U.S. Contractual "Outs" and COVID-19: Force Majeure, Material Adverse Effect and Frustration of Contract

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- As private industry and government authorities continue to react to the spread of COVID-19, market participants are evaluating the implications of the public health crisis for a wide range of contracts. This Client Update provides an overview of three doctrines that, depending on the facts and circumstances, may provide a basis for temporarily or permanently excusing performance of contractual obligations: *force majeure* clauses, material adverse events/change clauses and frustration of contract. The implications of these doctrines for any particular contract or transaction will depend on the applicable law (this update focuses on New York and Delaware law), the specific terms of the agreements and the relevant facts. We are providing advice regularly on such issues in connection with the COVID-19 outbreak.

Force Majeure

- *Force majeure* clauses in contracts allocate risk by excusing one party's nonperformance when its reasonable expectations have been frustrated due to circumstances beyond its control.[1]

- The applicability of a *force majeure* provision to a particular set of facts will depend in large part on specific contract language, which may relax or tighten the elements of establishing a *force majeure* and may impose specific notice requirements. Some contracts' *force majeure* clauses specifically excuse nonperformance due to outbreaks, epidemics, pandemics, quarantines, travel restrictions and the like, while others do not.[2]

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1 *Macalloy Corp. v. Metallurg, Inc.*, 284 A.D.2d 227, 227 (N.Y. App. Div. 2001); *see also Capital City Gas Co. v. Phillips Petroleum Co.*, 373 F.2d 128, 132 (2d Cir. 1967); *United Equities Co. v. First Nat'l City Bank*, 52 A.D.2d 154, 157 (N.Y. App. Div. 1976); *Kel Kim Corp. v. Cent. Mkts. Inc.*, 70 N.Y.2d 900, 902 (N.Y. 1987).

2 *See, e.g.*, *Wyndham Hotel Grp. Int'l, Inc. v. Silver Entm't LLC*, No. 15-CV-7996 (JPO), 2018 U.S. Dist. LEXIS 52144, at *27 (S.D.N.Y. Mar. 28, 2018) (contract enumerating "epidemic" as a *force majeure*); *Aukema v. Chesapeake Appalachia, LLC*, 904 F. Supp. 2d 199, 206 (N.D.N.Y. 2012) (same); *New York v. R.A.M. Used Auto Parts, Inc.*, No. 400463/10, 2014 WL 1315646 (N.Y. Sup. Ct. Mar. 24, 2014) (same).

- A party seeking to avoid performance based on a *force majeure* provision may need to demonstrate that performance has: (1) become objectively impossible (2) as a result of an event that could not have been foreseen.[3] The nonperforming party may also be required to demonstrate its efforts to perform its contractual duties despite the occurrence of the event it claims constituted a *force majeure* event.[4]

- Where a contract specifically identifies a pandemic or the like as a *force majeure* event, characterizations and analyses by the World Health Organization (WHO), the Centers for Disease Control and Prevention (CDC), the National Institutes of Health (NIH) and other similar agencies may be relevant.[5]

- Absent a specific reference to an epidemic or pandemic in a *force majeure* clause, parties should consider whether the COVID-19 outbreak falls within a contract's catch-all provision.[6] Parties also should consider the implications of government orders imposing restrictions in response to COVID-19, including whether such orders render performance impossible.[7]

- Even if it can be shown that the COVID-19 outbreak constitutes a *force majeure* event under the circumstances of a particular contract, parties are not necessarily relieved of their contractual obligations of timely notice.

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[3] *Kel Kim Corp.*, 70 N.Y.2d at 900; *see, e.g.*, *Team Mktg. USA Corp. v. Power Pact, LLC*, 41 A.D.3d 942-43 (N.Y. App. Div. 2007) (discussing "enumerated, unforeseeable events").

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

[5] For a different approach that other courts might decline to follow, see *W.D. on behalf of A. & J. v. County of Rockland*, 101 N.Y.S.3d 820, 824 (N.Y. Sup. Ct. 2019) (permitting a challenge to Rockland County's emergency declaration excluding unvaccinated children from places of public assembly as unauthorized under New York's Executive Law § 24 covering epidemics, because "[i]n a population of roughly 330,000 people, 166 cases is equal to .05% of the population, which does not appear, on the record before the Court, to rise to the level of an 'epidemic' as included . . . under Executive Law § 24" or within Merriam Webster's definition).

[6] *See, e.g.*, *Stroud v. Forest Gate Dev. Corp, Inc.*, No. Civ. A. 20063-NC, Civ. A. 20464-NC, 2004 WL 1087373, at *5 (Del. Ch. May 5, 2004) (clause excusing liability for delays caused by "fire, strikes, acts of God, or any other reason whatsoever beyond the control of [the drafting parties]" refers to a "delay-causing event" that was "not reasonably foreseeable in the ordinary course").

[7] *See, e.g.*, *Trump on the Ocean, LLC v. Ash*, No. 005274/2009, 2009 WL 2619233, at *4 (N.Y. Sup. Ct. Aug. 25, 2009) (finding government entity's refusal to grant a variance, when one was required and without which it would be impossible to construct a building under already-approved plans by the deadline, constituted a *force majeure* event under clause that included "unforeseen restrictive governmental laws, regulations, acts or omissions" as *forces majeures*); *Duane Reade v. Stoneybrook Realty, LLC*, 63 A.D.3d 433, 434 (N.Y. App. Div. 2009) (holding that temporary restraining order prohibiting construction of a building constituted a "governmental prohibition" beyond a landlord's control that allowed for added time to perform under the lease); *Burnside 711, LLC v. Nassau Reg'l Off-Track Betting Corp.*, 67 A.D.3d 718, 719-20 (N.Y. App. Div. 2009) (holding that *force majeure* clause, which excused performance in the event of "governmental action or inaction," relieved defendant from its obligation to pay rent after an amendment to a local zoning ordinance prevented the premises from being used as an off-track betting parlor because "the reasonable expectations of the parties [to use the premises as an off-track betting parlor] have been frustrated due to circumstances beyond the control of the parties").

- When performance is excused due to *force majeure*, it may be excused only for so long as those conditions persist and prevent performance. Parties should be prepared for the possibility that when *force majeure* event ends, their obligations to perform could quickly be reinstated.

Material Adverse Effect/Material Adverse Change:

- A Material Adverse Effect (MAE) or Material Adverse Change (MAC) clause contemplates a change in circumstances that significantly reduces the value of an enterprise, transaction or venture. MAE clauses allow buyers or investors to avoid completing a transaction if there is a significant change in the counterparty's business or underlying assets.

- MAE clauses are often heavily negotiated and, accordingly, their applicability depends on the language of the specific MAE clause at issue as applied to the relevant facts. Absent specific controlling language to the contrary, most courts require that the change pose a substantial threat to the overall financial health of a target or a venture[8] for a meaningful period of time.[9]

- In disputes over asserted MAEs, the forum for litigating the dispute can make a difference to the interpretation of such a clause.

- No U.S. court decision has tested an MAE provision against the circumstances presented, or that may be presented, by a pandemic or epidemic such as COVID-19. It is possible that the current COVID-19 outbreak will yield some case law on this topic. Even if so, these cases will likely turn on specific facts applied to the particulars of the governing contract.

Contract Frustration:

- In the absence of a contractual *force majeure*, MAE or other provision addressing the consequences of unanticipated risks, parties may seek to avoid contractual obligations based on the common law doctrine of frustration of contract (or

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[8] *See, e.g.*, *In re IBP, Inc. S'holders Litig.*, 789 A.2d 14, 68 (Del. Ch. 2001) (finding no MAE with a sharply reduced earnings estimate for target because the drop was not aberrational for what was typically a cyclical business and did not seem to presage a long-term drop in value).

[9] *See, e.g.*, *Frontier Oil Corp. v. Holly Corp.*, No. Civ. A. 20502, 2005 WL 1039027, at *36 (Del. Ch. April 29, 2005) (finding no MAE where a merger target faced the prospect of substantial litigation costs because the buyer had not established that its target would be unable to bear the costs over the long term); *Akorn, Inc. v. Freesnius Kabi AG*, C.A. 2018-0030-JTL, 2018 WL 4719347 (Del. Ch. Oct. 1, 2018). *Cf. Pan Am Corp. v. Delta Air Lines, Inc.*, 175 B.R. 438, 481 (S.D.N.Y. 1994) (applying New York law, upholding buyer's termination of contract on basis of MAE where seller Pan Am suffered "rapid deterioration" of revenue and bookings between August and October 1991).

frustration of purpose). Such frustration can occur when both parties are literally able to perform but, as a result of unforeseeable events, performance by one party would no longer give the other the benefit that induced that party to make the bargain in the first place.[10]

- Courts analyzing frustration claims typically consider the foreseeability of the allegedly frustrating event's occurrence, the fault of the nonperforming party in causing or not providing protection against the event's occurrence, the severity of the harm and other circumstances affecting the just allocation of the risk.[11]

- The doctrine of frustration may be governed by common law or by statute.[12]

- Market shifts or financial hardships on their own do not typically establish contract frustration.[13] In the case of the COVID-19 outbreak, the ability to obtain contractual discharge will likely depend on the developing circumstances, including the full scope and impact of the outbreak. Parties should consider whether the underlying reason the contract was entered into has been categorically undermined by circumstances related to the outbreak.

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Please do not hesitate to contact us with any questions.

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[10] *United States v. Gen. Douglas MacArthur Senior Vill., Inc.*, 508 F.2d 377, 381 (2d Cir. 1974); *D & A Structural Contractors Inc. v. Unger*, No. 001112-08, 2009 WL 3206596, at *5 (N.Y. Sup. Ct. Aug. 20, 2009) (citing *Crown IT Servs., Inc. v. Olsen*, 11 A.D.3d 263, 265 (N.Y. App. Div. 2004)); *cf. PPF Safeguard, LLC v. BCR Safeguard Holding, LLC*, 85 A.D.3d 506, 508-09 (N.Y. App. Div. 2011) (holding that Hurricane Katrina did not frustrate purpose of an indemnity agreement as it had no effect on the value of performance under the contract); *see Rockland Dev. v. Richlou Auto Body, Inc.*, 173 A.D.2d 690, 691 (N.Y. App. Div. 1991) (finding frustration of purpose claim not sustainable in an action to recover damages for nonpayment of rent because the defendant "merely allege[d] that he ha[d] sustained a loss," which was insufficiently substantial). *See also* Restatement (Second) of Contracts § 265 (Am. Law Inst. 2019).

[11] *D & A*, 2009 WL 3206596, at *5 (finding that the purpose of a contract for construction on a home was frustrated when payment was to be made upon settlement of an insurance claim and a court issued a restraining order barring transfer of relevant assets).

[12] *See, e.g.*, Del. Code. tit. 6, § 2-615; *J & G Assocs. v. Ritz Camera Ctrs., Inc.*, Civ. A. No. 9811, 1989 WL 115216, at *3 (Del. Ch. Oct. 3, 1989).

[13] *Freidco of Wilmington, Ltd. v. Farmers Bank*, 529 F. Supp. 822, 825 (D. Del. 1981).

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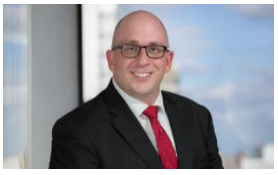

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