ALERT - Litigation & Dispute Resolution

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Navigating Contractual Disputes Arising From COVID-19

COVID-19 and the continuously changing laws and regulations that followed have greatly disrupted the way business is conducted. Indeed, even with the federal and state financial assistance available, businesses continue to face hardships satisfying contractual obligations. Common issues include rent and debt obligations, supply chain requirements, outstanding accounts payables/receivables, and other general business obligations. Likewise, some businesses may be suffering harm due to a contract partner's inability to satisfy its obligations. To understand the risks and potential remedies, business owners and in-house counsel should familiarize themselves with the applicability of the legal arguments discussed below as parties seek to lessen, and even completely relieve themselves of, contractual obligations.

FORCE MAJEURE

Does the contract in dispute contain a "force majeure" clause? Unsure? A sample force majeure clause is below.

> Force Majeure. If any Party to this Agreement shall be delayed or hindered in or prevented from the performance of any acts required hereunder beyond its reasonable control including, without limitation, acts of God, pandemics, epidemics, governmental shutdowns, governmental acts, terrorist acts, shortage of supply, breakdowns, malfunctions, or interruptions of computer equipment, software or facilities, or loss of data due to power failures or mechanical difficulties with information storage or retrieval systems, labor difficulties, war, or civil unrest, but not the fault of the Party delayed in doing acts required pursuant to this Agreement, the period for performance of any such act shall be extended for a period equivalent to the period of such delay.

The purpose and intent of a force majeure clause is to relieve parties of their contractual obligations when the performance thereof is prevented by a force beyond the parties' control.[1] Pursuant to New York law, however, force majeure clauses are to be narrowly interpreted, which requires the clause to list the specific event claimed to be preventing performance (*i.e.*,

[1] *Phillips Puerto Rico Core, Inc. v. Tradax Petroleum, Ltd.*, 782 F.2d 314, 319 (2d Cir.1985).

pandemics).[2] The narrow construction serves to allow parties to maintain reasonable expectations as to damages in light of such unforeseen events.[3]

For instance, following COVID-19's classification as a "pandemic" by the World Health Organization, if a force majeure clause includes "epidemics" or "pandemics" as an event, a party could argue that COVID-19 is a qualifying event. Similarly, COVID-19 could also potentially qualify under a "government act" to the extent that a failure to perform was the result of a government forced shutdown. Importantly, if a force majeure clause covers COVID-19 as a qualifying event, parties will still need to show: (1) that they took steps to mitigate the damage, and (2) that performance of the contract is truly impossible.[4]

Moving forward, to increase the likelihood that your contracts will excuse performance in light of a future recurrence of the COVID-19 or similar event, you should consider including a specific reference to "epidemics", "pandemics", "diseases", or "government acts" among the list of specific force majeure events.

FRUSTRATION OF PURPOSE

If the contract does not contain a "force majeure" clause, a party may still be able to excuse their performance by relying on the doctrine of frustration of purpose. A "frustration of purpose" defense "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."[5] In other words, the defense will apply if (1) an event substantially frustrates a party's principal purpose of the contract; (2) the nonoccurrence of the event was a basic assumption of the contract; and (3) the event was not the fault of the party asserting the defense.[6]

Ultimately, whether or not a party can rely on the defense boils down to whether the event frustrating the purposes of the contract is "unforeseen".[7] For example, the doctrine applied where an executive order issued by the President prevented a tenant from conducting business in the space it rented, thereby frustrating the reason for entering into the lease.[8] The takeaway is that the frustration must actually bar the purpose of the contract, not merely financially harm the business.

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

[3] *Constellation Energy Servs. of New York, Inc. v. New Water St. Corp.*, 146 A.D.3d 557, 558 (1st Dep't 2017).

[4] *Kel Kim Corp.*, 70 N.Y.2d at 902.

[5] *Jack Kelly Partners LLC v. Zegelstein*, 140 A.D.3d 79, 85 (1st Dep't 2016).

[6] *Id.*

[7] *Id.*

[8] *See e.g., Sage Realty Corp. v. Jugobanka, D.D.*, 1997 WL 370786 (S.D.N.Y. 1997).

In a world with COVID-19, leases have been rendered unusable, gatherings have been banned and occupancy rates have been reduced. It is possible that these restrictions have frustrated the ultimate purpose of a contractual relationship such that a party could be excused from performance thereof.

IMPOSSIBILITY

Although the doctrine of frustration of purpose applies to situations where the bargained for exchange has been materially changed due to an unforeseen event, the doctrine of impossibility, as its name suggests, excuses a party's performance if the subject matter of the contract or the means of performance renders performance objectively impossible as the result of an unforeseen event.[9] In other words, it has become impossible to fulfil the aims of the contract.

New York courts consider several factors in determining whether the defense of impossibility is applicable, including (1) the foreseeability of the event occurring; (2) the fault of the nonperforming party in causing or not providing protection against the event occurring; (3) the severity of harm; and (4) other circumstances affecting the just allocation of the risk.[10] Economic harm is not a sufficient excuse where performance is still possible.[11]

For instance, the doctrine of impossibility applied where an event venue's performance of a five-year contract to hold an annual conference at the venue was made impossible by a fire that destroyed the venue and it was not clear whether the venue would be rebuilt; thus, the agreement was found to be unenforceable.[12] In contrast, the doctrine was inapplicable where a party that defaulted on an agreement to purchase real estate sought to recover the contractual down-payment because his financial condition was negatively impacted by Bernie Madoff's fraudulent scheme.[13] The Court noted that, although it was unfortunate that the party was a victim of fraud, the negative impact on his finances did not excuse performance of the contract.[14]

Examples of how the doctrine may apply to scenarios arising from COVID-19 may include situations where it has become impossible for a business to manufacture or distribute product or has faced other supply chain issues. Perhaps a party contracted to hold an event, however, it has become impossible for the venue to host the event due to newly enacted laws. Similarly, a contract could have included specific deadlines that were rendered impossible to meet. These are just examples and whether the doctrine may apply is a fact specific inquiry.

[9] *Kolodin v. Valenti*, 115 A.D.3d 197, 198 (2014).

[10] *D & A Structural Contractors Inc. v. Unger*, 901 N.Y.S.2d 898 (Sup. Ct. Nassau Cty. 2009).

[11] *Warner v. Kaplani*, 71 A.D.3d 1 (1st Dep't 2009).

[12] *Leisure Time Travel, Inc. v. Villa Roma Resort And Conference Center, Inc.*, 55 Misc.3d 780 (Sup. Ct. Queens Cty. 2017).

[13] *Sassower v. Blumenfeld*, 24 Misc.3d 843 (Sup. Ct. Nassau Cty. 2009).

[14] *Id.* at 848.

APPLICABILITY IN NEW YORK

The United States District Court for the Southern District of New York recently issued two rulings that provide insight into how courts may interpret the foregoing defenses in connection with COVID-19.

In *E2W LLC v. KidZania Operations SARL*, No. 1:20-cv-02866-ALC, decided on April 6, 2020, KidZania terminated the parties' franchise agreement for E2W's failure to pay certain royalties. E2W filed a cause of action against KidZania for breach of contract for wrongful termination relying on the franchise agreement's force majeure provision and the doctrines of frustration of purpose and impossibility because it could not lawfully operate its facility (*i.e.*, an amusement park) during COVID-19.

In conjunction with its action, E2W sought a preliminary injunction to maintain the status quo of the parties' relationship, which requires a party to establish their likelihood of success on the merits of case (this often gives insight into how a court will interpret a specific matter moving forward). Tellingly, the Court granted E2W's request for a preliminary injunction while the parties arbitrated the matter pursuant to the arbitration clause in the franchise agreement. Specifically, based on the force majeure clause excusing performance due to "governmental orders," "actions by government or by political sector(s) of their respective counties," and acts of God and the indefinite closure of its facility and termination of its development activities, which was the alleged purpose of the franchise agreement, E2W demonstrated a likelihood of success on the merits.

In *Latino v. Clay LLC*, 2020 WL 2239957 (S.D.N.Y. May 8, 2020), plaintiffs were parties to a class action settlement agreement with Clay, a gym owner, whereby Clay was required to pay $300,000 over a period of 23 months and, if Clay defaulted, plaintiffs would be permitted to file a consent judgment.

As a result of COVID-19, Clay was required to close its gyms and was not able to make the required monthly payment. Following Clay's default, the plaintiffs filed a motion for entry of the consent judgment. Clay argued that their performance was excused pursuant to doctrine of impossibility because as a result of Governor Cuomo's PAUSE Executive Order, which required the closure of its gyms, its cash flow was reduced; thus, it could not satisfy its payment obligations. The Court held that Clay's performance of the settlement agreement was not

excused. Specifically, Clay's inability to make payments was merely the result of financial difficulty, which alone, does not excuse performance under the doctrine of impossibility.

The foregoing decisions show that while Courts may be willing to grant relief to parties arising from the unforeseeable consequences resulting from COVID-19, financial harm alone will generally not excuse performance. Each contract, however, requires a fact specific inquiry to determine whether a party may be entitled to relief.

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