THE IMPACT OF COVID-19 ON CONTRACTS: FORCE MAJEURE CLAUSES, TRADITIONAL DEFENSES, AND SELECT CONTRACTUAL CONSIDERATIONS

Drew Bailey, Bailey & Company, Attorneys & Counselors, P.A.
Lauren Spencer, Barber Law Firm PLLC

Given the hardships COVID-19 has placed on businesses both financially and operationally, companies should consider evaluating their rights and duties under contracts during the COVID-19 pandemic. While such an evaluation should be tailored to the specific circumstances of a particular contractual relationship, the following steps can be helpful to any business in evaluating its contracts: (1) identify rights and duties that relate to the occurrence of certain events and performance of obligations (e.g., conditions, minimum sales, production or royalty requirements, termination rights, notice requirements, force majeure clauses, or choice-of-law clauses) and (2) determine whether the COVID-19 pandemic is an event that would trigger such a right or duty under the contract and the applicable laws. Discussed below are additional considerations in evaluating force majeure clauses and traditional defenses for nonperformance of contractual obligations. Further, we discuss special considerations in the context of commercial insurance policies and intellectual property licenses.

Force Majeure and Traditional Doctrinal Defenses

In evaluating the impact of a force majeure clause on the rights and duties under a particular contract, a business should consider the availability and scope of force majeure as a defense under the governing law and the provisions of the contract. Although the freedom of contract provides parties with broad discretion in defining the scope of a force majeure clause, in general, a force majeure clause is a contractual provision that excuses the nonperformance of contractual obligations in circumstances beyond a party's control and that render performance impossible, commercially impracticable, or inadvisable. Force majeure clauses are commonly drafted to include a series of agreed-upon events excusing nonperformance, such as natural disasters, restrictive governmental laws or regulations, and acts of god. Without a force majeure clause, parties may only be able to rely on the doctrines of impracticability, impossibility, and/or frustration of purpose, which are rarely accepted by courts as grounds to excuse performance.

Consider the doctrine of impossibility as applied in the context of a contract for the sale of goods during the COVID-19 pandemic: at the beginning of the COVID-19 outbreak, a manufacturer enters a valid contract for the sale of five million non-specialized widgets to a supplier in exchange for $70 million. Under the contract, the widgets must be delivered on a certain date and time is of the essence. Shortly after the manufacturer enters the contract, in response to a rapid spread of COVID-19, a government order is issued, whereby the manufacturer's employees are prohibited from occupying the manufacturer's manufacturing facility. On the date delivery is due, the manufacturer's employees are still barred from entering its facility. Can the manufacturer claim impossibility of performance as a defense? Although performance may seem impossible, courts likely will not find performance impossible if the widgets can be manufactured or acquired elsewhere, even if the cost of performance would be tripled by so doing. Consequently, impossibility of performance will not likely be a viable defense for the manufacturer. Note, however, that a court might nevertheless find performance impossible when unforeseeable costs exceed a substantial threshold. In *Mineral Park Land Co. v. Howard*, for instance, a court found that granting relief to a promisor on the basis of impossibility was proper where the cost of performance increased "ten or

twelve times" as much as the usual cost. 172 Cal. 289, 156 P. 458 (1916). Consequently, predicting a judgment could be difficult where the cost of performance is increased by a factor slightly less than ten times as much as usual.

Likewise, consider the doctrine of frustration of purpose as applied in the context of COVID-19: a person rents a room to view a popular holiday parade, and subsequently, a government order issued in response to COVID-19 causes the parade to be canceled. Under the doctrine of frustration of purpose, in general, a contracting party's duty of performance is discharged where the purpose of the contract has been destroyed because of a supervening, unforeseen event not the fault of the party seeking discharge. The defense of frustration of purpose, thus, appears useful to the renter in this example; indeed, the purpose for which the room was rented (viewing the parade) was destroyed by a supervening event (COVID-19) for which the renter was not at fault. However, the foreseeability of the supervening event will be determined as of the time the contract was formed. This could present challenges for the renter depending on the time he or she booked the room.

Force majeure clauses are commonly used to avoid the foregoing issues, but these clauses also have shortcomings. Often, force majeure clauses are narrowly interpreted by courts such that they excuse performance only in the circumstances specifically listed in the clause or circumstances of the same kind or nature as those listed. Accordingly, businesses should evaluate contracts to identify any force majeure clause therein and consider consulting with an attorney to determine whether the COVID-19 pandemic gives rise to circumstances for which the force majeure clause will excuse nonperformance of any contractual obligation.

Indeed, in the example above, the manufacturer's failure to timely deliver the widgets may be excused if the contract contained a force majeure clause that can be interpreted such that COVID-19 could be considered an "act of god" or the government order could be considered sufficiently restrictive to excuse. Even if only excused for a limited time, the manufacturer will have known in advance to consider alternative means for performance or strategies for efficiently restarting operations once the order is lifted.

COVID-19 in the Context of Insurance Policies

Insurance coverage for losses related to COVID-19 will ultimately be governed by the specific terms and conditions of each particular insurance policy. As a general matter, though, businesses can benefit by evaluating their commercial property insurance policies. Many commercial property insurance policies provide coverage for business interruption, but a common requirement for recovering under these policies is a physical loss to property. In these instances, businesses are compensated for lost income the business would have earned had it operated normally and without interruption. Specialized insurance policies, such as force majeure insurance or trade disruption insurance, might be a viable alternative for businesses to recover future COVID-19-related losses. It is essential for businesses, both large and small, to evaluate their existing insurance policies for business interruption protections and make certain expansions of coverage where necessary. It is equally important for business owners to be keenly aware of any notice requirements included within these provisions. Failure to comply with notice of claim guidelines can void the insurance contract and subsequently eliminate the potential for financial relief through such insurance products.

COVID-19 in the Context of Intellectual Property Licenses

COVID-19 can be problematic in the context of intellectual property licenses, especially with respect to the performance of duties owed under common provisions for royalties and minimum sales requirements. The operational and financial hardships imposed by COVID-19 can make fulfilling these duties immensely difficult. Often, intellectual property licensing agreements contain a force majeure clause, in which case the considerations discussed above will apply. Likewise, the doctrines of impossibility, impracticability, and frustration of purpose may also be available.

Another important consideration with respect to intellectual property licenses amid COVID-19 is the impact of a party commencing bankruptcy. The threshold concern in bankruptcy is whether the intellectual property license at issue is an executory contract. If so, a debtor can generally assume or reject the license. If assumed, the debtor can then continue performing its obligations thereunder or assign the license to a third party. Non-executory contracts, by contrast, are considered an asset or obligation of the bankruptcy estate and must be treated accordingly. A contract is generally "executory" whenever unperformed, material obligations remain for both parties. Hence, a provision in an intellectual property license stating that failure to perform an obligation thereunder is a material breach may render the license executory. On the contrary, if the parties' performance was due concurrently under the license, and any indication of a breach being material was omitted, the license may not constitute an executory contract. Alternatively, an intellectual property license may provide that it is terminated upon the licensee commencing bankruptcy. Given the increase in bankruptcies caused by the COVID-19 pandemic, the foregoing provisions of intellectual property licenses are particularly important to identify and evaluate during licensing negotiations or when either party to a license is experiencing financial instability. Recognizing the complexity of these matters, it is advisable to consult with a knowledgeable attorney experienced in conducting such an evaluation.

Additionally, companies in the pharmaceutical and healthcare industries face a unique risk with respect to compulsory licensing. Under 35 U.S.C. § 203, United States government agencies can compel licensing of certain federally-funded patents to third parties if certain conditions are satisfied, some of which concern licensing terms and compliance therewith. Although no federal agency has exercised its authority under 35 U.S.C. § 203, in light of COVID-19, companies that own federally-funded patents to healthcare and pharmaceutical inventions, or have rights pursuant to a license therein, should be aware of the potential breadth of 35 U.S.C. § 203 and its interplay with their current licensing arrangements, as the risk of compulsory licensing may make investors more hesitant.

Final Take

In conclusion, as the COVID-19 pandemic continues, a company can benefit when its leadership takes proactive steps to evaluate and understand its contractual rights and duties, and, when in doubt, consults with an attorney that is knowledgeable in the contractual relationship at issue. Also, going forward, the addition of "pandemic" to the list of circumstances in a force majeure clause might be a topic worthy of discussion at the negotiating table.

Drew Bailey is a patent attorney with Bailey & Company, Attorneys & Counselors, P.A. He practices in the areas of intellectual property law and business law.

Lauren Spencer is an associate attorney with Barber Law Firm PLLC in Little Rock, Arkansas. She practices in the areas of civil and commercial defense litigation.