Contractual Impossibility and Frustration of Purpose in the Face of the COVID-19 Epidemic

By Lisa Bentley

The outbreak of the global epidemic now known as COVID-19, which has come to be all too familiar to us in the past few weeks, is a story that has only just begun. As many of us watch this current health and economic calamity unfold, it is simply not clear at this point what the myriad of long-term effects of the virus will be on our world.

As commercial litigators, however, one thing that we can realistically expect is that the performance of thousands of commercial contracts will be jeopardized. From cross-border contracts for the purchase and sale of goods, to lease agreements for retail space, to contracts for international mergers and acquisitions, to agreements for the use of event space, businesses are likely to be faced with the fact that performance if their commercial contracts is no longer possible, is extremely difficult, or just no longer makes any sense.

Impossibility, Impracticality and Frustration of Purpose.

When faced with such situations, businesses might look to the doctrines of contractual impossibility, or impracticality, or the related doctrine of frustration of purpose. While limited in their applicability, these doctrines are defenses that a contracting party may invoke to their performance obligations under a contract. The defense of impossibility, or impracticality, may be available when there is an unanticipated event that could not have been foreseen or guarded against in a contract.[1] Frustration of purpose applies when the purpose of the contract as understood by both parties is so completely frustrated that it makes little sense to proceed with the transaction.[2] Typically, impossibility or impracticality is asserted by the party who has contracted to perform work or provide services, while frustration of purpose is invoked by the party that has contracted to pay for it.[3]

Whether performance of a contract will be excused based on the defenses of impossibility/impracticality or frustration of purpose can depend upon numerous factors, including the foreseeability of the event in question, the fault of the party not performing the contract in causing or failing to protect against the event, the severity of the potential harm and other factors affecting the appropriate allocation of risk.[4]

With regard to non-performance of contracts on account of the COVID-19 epidemic, there will be no standard way to apply these doctrines, not only because performance obligations in each contract are different, but also because the specific reason that performance is impossible or impractical, or the purpose is frustrated, will differ in each situation. Non-performance may be brought about by, for example, absence of an available labor market, closure of public facilities, illness, closure of borders, cutting off of supply chains, quarantine, or health concerns associated with congregations of people. Each of these circumstances might be viewed differently by a court in assessing foreseeability, fault and allocation of risk.

History as a Guide.

History provides a potentially helpful, albeit limited, guide for how non-performance defenses arising out of epidemics might be addressed. In one case arising in Connecticut at a time of an outbreak of infantile paralysis, a party had contracted to promote and manage a “baby show,” but had reneged on that obligation once it was determined that congregations of large numbers of

children would be dangerous on account of the outbreak, making it impossible to go forward with the show.[5] The court determined that the contract need not be honored and no damages would be awarded because an assembly of children at that time would have been highly dangerous and, therefore, contrary to public policy, making the contract void.

Another case addressed performance issues arising from the lack of a labor market during an influenza outbreak in Kentucky. Specifically, a construction contact required plaintiff's performance by a certain date to receive full payment; plaintiff would receive only partial payment if the work were completed after that date.[6] Plaintiff failed to meet the completion deadline, but argued he was entitled to full payment because completion by the earlier date was rendered impossible because the epidemic prevented him from securing labor in time. The court rejected this argument, finding that the plaintiff's work might have been hindered because of the epidemic, but it was not necessarily impossible. It also should be noted that the plaintiff here was not using impossibility for its intended purpose – as a defense to performance – but rather as an affirmative basis to assert he was entitled to damages.[7]

A series of cases from across the country also considered the impossibility defense in the context of teachers who brought suits against school boards for their unpaid salaries after epidemics temporarily closed the schools in which they were employed. The arguments in defense of these claims made by the school boards and other counter-parties were that the schools had no choice but to close because of the epidemic, which amounted to an "act of God" making performance impossible. While this issue has not been addressed uniformly, the majority of courts to consider the issue held that closing of schools on account of an epidemic is *not* an act of God and did *not* render performance impossible, such that the contracts must be honored and the teachers must be paid.[8]

Another court, however, invoked language suggesting a view of epidemic-related fallout as an "act of God" in order to uphold an insurance contract.[9] There, a furniture factory temporarily halted operation because of a yellow fever epidemic. The factory's fire insurance policy provided that it was void if a fire occurred while the business was not in operation. Eleven days into the temporary shutdown, a fire destroyed the factory. The court interpreted the "cease to be operated" language in the policy to apply only to a permanent shut-down, noting "it can scarcely be successfully maintained that a temporary cessation occasioned by the visitation of Providence in the form of a deadly epidemic shall have a greater effect."

While it is difficult to draw any clear conclusions from the above cases, it might be said that courts evidence some acceptance and understanding of the difficult circumstances that epidemic-related issues may have on contractual performance and, more generally, on businesses and individuals that find themselves trying to navigate issues that were not anticipated and may not have been contemplated by a contract. Sometimes this understanding manifests itself as an acceptance of an impossibility defense and sometimes – in particular when the doctrine is used as a "sword" rather than a "shield" – as a rejection of that defense.

Practical Considerations for Businesses.

The first step that a business should undertake where it faces the possibility of it being impossible or impractical for it to perform its contractual obligations is to look to the contract itself. Many business agreements contain *force majeure* or "act of God" provisions. While these provisions at times remain undefined in a contract, it is possible that triggering events could be defined to specifically include epidemics, pandemics, disease, quarantine and/or "acts of government." It is also important to consider the particular US state or nation's law that govern the

contract, as interpretation of these provisions can vary from jurisdiction to jurisdiction.[10] Parties should also review their contracts in order to determine if there is any notification requirement or time limitation imposed upon the party seeking the benefit of an act of God or *force majeure* provision.

Conversely, parties that are being notified by their counterparty that performance may be impossible or impractical – or anticipate this being an issue in the future – should look to any contractual obligations that are imposed on the potentially-defaulting party in terms of timely notification and/or proper documentation. The fact that there is a pending global epidemic cannot be used as a basis for a party to escape liability where a breach would have occurred in any event.

Definitionally, *force majeure* might be interpreted more broadly than "act of God" to include not only events that occur due to natural causes that cannot be avoided or prevented (*i.e.*, floods, tornadoes, hurricanes), but also acts of people or governments (*i.e.,* wars, riots, strikes). Thus, while an epidemic itself might be considered an "act of God," it is unclear if a government response to epidemic, such as a quarantine, would be subsumed within this this term, though quarantine would likely be included within a *force majeure* provision.[11] Depending upon the underlying reason for performance difficulties, this distinction could be an important one.

A business should also consider the fact that "performance" might not be an all-or-nothing undertaking. Perhaps partial performance, delay in performance, or compliance with certain provisions remains a possibility. For example, a tenant might seek a partial abatement in rent, but still be able to cover some amount. A seller might not be able to deliver product that had not yet shipped from its point of origin following the closure of borders, but shipments already in progress will be able to be completed. We have even seen some *force majeure* provisions that require the parties to reschedule events at a future point in time, as opposed to cancelling them altogether. These are unprecedented times, and parties to commercial contracts should all aware of this. Thus, even where there are no clear contractual provisions favoring a commercial party, proposing a modification to an existing agreement is a possibility that is likely to be considered by a counterparty, particularly where the alternative could be complete non-performance.

Before pursuing legal remedies – either as a party demanding performance or as a party who seeks to assert impossibility as a defense – both the short-term and long-term consequences of such an action should be considered. What are the other contractual consequences of invoking *force majeure* or otherwise taking the position that performance is not possible? If a lawsuit is commenced against a supplier for breach of contract, are there other suppliers that would be available turn to who could quickly step in as a replacement supplier? Are more favorable terms with a non-party likely to be available in the current climate?

Parties potentially planning to invoke an impossibility defense should also undertake to document their efforts to perform under the contract, such that if performance ultimately is not feasible, there will be a clear record of steps taken and efforts made to perform, which will allow a court to assess whether performance was truly impossible or commercially impractical. Parties should also consider and monitor how the COVID-19 epidemic specifically affects the ability to perform, be it quarantine, lack of labor, cutting off of supply routes, or any other factors.

One final issue of consideration should be insurance coverage and reporting obligations. Parties should review their business interruption coverage to determine whether coverage may be provided for losses associated with an epidemic such as COVID-19.

Conclusion

Aguilar Bentley is committed to providing legal advice to our clients during this difficult time. Should you wish to discuss any of the above information in further detail, or any other legal concerns you have in the current environment, please feel free to reach out to us.

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[1] *Estates at Mountainview v. Nakazawa*, 38 A.D.3d 828, 829 (N.Y. 2d Dept. 2007).

[2] *Crown IT Services, Inc. v. Olsen*, 11 A.D.3d 263, 265 (N.Y. 1st Dept 2004).

[3] Corbin on Contracts § 77.1.

[4] *Id.*

[5] *Hanford v. Connecticut Fair Ass'n*, 92 Conn. 621 (1918).

[6] *Napier v. Trace Form Mining Co.*, 193 Ky. 291 (1921).

[7][7] *See Dove v. Rose Acre Farms, Inc.*, 434 N.E.2d 931 (Ind. App. 1982) (rejecting impossibility of performance argument where plaintiff argued he was entitled to his bonus notwithstanding impermissibly missing work because he was severely ill, concluding impossibility is a defense against damages, not a basis pursuant to which a party can argue it is entitled to damages).

[8] See *Great et al. v. Gray*, 10 Ind. App. 428 (1894); *Phelps v. School District No. 109*, 221 Ill. App. 500 (1921); *Libby v. Inhabitants of Douglas*, 175 Mass. 128 (1900); *Dewey v. Alpena School Dist.*, 43 Mich. 480 (1880); *McKay v. Barnett*, 21 Utah 239 (1900); *but see Gregg School TP, Morgan County v. Hinshaw*, 76 Ind. App. 503 (1921).

[9] *P. Poss v. The Western Assurance Co.*, 75 Tenn. 704 (Tenn. 1881).

[10] For instance, it appears that China will take the view that the COVID-19 outbreak is an unforeseeable event, which will be considered a *force Majeure* event under Chinese law, and China has begun issuing *force majeure* certificates to that effect. *See* http://en.ccpit.org/info/info_40288117668b3d9b01701980aa0c06b4.html.

[11] *See, e.g., Reade v. Stoneybrook Realty*, 63 A.D.3d 433 (N.Y. 1st Dept. 2009) (*force majeure* clause that includes "governmental prohibitions" operates to allow for rent abatement where a temporary restraining order prevented construction and resulted in delays in delivering possession of the subject property).