use**: Restatement suggests that if the use intended by the parties of the leased property becomes illegal after the lease is made and without the tenant's fault, the tenant may terminate the lease ***if no other use of the premises is permitted or if it would be unreasonable to place on the tenant the burdens of the lease after converting to a different use permitted under the lease***. § 9.2.
  - This appears to come up when the lease restricts the tenant to specific use that is no longer legal after a change in the law.

# Maryland - Frustration and Commercial Leases

- In determining commercial frustration, the "most important" factor of consideration is "whether the intervening act was ***reasonably foreseeable*** so that the parties could and should have protected themselves by the terms of their contract." *Montauk Corp. v. Seeds*, 215 Md. 491, 499 (1958). The court "then must consider the questions of whether the act was an exercise of sovereign power or *vis major*, and whether the parties were instrumental in bringing about the intervening event." *Id.*
- "Generally, with respect to leases, the doctrine of frustration has been limited to cases of ***extreme hardship***. . . . the lessee must prove that the risk of the frustrating event was not reasonably foreseeable and that the value of the leased premises was substantially or totally destroyed." *Maryland Trust Co. v. Tulip Realty Co. of Md.*, 220 Md. 399, 416 (1959); *see also id.* at 415 (finding construction of wall or fence that lessee claimed destroyed value of lease was reasonably foreseeable and there was "no proof that the obstruction of the boundary line by the erection of a wall or fence would be an extreme hardship capable of substantially or totally destroying the value of the leased premises").

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# Virginia - Impossibility Within *Force Majeure* Clause in Lease Agreement

- *Reston Recreation Ctr. Assocs. v. Reston Prop. Investors Ltd. P'ship*, 238 Va. 419 (1989):
  - Defendant tenant was unable, as required by the lease, to maintain public liability insurance with at least a $5 million limit after its carrier cancelled coverage.
  - Lease's ***force majeure clause*** provided: "in the event that either party hereto shall be delayed or hindered in or prevented from the performance of any act required hereunder by reason of strikes, . . . restrictive governmental laws or regulations, . . . **or other reason of a like nature not the fault** of the party delayed in performing work or doing acts required under the terms of this Lease, then **performance of such act shall be excused for a period equivalent to the period of such delay**."
  - Clause was a permissible contractual expansion of impossibility doctrine unless contrary to law or public policy.
  - Tenant's reliance on ***force majeure*** defense turned on an issue of fact. If no carrier would provide coverage through no fault of the tenant and despite tenant's diligent efforts, that refusal would be "of like nature" to other reasons listed in the clause and the tenant's obligations to maintain the insurance should be "modified."

# DC – Force Majeure and Commercial Leases

- *Whole Foods Mkt. Grp., Inc. v. Wical Ltd. P'ship*, 288 F. Supp. 3d 176 (D.D.C. 2018)
  - Tenant, Whole Foods, was forced to close a store after being issued two ordinance violations due to a rodent problem, which required the store to undergo renovations and inspections to address the issue.
  - The lease prohibited closure of the store for more than 60 days. Tenant brought action for declaratory judgment that it was not in breach of the lease based on the ***force majeure provision***.
  - Payment of rent was specifically excluded from the force majeure provision. The Court read the Force Majeure provision as excusing the Tenant from the prohibition on being closed for greater than 60 days due to the unforeseen problem (rodent infestation) beyond its control "the lease specifically calls out that 'payment of monies' are not excused [and] if the parties intended to preclude excusal of the 60-day requirement, it could have also been explicitly called out in the lease." Based on this, if some tenant obligations are excluded from force majeure but rent is not, the tenant could argue that payment of rent is excused.

# Legislative Relief – Developing Area

- Prohibition on issuance of Summons (DC)
- Prohibitions on Evictions (DC, NY)
- Requirement for Commercial Loan Forbearance (NY)
- Practically speaking, many courts are closed
- Negotiated Solutions

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# New York

## Case studies from 9/11

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# New York

- Force majeure/Impossibility/Frustration of Purpose Doctrines Similar to Other Jurisdictions, Treatises (see annex)
- Let's look at two examples from 9/11
  - *Compare Bush v. Protravel Int. , Inc.* (Richmond Co. Civ. Ct. Aug. 9, 2002); and
  - *OWBR LLC v. Clear Channel Communications* (D. Haw. Feb. 5, 2003).

# *Bush*: lower court case from Staten Island, New York City

- Consumer signed up for expensive Africa safari on May 15, 2001 for safari set to start November 14, 2001
- Cancellation policy required cancellation by September 14, 2001, otherwise a 20% cancellation policy (full amt. of initial deposit); acknowledged in writing at the time by consumer
- No *force majeure* provision
- 9/11: Consumer stuck on Staten Island; couldn't get to Manhattan for days; office closed; phone service disrupted
- Consumer unable to cancel until September 27, 2001: no evidence that phones worked or that consumer wasn't prevented from contacting
- Tour and travel people wouldn't return deposit; consumer sued in her home court (Staten Island Civil Court)

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# *Bush* Court denied summary judgment for the travel companies

- Court cited fact that from 9/12 to 9/14, "New York City was in the state of virtual lockdown with travel either forbidden altogether or severely restricted. Precedent is plentiful that contractual performance is excused when unforeseeable government action makes such performance objectively impossible."
- Court noted fact that governor had issued an executive order tolling the limitations period for filing lawsuits and similar official documents, well beyond the time limit for cancelling the safari. **"to even hint that [the consumer] … failed to raise a triable issue of fact by her argument that the doctrine of impossibility excuses her late cancellation of the safari … borders on the frivolous."**
- Particularly since no evidence of material hardship to the travel companies

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# OWBR: federal case from Hawaii

- Communications companies signed contract on November 19, 2000 for major conference (500 rooms) at Hawaii resort scheduled for February 13-17, 2002
- Contract was governed by Hawaii law and had a liquidated damages provision
  - "should cancellation of the event occur zero to thirty days prior to the group's scheduled arrival, liquidated damages in the amount of one-hundred percent of the 'Total Guest Room Revenue' plus applicable taxes would be due."
- Contract included *force majeure* provision
  - performance excused if various acts, including terrorism, "or any other emergency beyond the parties' control, making it ***inadvisable***, illegal, or impossible to perform their obligations…"
- Following 9/11: On January 16, 2002, within the thirty-day non-cancellation window and **four months after 9/11**, the communications companies wrote the resort to cancel the conference seeking cancellation without penalty, claiming **performance of the contract would be "inadvisable" due to the "events of September 11th coupled with the fragile condition of the U.S. and international consumer economies have resulted in the withdrawal of commitments to this event from many of our sponsors and participants."**
- Only 138 of the 500 rooms had been filled and 38 of 102 potential corporate participants had signed up
- The resort company filed suit in Hawaii, claiming entitlement to the full liquidation amount for late cancellation

# *OWBR* Court applying Hawaii law ruled for the resort

- While “inadvisable” performance within the force majeure provision potentially gave the communications companies an out, the court struck down simple economic hardship as a basis for cancelling without penalty.
- The term “inadvisable” had to be viewed against the backdrop of the purpose behind force majeure provisions generally, which do not “excuse performance for economic inadvisability even where the economic conditions are a product of a force majeure event.”
- Over four months had passed since 9/11 and people were back to flying globally, even if resort travel hadn’t fully rebounded invoking the force majeure provision or related doctrines was simply too attenuated.
- Otherwise, any party could simply claim bad economics long after the event.

# Key takeaways from these examples

- The twist on that old adage “Bad facts make bad law” is “Bad facts lead to equitable outcomes.”
  - Courts, when gripped by an event that causes major global, national or local upheaval, will typically try to do the right thing if they have any discretion, which they often do.
- Relatedly, if you are going to stand on the exact letter of your agreements to require enforcement in a COVID-19 world, be prepared to be critiqued or disappointed by courts looking for the most equitable outcome – seek a reasonable outcome in any negotiations.
- Timing is important:
  - If the roles in the two cases were reversed and the safari traveler wanted to cancel on November 11 for a November 14 trip, would the court decision have come out the same way? Particularly since air travel had been largely restored worldwide, and New York was back working and had even hosted a World Series by then? Maybe not.
- Your venue is equally important:
  - Would a New York as opposed to a Hawaii court have been so quick to find for the resort company if a New York-based plaintiff communications firm could show economic devastation and disruption in the immediate wake of 9/11, such that requiring enforcement of a liquidated damaged provision for cancelling the event would bring hardship? There are a lot of “ifs” there to navigate, but maybe not.

# Bottom Line

- Read over all your existing agreements as soon as it makes sense and start your internal discussions about
  - what you want to do;
  - what you think a reasonable judicial fact-finder would let you do; and
  - whether you have onerous choice-of-law, termination, arbitration, or venue provisions that may limit your freedom to proceed after the dust settles

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# Questions?

Case 1:  Supply contract

Case 2:  Employment agreement

Case 3: short term lease

Case 4: credit agreement

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# Annex

## For additional information

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# Examples of *Force Majeure* Clauses

- "FGDC shall not be held responsible for, and is hereby relieved and discharged from all liability by reason of any delay in completion of premises or settlement caused by changes ordered by buyer, [buyers' delay in making material or color selections], fire, strikes, acts of God, or any other reason whatsoever beyond the control of [FGDC]." *Stroud v. Forest Gate Dev. Corp.*, No. CIV.A. 20063-NC, 2004 WL 1087373, at *5 (Del. Ch. May 5, 2004)
- "In the event the performance of either party hereunder is hindered or prevented, in whole or in part, because of an act of God, inevitable accident, fire, labor dispute, riot or civil commotion, act of public enemy, war or terror, epidemic, governmental act, regulation or rule, or any other reason beyond the control of the parties, neither party shall be liable to the other for any loss, expense or damage incurred by reason of such hindrance or prevention, provided that the non-performing party notifies the other party as soon as possible of the hindrance or prevention." *Emelianenko v. Affliction Clothing*, No. CV0907865MMMMLGX, 2011 WL 13176615, at *4 n. 40 (C.D. Cal. June 7, 2011)
- "If and when drilling or other operations hereunder are delayed or interrupted by lack of water, labor or material, or by fire, storm, flood, war, rebellion, riot, strike, differences with workmen, or failure of carriers to transport or furnish facilities for transportation, or as a result of some order, rule, regulation, requisition or necessity of the government, or as the result of any other cause whatsoever beyond the control of Lessee, the time of such delay or interruption shall not be counted against Lessee, anything in this lease to the contrary notwithstanding. All express or implied covenants of this lease shall be subject to all Federal and State Laws, Executive Orders, Rules or Regulations, and this lease shall not be terminated, in whole or in part, nor Lessee held liable in damages for failure to comply therewith, if compliance is prevented by, or if such failure is the result of any such Law, Order, Rule or Regulation." *Beardslee v. Inflection Energy, LLC*, 31 N.E. 3d 80, 82 (Ct. App. N.Y. 2015)

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# Restatement (Second) of Contracts

- Discharge by supervening impracticability: “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.” Restatement (Second) of Contracts § 261 (1981).
- Discharge by supervening frustration: “Where, after a contract is made, a party's principal purpose is substantially frustrated 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 remaining duties to render performance are discharged, unless the language or the circumstances indicate the contrary.” Restatement (Second) of Contracts § 265 (1981).

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# Delaware – Impracticability

"Commercial impracticability applies when: (1) an event occurs that the parties assumed would not happen; (2) continued performance is not commercially practicable; and (3) the party asserting the defense . . . did not expressly or impliedly agree to performance in spite of impracticability. Performance may be impracticable because of extreme and unreasonable difficulty, expense, injury, or loss to one of the parties involved."

*CRS Proppants LLC v. Preferred Resin Holding Co., LLC*, No. CVN15C08111MMJCCLD, 2016 WL 6094167, at *6 (Del. Super. Ct. Sept. 27, 2016)

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# Delaware – Frustration

"A frustration of purpose defense is available when: (1) there is substantial frustration of the principal purpose of the contract; (2) the parties assumed that the frustrating event would not occur; and (3) the Defendant is not at fault."

*CRS Proppants LLC v. Preferred Resin Holding Co.*, LLC, No. CVN15C08111MMJCCLD, 2016 WL 6094167, at *6 (Del. Super. Ct. Sept. 27, 2016)

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# California – Impracticability

"A thing is impossible in legal contemplation when it is not practicable; and a thing is impracticable when it can only be done at an excessive and unreasonable cost. This does not mean that a party can avoid performance simply because it is more costly than anticipated or results in a loss. Impracticability does not require literal impossibility but applies when performance would require excessive and unreasonable expense."

*Habitat Tr. for Wildlife, Inc. v. City of Rancho Cucamonga*, 175 Cal. App. 4th 1306, 1336 (2009) (citations omitted)

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# California – Frustration

"[W]here performance remains possible, but the reason the parties entered the agreement has been frustrated by a supervening circumstance that was not anticipated, such that the value of performance by the party standing on the contract is substantially destroyed, the doctrine of commercial frustration applies to excuse performance."

*Habitat Tr. for Wildlife, Inc. v. City of Rancho Cucamonga*, 175 Cal. App. 4th 1306, 1336 (2009) (citations omitted)

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# New York – Impossibility

"Impossibility excuses a party's performance only when the destruction of the subject matter of the contract or the means of performance makes performance objectively impossible. Moreover, the impossibility must be produced by an unanticipated event that could not have been foreseen or guarded against in the contract."

*Kel Kim Corp. v. Cent. Markets, Inc.*, 70 N.Y.2d 900, 902 (Ct. App. 1987)

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# New York – Frustration

"For a party to a contract to invoke frustration of purpose as a defense for nonperformance, the frustrated purpose must be so completely the basis of the contract that, as both parties understood, without it, the transaction would have made little sense. The doctrine applies when a change in circumstances makes one party's performance virtually worthless to the other, frustrating his purpose in making the contract."

*PPF Safeguard, LLC v. BCR Safeguard Holding, LLC*, 85 A.D.3d 506, 508 (N.Y.S.C. App. Div. 2011) (citations and internal quotations omitted)

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