March 30, 2020

COVID-19, Commercial Disruption and Contractual Considerations

Dear Friends,

In the midst of the outbreak of the novel coronavirus ("COVID-19"), which has caused unprecedented disruption in all industries, we hope to bring some clarity and guidance for dealing with the legal challenges arising from the virus. At a moment in which the United States federal, state and local governments, and those of many others around the globe, are adopting social and economic measures attempting to combat and mitigate the impact of COVID-19, it is important to understand the alternatives provided by the different sources of law that might help our clients and friends to safeguard their business interests.

Being proactive, rather than reactive, will in many cases benefit and increase the chances of survival of contractual relations between businesses and, consequently, the organizations bound by them. We also understand that like other crises, COVID-19, too, shall pass, and therefore parties would benefit from adopting, to the greatest extent possible, an amicable approach with their counterparties in assessing and approaching suspension or modification of contractual obligations. Our recommendation to every affected business is to carefully review its existing contracts in order to understand which obligations are, in accordance with both parties' best interests, necessary to postpone, modify or suspended in order to avoid a potential contractual breach or termination, thus allowing the commercial relationship to survive.

This alert has a twofold approach. *First*, we address the legal doctrines aimed at avoiding unwanted breaches of contractual obligations. *Second*, we suggest some considerations that should be borne in mind during the COVID-19 crisis.

1. LEGAL DOCTRINES AND DISRUPTION OF CONTRACTUAL OBLIGATIONS

Business owners and organizations have different alternatives for addressing situations like those caused by COVID-19. We highlight below those which would have a better chance of acceptance while at the same time increasing the potential of maintaining commercial relationships.

Many of the situations that companies are currently facing have a good chance of finding their way to court. Yet many courts have already started suspending proceedings and time frames. The same is happening with proceedings subject to arbitration and other alternative dispute resolution mechanisms. While the latter are often considered to provide more flexibility to the parties, and in many cases some of their procedural phases can still be carried out with the assistance of technology, the outcome is not always optimal and temporary suspension is in some cases recommended. This does not necessarily carry a negative effect. In fact, the current situation

might open the door to new negotiations and possible creative solutions that, but for COVID-19, might have taken years to resolve.

Our advice here flows from the thoughts we shared in our introduction: before taking more drastic steps, businesses should consider engaging in amicable and commercial negotiations with the counterparties avoiding breaking up the relationship. Parties should not enter those conversations unprepared, however. To the contrary, every company should have a carefully thought-out plan, allowing them to focus on the strengths and weaknesses that the specific agreement creates for each side. Every company should understand when it can secure a negotiation advantage and, in some cases more importantly, when is better to compromise.

If an amicable negotiation is not feasible, either due to a counterparty's intransigent position, the economics of the agreement, the language of the contract or any other reason, prepare a contingency plan, start looking for alternatives and make sure you are able to capitalize on the opportunities that are to come. Those opportunities, by the way, are in fact likely to be coming. Additionally, make sure that the contingency plan includes a dispute resolution alternative aimed at protecting the commercial and legal interests of the company.

Here are some of the legal doctrines that might aid a party in getting out of a contract. The reader should understand that every situation is different, and that constructing effective arguments using these theories should be done with the aid of counsel. Moreover, we caution against relying on any of these doctrines to simply cancel contracts. Again, such a decision must be made with the advice of well-informed counsel.

a. Force Majeure

Force majeure is a common clause in commercial and other agreements that permits the parties to suspend or postpone performance of obligations caused by unforeseeable and unpredictable circumstances—in other words, an event beyond the parties' reasonable control.

A traditional declaration of force majeure relieves both parties of their contractual obligations. Yet the parties may have broadened or narrowed the scope of the traditional understanding of this provision in the contract, agreeing to different and probably more limited effects.

Following the freedom of contract doctrine, the parties might have even included conditions for triggering the effectiveness of a force majeure declaration. Parties should analyze whether the force majeure provision establishes or requires following a specific notice proceeding or mechanism. Time frames for providing notice of force majeure events are also typically included in commercial contracts. To the extent there are conditions, the parties should make sure they understand and comply with them.

A detailed analysis and understanding, from legal and economic standpoints, of the consequences of triggering these provisions is recommended. While in some cases a declaration of force majeure might seem a good alternative to avoid having to comply with contractual obligations, the party considering such a declaration should also bear in mind that it will be prevented from receiving its part of the contractual bargain.

Additionally, parties should be mindful of the duty to mitigate, or obligation to minimize the effects of, a force majeure declaration on its counterparty. Such a duty could require the triggering party to consider alternatives prior to formalizing the declaration and is heavily fact-based and guided on an *ad hoc* basis.

b. Frustration of Purpose Doctrine

The situation arising out of the COVID-19 social and economic lockdowns is likely to undermine some companies' purposes for entering into certain commercial agreements. This is particularly significant at a moment in which governments are considering, and in some cases enforcing, mandatory lockdowns and quarantines. In such situations, a company is generally not considered an essential business or does not provide related services and is therefore forced to restrict and, in extreme cases, halt its economic activities.

The frustration of purpose doctrine permits one of the parties to excuse the performance of contractual obligations when circumstances have undermined the purpose of such agreement. In order to excuse the contractual performance under this doctrine, it is required that the change of circumstances destroy the reasons for performing the contract, rendering its performance virtually worthless.

This is an interesting alternative when the contract does not include a force majeure provision. It can also be considered for suspending the effectiveness of the contract until the new circumstances disappear or until the parties consider that the performance of the contract makes sense again.

Readers should note that suspending the effectiveness of a contract due to frustration of its purpose might, in many cases, benefit both parties (e.g.: service agreements where the purchaser of such services might not be able to enjoy the services performed by the services provider; financial agreements where the financed party is not able to conduct the specific activities it sought funding for and is also unable to repay; *inter alia*). Again, our recommendation is to initially look at all the alternatives herein provided as negotiation points.

c. Impossibility and Impracticability of Performance

The legal consequences of COVID-19 extend to the impossibility and impracticability of performance of certain obligations arising from commercial agreements. This is different from frustration of purpose in that the purpose of the contracts still exists, but circumstances make it

impossible to perform. As mentioned in the previous subsection, mandatory lockdowns and quarantines together with border shutdowns and other government measures can create burdens to performance of contractual obligations. The likelihood that these burdens will become too burdensome, to the point of making the performance of a contract impossible or impracticable, is soaring.

Impossibility of performance implies that new unforeseen circumstances or an unforeseen event creates an impossibility to perform a contractual obligation and the affected party is permitted to be released from complying with such obligation. It is an objective condition. Release from a contractual obligation is generally confined to the destruction of the means of performance and has a high standard of proof.

Although similar in its effects, impracticability of performance has one major difference with the doctrine of impossibility of performance. Impracticability is a subjective condition. In order to avoid performance of a contractual obligation under this doctrine, such obligation shall have become unfeasibly difficult or expensive to perform.

As mentioned earlier, our intention is to put the different alternatives on the table and avoid, when possible, ending up in court. Therefore, these doctrines are as good as the others if used as a negotiating strategy, if fact- or circumstances-backed.

d. Act of God Doctrine

The Act of God doctrine exonerates a contractual performance and permits the exclusion of liability under certain circumstances, provided the damages have been caused solely by a natural accident with no human interaction.

The view of the majority of the scientific community is that the virus was first transmitted to humans by consumption of a specific animal, which itself was infected from the bite of another animal. Therefore, COVID-19 and its spread are not man made. If it is not man made and actually exists despite man's efforts to eradicate it, COVID-19 is arguably a natural accident.

With this in mind, an argument can be made that business disruption due to COVID-19 can potentially fall under the Act of God doctrine. Would a scenario in which certain type of goods that are exposed to the COVID-19 are deemed worthless support this theory? If so, there is an argument that the seller of such contaminated goods would not be liable to a buyer for breach of contract breach, whether based on non-delivery or delay in the delivery.

e. Act of a Public Enemy Doctrine

To finalize the first section of this piece, we want to maintain our thought-provoking tone. On many occasions during the past few weeks the authorities of the United States, President Trump

among others, as well as the leaders of many other nations, have characterized COVID-19 as a public enemy. The current situation has also been compared to a war.

Bearing this in mind, there could be an argument that damages caused due to the business disruption caused by COVID-19 could be considered an act of a public enemy doctrine exemption, provided, as in the case above, that those damages are solely caused by this new public enemy.

2. CONSIDERATIONS OF PARTICULAR IMPORTANCE IN TROUBLED TIMES

We understand that during these uncertain times some business decisions are adopted in the so-called "heat of the moment" or without taking as much time as companies would in other circumstances. This is normal. The priority now is to try keep everyone safe and keep the business afloat.

But it is important to keep in mind that many of the decisions that are currently being adopted will have long-term consequences that, when the COVID-19 is long gone, might not play out as expected.

We recommend paying specific attention to the following concepts in order to avoid minimize unexpected consequences in the months to follow.

a. Assumption of Risk Doctrine

The assumption of risks is inherent to the business community. Every business, by its own nature, assumes risk. Yet there are certain assumptions of risk that, while not preventing recovery from the other party, negate certain duties that under different circumstances would have been in place.

For this doctrine to apply and negate a duty to one party, such party needs to have freely assumed the risk. Consequently, it first needs to have specific knowledge of that risk.

Many business decisions during these coming months will be conditioned by COVID-19. And many questions will arise in relation to the scope of this risk prior to entering contractual obligations. Decision makers should bear in mind that the risk needs to be specific, and not as broad as the mere existence of the virus. It is likely that they will adopt riskier decisions than those they would have during another period. Analyzing and understanding the legal and economic consequences arising out of a commercial agreement and considering the current situation are of paramount importance. This will certainly prove to be the best alternative for mitigating them.

b. General Release

A plausible scenario during the next few months is the occurrence of a higher number of contractual breaches and defaults. This situation will be accompanied by negotiations and settlement agreements. An important piece of a settlement agreement is a section related to releasing the former debtor/obligor from further liability, whether in a narrow or broad fashion.

General releases of obligations, which are broad in nature, are to be treated carefully. On the one hand, the party providing the release should have conducted a detailed analysis of the consequences of providing such general release, as this document will most likely prevent it from initiating further claims against its counterparty. On the other hand, the party being released needs to carefully draft the document in a fashion that would avoid its counterparty from bringing further claims in the future.

c. Waiver

In addition to releasing counterparties from obligations, companies will also likely waive their contractual rights in the pursuit of maintaining commercial relationships. Or in some cases counterparties might be under the assumption that certain rights have been waived.

The specific circumstances of each case are of particular importance and understanding that contractual rights will only be waived if compliant with certain requirements needs not to be forgotten. This might help avoid surprises further down the road. Additionally, understanding these requirements will also benefit those who, by omission, could have otherwise waived some contractual rights.

For contractual rights to be effectively waived, there needs to be a knowing, voluntary and intentional abandonment of the exercise of such right. Many contracts require such waiver to be in writing to be effective. The abandonment will be determined by the affirmative conduct of the waiving party or its failure to act evidencing an intent to not claim a purported advantage. Although a waiver requires a clear manifestation of intent, the failure to act prospect needs to be carefully carved out from commercial agreements in order to avoid unwanted scenarios.

d. Material Adverse Change or Effect

A Material Adverse Change ("MAC") or Material Adverse Effect ("MAE") is a commonly defined term in certain types of commercial agreements. Particularly, it is commonly found in loan facilities and merger or acquisition transactions.

This defined term grants a right to one of the parties to terminate or suspend the agreement should some events or changes occur. The definition of such a concept in each agreement will be paramount in determining whether COVID-19 might be considered a MAC or MAE falling under its scope.

Additionally, having knowledge of the COVID-19 prior to entering in commercial agreements will determine the application of MAC or MAE provisions. Parties that signed agreements after the outbreak of the virus will not be able to rely on these provisions for terminating or suspending agreements due to the virus.

e. Novation of Contract

COVID-19 poses a likely trigger for commercial agreements to be novated. A novation is the replacement of an existing agreement with a new one or addition of a new obligation, creating new rights and obligations between the parties.

In the midst of maintaining relationships, parties might be open to novation, or its close cousin amendment, and to create a new and different set of rights and obligations targeted to cope with the current situation. When doing so, it should be kept in mind that novations do not discharge obligations created under prior agreements unless the parties intend to do so.

Contacts

Brian C. Dunning
bdunning@drdllplaw.com
Tel.: +1 646 873 7522

Josh D. Rievman
jrievman@drdllplaw.com
Tel.: +1 646 435 0027

Michael G. Davies
mdavies@drdllplaw.com
Tel.: +1 646 383 7738

Damián Vallejo
dvallejo@drdllplaw.com
Tel.: +1 646 688 2765