GIBSON DUNN

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WHEN A COMMERCIAL CONTRACT DOESN'T HAVE A FORCE MAJEURE CLAUSE: COMMON LAW DEFENSES TO CONTRACT ENFORCEMENT

To Our Clients and Friends:

The rapid spread of the COVID-19 pandemic, and stringent government orders regulating the movement and gathering of people issued in response, continues to raise concerns about parties' abilities to comply with contractual terms across a variety of industries. As discussed previously here, *force majeure* clauses may address parties' obligations under such circumstances. Even without *force majeure* clauses, depending on the circumstances parties may seek to invalidate contracts or delay performance under the common law based on COVID-19. To assist in considering such issues, we have prepared the following overview. As the analysis of the applicability of any of the doctrines below is fact-specific and fact-intensive, this overview is intended only as a starting point. We encourage you to reach out to your Gibson Dunn contact to discuss specific questions or issues that may arise.

Impossibility of Performance

The doctrine of impossibility is available where performance of a contract is rendered objectively impossible.[1] In assessing whether impossibility of performance applies to your situation and your contract, it is useful first to determine whether the jurisdiction applicable to your contract or dispute has codified the doctrine. As in California, the statutory language might provide guidance to or place limitations on its applicability.[2]

A party seeking to invoke the impossibility doctrine under common law must show that the impossibility was produced by an unanticipated event and the event could not have been foreseen or guarded against in the contract.[3] Courts have held that impossibility of performance during times of emergency or disaster has generally excused performance on the basis of governing law, governmental regulations, or the disruption of transportation or communication networks. However, the economic consequences of those events do not necessarily permit a claim of impossibility.

A handful of cases from the early 20th century which discuss epidemics in connection with school closures and resulting performance failures under teacher contracts are divided on whether performance was excused.[4] Federal courts have excused performance for impossibility where, in times of war, manufacturers prioritized governmental orders issued under the Defense Production Act.[5] In the wake of the September 11, 2001 terrorist attacks, courts excused performance resulting from the effective lockdown of communications in New York City.[6]

In New York, the doctrine is narrowly construed and is limited to specific circumstances, including "the destruction of the means of performance by an act of God, vis major, or by law."[7] Thus, it will be necessary to evaluate the impact of any governmental orders relating to COVID-19, or any applicable court orders, to assess their impact on any given contract. The First Appellate Division of New York previously found that performance of music recording and management contracts was objectively impossible after a court ordered that the parties could not have any contact with each other.[8] There, the means of performance was made impossible by operation of law—the court's order that the parties cease contact.

By contrast, historically, performance has not been excused where the impossibility or difficulty was caused "only by financial difficulty or economic hardship, even to the extent of insolvency or bankruptcy."[9] Certain New York courts have rejected claims of impossibility related to an economic downturn with the explanation that "the risk of changing economic conditions or a decline in a contracting party's finances is part and parcel of virtually every contract."[10]

Commercial Impracticability of Performance

As with impossibility, the doctrine of commercial impracticability may also be available where performance is rendered impracticable. The treatment and availability of commercial impracticability varies significantly across states, with some treating it as its own standalone defense and others including it under the umbrella of the impossibility defense.[11] But regardless of the form it takes, many states that recognize commercial impracticability as a defense have adopted the Restatement (Second) of Contracts Section 261, or similar language, which provides that a party's duty to perform under a contract is excused where "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."[12] Looking to Section 261 for guidance, one Hawaii court found that fear and uncertainty in the aftermath of the September 11, 2001, by themselves, were insufficient grounds for showing impracticability.[13]

As in the case of the doctrine of impossibility, the impracticability at issue must be the product of unforeseen events. In general, mere economic loss or hardship is insufficient to render performance impracticable because courts generally treat it as foreseeable.[14] However, in some circumstances the defense may be available where performance "can only be done at an excessive and unreasonable cost."[15]

The Uniform Commercial Code, which has been adopted as law in most states, covers commercial contracts, including contracts related to the sale and leasing of goods, commercial paper, banking transactions, letters of credit, auctions and liquidations of assets, storage and bailment of goods, securities, financial assets and secured transactions. For a transaction governed by the UCC, the defense of commercial impracticability may apply where performance "has been made impracticable by the occurrence of a contingency the non-occurrence of which was a basic assumption on which the contract was made."[16]

Frustration of Purpose

The doctrine of frustration of purpose may be available where "a change in circumstances makes one party's performance virtually worthless to the other," thereby frustrating the principal purpose in making the contract.[17] Whether or not frustration of purpose applies depends on the precise wording of the contract but, in any event, the frustration itself must be "substantial."[18] Or, in other words, "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."[19]

Similar to the doctrines of impossibility and impracticability, frustration of purpose is applied narrowly and is limited to instances where the event rendering the contract valueless is unforeseeable.[20] It has been most commonly applied by courts upon the death or incapacity of a person necessary for performance, the destruction or deterioration of a thing necessary for performance, or a change in the law that prevents a person from performing.[21]

Moreover, as with the doctrine of impossibility, frustration of purpose does not usually apply merely "because it becomes more economically difficult to perform."[22] For example, a New York federal district court rejected an argument that losses prevented the defendant from being able to pay the plaintiff because "[t]he application of the frustration of purpose doctrine in such circumstances would 'place in jeopardy all commercial contracts.'"[23]

Consequences of Successful Defense

If one of the above defenses were deemed to apply, the duties of the party asserting the defense may be discharged.[24] However, if impossible or impracticable performance were temporary in duration, these doctrines generally would excuse performance only for so long as the disabling condition persisted. In addition, if performance were excused, courts could potentially grant quantum meruit claims of the counterparty, in order to equitably adjust for gains and losses sustained by the parties. This could require the excused party to reimburse the counterparty for expenses incurred in expectation of the performance.[25]

We expect all of these doctrines to be tested in the context of the COVID-19 pandemic and the associated governmentally mandated shutdowns and other actions. We will continue to monitor developments in this regard and are available to discuss if you have any questions.

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[1] *See Kel Kim Corp. v. Central Mkts.*, 70 N.Y.2d 900, 902 (1987).

[2] For example, under the California Civil Code, performance is excused when a party "is prevented or delayed by an irresistible, superhuman cause, or by the act of public enemies of this state or of the United States, unless the parties have expressly agreed to the contrary." Cal. Civ. Code § 1511(2).

[3] *Kel Kim Corp.*, 70 N.Y.2d at 902; *see also, e.g.*, *Citadel Builders, LLC v. Transcon. Realty Inv'rs, Inc.*, 2007 WL 1805666, at *4 (E.D. La. June 22, 2007) (noting that although hurricanes are foreseeable

events in New Orleans during the summer, impossibility defense was available because Hurricane Katrina and her aftermath "devastated th[e] area in ways beyond what anyone predicted"); *Gregg School Tp., Morgan Cty. v. Hinshaw*, 76 Ind. App. 503 (Ind. App. Ct. 1921) (performance excused due to legally mandated school closure related to Spanish Influenza).

[4] *Phelps v. School District No. 109, Wayne County*, 302 Ill. 193, 198 (1922) rejected the defense on the basis that the closure had been foreseeable. *Gregg School Tp., Morgan County*, 76 Ind. App. 503, however, excused performance because the law of the land (which allowed closure of schools) was part of every contract.

[5] *Eastern Air Lines, Inc. v. McDonnell Douglas Corp.*, 532 F.2d 957, 996 (5th Cir. 1976); *U.S. for Use and Benefit of Caldwell Foundry & Mach. Co. v. Texas Const. Co.*, 224 F.2d 289, 293 (5th Cir. 1955).

[6] *See, e.g., Bush v. Protravel Int'l, Inc.*, 192 Misc.2d 743, 750 (N.Y. Civ. Ct. 2002) (acknowledging impossibility defense may be available where communications and transportation networks damaged by September 11, 2001 terrorist attack in New York City).

[7] *Kolodin v. Valenti*, 115 A.D.3d 197, 200 (N.Y. App. Div. 1st Dep't 2014).

[8] *Id.*

[9] *407 E. 61st Garage, Inc. v. Savoy Fifth Ave. Corp.*, 23 N.Y.2d 275, 281 (N.Y. 1968); *see also Stasyszyn v. Sutton E. Assocs.*, 161 A.D.2d 269, 271 (N.Y. App. Div. 1st Dep't 1990) (absent an express contingency clause "compliance is required even where the economic distress is attributable to the imposition of governmental rules and regulations" rendering performance more costly "or the inability to secure financing").

[10] *Route 6 Outparcels, LLC v. Ruby Tuesday, Inc.*, 27 Misc. 3d 1222(A) (N.Y. Sup. Ct. Albany Cty. 2010), *aff'd*, 88 A.D.3d 1224 (N.Y. App. Div. 3d Dep't 2011); *Urban Archaeology Ltd. v. 207 E. 57th St. LLC*, 68 A.D.3d 562, 562 (N.Y. App. Div. 1st Dep't 2009) (doctrine not available because "economic downturn could have been foreseen or guarded against in the [contract]").

[11] Courts in New York and California both treat impracticability as a form of the impossibility defense. *See Axginc Corp. v. Plaza Automall, Ltd.*, 2017 WL 11504930, at *8 (E.D.N.Y. Feb. 21, 2017), *aff'd*, 759 F. App'x 26, 29 (2d Cir. 2018) (New York courts do not recognize "commercial impracticability as a separate defense to the doctrine of impossibility; rather, impracticability is treated as a type of impossibility and construed in the same restricted manner."); *Emelianenko v. Affliction Clothing*, 2011 WL 13176615, at *28 (C.D. Cal. June 7, 2011) ("The enlargement of the meaning of 'impossibility' as a defense [] to include 'impracticability' is now generally recognized.").

[12] *E.g.*, *LECG, LLC v. Unni*, 2014 WL 2186734, at *6 (N.D. Cal. May 23, 2014), *aff'd*, 667 F. App'x 614 (9th Cir. 2016) (California); *Waddy v. Riggleman*, 216 W. Va. 250, 258 (W. Va. 2004) (West Virginia); *Tractebel Energy Mktg., Inc. v. E.I. Du Pont De Nemours & Co.*, 118 S.W.3d 60, 65 (Tex.

App. 14th Dist. 2003) (Texas); *Step Plan Servs., Inc. v. Koresko*, 12 A.3d 401, 414 (Pa. Super. Ct. 2010) (Pennsylvania).

[13] *OWBR LLC v. Clear Channel Comm'cs, Inc.*, 266 F. Supp. 2d 1214, 1222 (D. Haw. 2003) (analyzing impracticability doctrine in context of contract containing *force majeure* provision).

[14] *See, e.g.*, *Karl Wendt Farm Equip. Co. v. Int'l Harvester Co.*, 931 F.2d 1112, 1117 (6th Cir. 1991) (dramatic downturn in farm equipment market causing defendant to go out of business did not excuse unilateral termination of its dealership agreements due to commercial impracticability).

[15] *Emelianenko*, 2011 WL 13176615, at *28; *see also City of Vernon v. City of Los Angeles*, 45 Cal.2d 710, 720 (1955).

[16] U.C.C. § 2-615(a); *see also, e.g.*, Cal. Com. Code § 2615 (codifying language of U.C.C. § 2-615).

[17] *PPF Safeguard, LLC v. BCR Safeguard Holding*, LLC, 85 A.D.3d 506, 508 (N.Y. App. Div. 1st Dep't 2011) (citing Restatement (Second) of Contracts § 265 (1981)). The Restatement (Second) of Contracts § 265 provides that "[w]here, 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." The Restatement commentary further explains that Section 265 requires that (1) the purpose that is frustrated was a "principal purpose" in making the contract, such that without it the transaction "would make little sense"; (2) the frustration is substantial; and (3) the non-occurrence of the frustrating event was a basic assumption on which the contract was made. Restatement (Second) of Contracts § 265, cmt. a.

[18] *Crown IT Servs., Inc. v. Koval-Olsen*, 11 A.D.3d 263, 265 (N.Y. App. Div. 1st Dep't 2004).

[19] *Id.*

[20] *Crown IT Servs.*, 11 A.D.3d at 265; *A + E Television Networks, LLC v. Wish Factory Inc.*, 2016 WL 8136110, at *12 (S.D.N.Y. Mar. 11, 2016); *Warner v. Kaplan*, 71 A.D.3d 1, 6 (N.Y. App. Div. 1st Dep't 2009) (frustration of purpose "is not available where the event which prevented performance was foreseeable and provision could have been made for its occurrence").

[21] *Bayou Place Ltd. P'ship v. Alleppo's Grill*, Inc., 2020 WL 1235010, at *8 (D. Md. Mar. 13, 2020); *see also Warner*, 71 A.D.3d at 6.

[22] *A + E Television Networks*, 2016 WL 8136110, at *13.

[23] *Id.* (quoting *407 E. 61st Garage, Inc.*, 23 N.Y.2d at 282).

[24] In the event that a court rejects such defenses, a party found to be in breach of a contract may still raise the counterparty's failure to mitigate its damages as an alternative defense or option for reducing

any prospective damages award. *See U.S. Bank Nat. Ass'n v. Ables & Hall Builders*, 696 F. Supp. 2d 428, 440-41 (S.D.N.Y. 2010) ("In a breach of contract action, a plaintiff ordinarily has a duty to mitigate the damages that he incurs. If the plaintiff fails to mitigate his damages, the defendant cannot be charged with them.").

[25] *D & A Structural Contractors Inc. v. Unger*, 25 Misc.3d 1211(A) (N.Y. Sup. Ct. Nassau Cty. 2009).

Gibson Dunn's lawyers are available to assist with questions you may have regarding developments related to the COVID-19 outbreak. We regularly counsel clients on issues raised by this pandemic in the commercial context. For additional information, please contact any member of the firm's Coronavirus (COVID-19) Response Team, the Gibson Dunn attorney with whom you work, or the following authors:

AUTHORS: Shireen Barday, Mary Beth Maloney, Rahim Moloo, Hannah Kirshner, and Robert Banerjea