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Who Pays When Contract Performance Is Excused Due to Covid-19?

BY PAUL "TAD" M. O'CONNOR III AND JENNIFER MCDOUGALL

Covid-19 has given new relevance to the common law breach of contract defenses of impracticability and impossibility of performance, as well as force majeure contract clauses, under which contract performance may be excused because of external events (like the Covid-19 pandemic) not the fault of the parties.

Where such a defense is successfully invoked, however, the consequences can potentially be inequitable—a party, for example, could face a loss of expenses it laid out before the occurrence of the event in anticipation of performance by the party whose performance is excused.

Courts have taken different approaches to avoid inequitable results.

Damages Following Discharge Where performance is excused, courts may "discharge" the contract, terminating all obligations. However, by the time the event excusing performance occurs, one party may have already rendered, or received the benefit of, some performance.

To ameliorate or avoid inequitable results from discharge of the contract, courts may award restitution or reliance damages. Restitution compensates a party for benefits it rendered to the other party at its expense, while reliance damages compensate for costs incurred in preparation for performance.

Damages may be awarded even where no benefit was conferred on the other party: "the court may grant relief as justice requires including protection of the parties' reliance interests." (Restatement Section 272 (2))

The court in the early case of *Young v. City of Chicopee*, which involved the destruction by fire of a bridge under construction, adopted a "but-for" test to determine the extent to which damages should be awarded. Under that test, damages are awarded to compensate a party for performance which "but for the [external event] would have enured" to the benefit of the other party. Plaintiff, who was constructing the bridge, was thus permitted to recover from the owner the cost of materials "wrought into" the bridge, but not those that had not yet "come into relations" with the bridge.

Reformation or Adjustment Where there is a compelling fairness or efficiency concern, courts may modify the contract, salvaging those obligations that can still be performed, while excusing obligations whose performance has been prevented.

Thus, courts have been willing to modify, rather than discharge, contracts where the ongoing relationship is significant, such as long-term supply contracts.

In the seminal 1980 case of *Aluminum Co. of America v. Essex Group Inc.*, the court adjusted a long-term supply contract where, under the parties' contracted-for price index, plaintiff Alcoa faced such a huge loss, principally due to unexpected inflation, that the court held its performance was impracticable. However, instead of discharging the contract, the court adjusted the price index on the basis of the "general rules of equitable restitution."

Since that *Alcoa* case, courts have become increasingly willing to make adjustments to contracts. Thus, in *In re Hitz Rest. Grp.*, the court held that a force majeure clause in a restaurant lease was "unambiguously triggered" by the state governor's Covid-19 executive order barring indoor dining, but rather than eliminate the restaurant's rent obligation entirely, the court reduced it by 75% because it could remain open for take-out.

Going Forward Parties in litigation should be alert not just to whether performance should be excused, but also to whether an adjustment to the contract is feasible and warranted and whether losses resulting from excusing performance can and should be allocated.

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In contract negotiations, parties should consider including in the contract not just a force majeure clause, but also on explicit allocation of risk of, and damages resulting from, a party's performance being excused by an unforeseen event. Typically the allocation should be based on which party is better situated to bear or ameliorate the damages. If the parties cannot agree on which one is better situated, the allocation could be 50-50 or some other equitable or agreed upon ratio.

The massive disruptions caused by Covid-19 will no doubt provide fertile ground for contractual disputes invoking the excuse doctrine and for further development of the law concerning how losses should be allocated. More is surely to come.

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