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Mediating and Resolving COVID-19-Related Contract and Commercial Lease Disputes

This turbulent pandemic year will undoubtedly lead to many court cases, and there are many pathways to settlement in contract and commercial lease cases.

By Frank Burke

The COVID-19 pandemic and a series of government shutdown orders have negatively impacted many contracts and commercial leases, either preventing or slowing performance and upending the expectations of contracting parties. As resulting contract and lease actions enter the court systems, the parties and the court will have to unravel complex facts, causation and allocation of risk of loss issues impacting performance often leading to losses for both parties. We will examine how these actions might be approached and resolved by settlement by applying a series of contract performance doctrines that inevitably arise during these types of situations: force majeure, impossibility, impracticability, commercial frustration of purpose, and material adverse change or effect clauses.

(Courtesy photo)

Frank Burke, a panel member of ADR Services Inc.

Strategic Considerations

Parties should approach these types of cases with realistic expectations about what will occur and the need for compromise. This is difficult time to get an early jury trial setting. Since many of the contract issues discussed herein are decided as a matter of law by the court, not a jury, the parties should consider a bench trial as a possibility. This might lead the non-performing party to initiate a declaratory relief action.

To value its case, each party should explore its best, most likely and worst trial results on liability, damages and allocation of the risk of loss. For example, the Restatement 2d Contracts Section 272 provides for restitution for part performance conferring a benefit upon another or reliance in cases of impracticability or frustration of purpose.

Finally, the parties must be cognizant of the possibility of a bankruptcy filing by one of them. This has already happened in certain sectors, such as large retail tenants, which have been able to reject commercial leases in bankruptcy to reduce the size of their national footprint or force

their landlords to renegotiate. The bankruptcy automatic stay applies to collection actions for past due rents or eviction actions.

Does your contract contain a force majeure clause?

Force majeure is a contract defense available to a party when the contract includes a clause excusing the nonperformance of one or both parties to the contract because of a force majeure event. No matter what specific events are enumerated in a force majeure clause, courts will not enforce the clause unless the qualifying event is beyond the parties' control.

The language of force majeure clauses can vary widely depending on when written, the parties, and industry. Many refer to an "act of God" with further generic language and may not apply. Some may contain references to "epidemic," "pandemic," "disease" or "public health event," which would be helpful language. Others may refer to "government order" or "shutdown order," "government acts, regulations, rules or laws" or "acts of civil or military authority," which would also be helpful because for many businesses, the shutdown orders were the triggering event.

A few factors apply to specific types of contracts. With regard to construction projects the AIA form contract force majeure clause does not include pandemic language while the Consensus Docs form does contain pandemic language. If the force majeure clauses apply, they allow additional time, not expense. This does not preclude damages or additional costs for delay under other clauses. Those other clauses include delay and disruption clauses, suspension of the contract for convenience, price escalation clauses for supply chain disruption, mobilization costs for demobilization and remobilization, emergency and safety clauses that relate to increased costs of COVID-19 protocols, and change order clauses, that can relate to the contract amount and time. On ongoing construction projects owners, contractors and subcontractors have been cooperating and flexible in applying these clauses to enable the projects to continue despite government shutdowns followed by social distancing requirements that slowed progress on the construction.

Regarding commercial leases that contain force majeure clauses, the payment of rents is usually excluded from the clause. Therefore, renegotiation of existing commercial leases has included: rent abatement with deferred payments; moving from a set base rent to a percentage of monthly sales; increasing tenant improvement allowances to implement social distancing; allowing the tenant to use a portion of its security deposit to help reopen or reconfigure; moving the tenant to a smaller space at less rent or larger space for the same rent; shortening or lengthening the lease; triggering "kick out" clauses that enable mutual cancellation; landlords seeking release of cotenancy or key tenant provisions that allow rent reduction based on lower foot traffic; smaller tenants insisting that they not be required to reopen or pay full rent until key tenants are open or replaced.

Other types of impacted contracts include real estate development agreements, supply contracts and sales of goods, consulting agreements, and event agreements. To the extent these may become contested, the force majeure clauses must be reviewed.

Did COVID-19 render performance impossible?

The doctrine of impossibility is available where performance of a contract is rendered objectively impossible. A party seeking to invoke the impossibility doctrine under common law or state statute 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. 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 fact that performance is made more difficult or more expensive do not necessarily permit a claim of impossibility.

Did COVID-19 render performance impracticable?

As with impossibility, the doctrine of commercial impracticability

may also be available where performance is rendered impracticable. Many states that recognize commercial impracticability as a defense have adopted the Restatement 2d of Contracts Section 261, or similar language. The doctrine also applies to sales of goods through UCC Section 2-615. The impracticability at issue must be the product of unforeseen events. Mere economic loss or hardship is insufficient to render performance impracticable because courts generally treat it as foreseen. However, in some circumstances the defense may be available where performance "can only be done at an excessive and unreasonable cost." The Restatement also includes provisions for partial and temporary impracticability, which could prove useful in resolving contract disputes impacted by COVID-19 and allocation of risk, but there is sparse judicial guidance on these concepts.

Did COVID-19 frustrate the central purpose of the agreement?

Frustration of purpose applies to instances where the event rendering the contract valueless is unforeseen. It has been applied 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. Frustration of purpose does not usually apply merely "because it becomes more economically difficult to perform." The Restatement contains a provision relating to temporary frustration, which might prove useful in allocating risk of loss to achieve resolution, but again there is sparse judicial precedent for guidance.

Does your contract contain a material adverse effect clause?

Material Adverse Change (MAC) and Material Adverse Effect (MAE) clauses are typically utilized in financial transactions such as merger and acquisition agreements, loan financing for merger and acquisition agreements, traditional loan financing or commitment letters, as continuing obligations under a loan, and in licensing agreements.

The typical MAC/MAE clause in a proposed merger transaction is defined as any development, event, condition or state of facts that have had, or would reasonably be expected to have, a material adverse change (effect) on the business, assets, financial condition or results of operations of the subject party, but excludes various categories of broader market or industry risk. These clauses may be a condition to closing or may be included in the representations and warranties section of the agreement. When such cases are settled, it is often through a price adjustment.

At least 10 disputes have arisen this year from large mergers that included MAE or MAC clauses where the buyer has declined to complete the acquisition. The two most high-profile matters have involved a $3.6 billion sale involving Taubman Centers Inc. as seller and Simon Property Group Inc. as buyer, pending in Michigan and a $16 billion sale involving Tiffany & Co. as seller and LMVH Moet Hennessy-Louis Vuitton SE as buyer, which recently settled. There are eight other similar matters pending in Delaware and one in Texas. The cases are weighing whether the seller was disproportionately impacted by the pandemic and whether the seller complied with its covenant to conduct business in the ordinary course.

Conclusion

This turbulent pandemic year will undoubtedly lead to many court cases, and this paper has outlined pathways to settlement in contract and commercial lease cases.

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