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CORONAVIRUS AND FAILURE TO PERFORM UNDER BUSINESS CONTRACTS

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Note: This article specifically addresses patent licenses and manufacturing agreements. However, it applies equally to all business agreements during the coronavirus pandemic and its aftermath.

You're the president at Sigma Technologies. The COVID-19 crisis has shut down most incoming orders or your business has shuttered. As a patent licensee, Sigma is contractually obliged to make a scheduled periodic minimum or milestone royalty payment in four days. You are currently getting no value from the license and want to know if you have to make the payment, or whether your company is excused from making payment.

Your business colleague at Delta Industries is concerned about its manufacturing patent agreement. The U.S. company producing a critical component for Delta's key product under a patent license is able to supply only a fraction of the required quantity of components because of COVID-19 disruption. Further, your colleague is worried its own commitments, just as Sigma is. Your colleague wonders what rights it has under the manufacturing patent agreement.

You may well need to get full-throated advice on the issue, but it's good to know some basic principles at the outset. Keep reading even if you have no agreement regarding patents: these principles apply to all business contract disputes.

Your first order of business is to look at the agreement. Does it have a *force majeure* clause, or similar provision dealing with non-performance/delay caused by unforeseen or uncontrollable events? If so, does it give clear guidance on rights and duties? Before addressing that, let's ask what your options are if your agreement has no such clause.

Whether or not there is such a clause, bear in mind that license interpretation is governed by state law. One of fifty state jurisdictions will apply its own statutory and case law to the question, assuming there are no international legal issues involved.

WHAT IF THE AGREEMENT IS SILENT?

If your license agreement does *not* have a *force majeure* clause, contract law recognizes two defenses, even if the parties failed to expressly address such eventualities in the license.

The doctrine of "impracticability" or "impossibility." Most jurisdictions will excuse a breach of license agreement if an unforeseeable event makes performance impracticable by causing a high level of difficulty or high level of added expense for the breaching party if it were to perform under the contract. In the seminal English case, *Taylor v. Caldwell*, the owner of a music hall was excused of liability for failing to make the hall available due to an accidental fire that destroyed the building.

However, there are additional requirements. The event must be beyond the control of the breaching party; and the breaching party must not have assumed the risk of the event occurring. Given that the occurrence and rapid spread of COVID-19 was unforeseeable at the beginning of this year, a breach may be excused if the contract was entered into before then and if performance becomes impracticable.

What constitutes a "high level" of difficulty or expense? Some jurisdictions, notably New York, require impossibility of performance. California case law does not. Generally, the performance should be at least so impractical, viewed *objectively*, that it is inconsistent with the basic assumption of the parties at the time the contract was made. The event may also have to be so unlikely that a reasonable party would not have guarded against it in the contract.

The doctrine of "frustration of purpose." Similar to the doctrine of impracticability, the unforeseeable event here must go so far as to "destroy the purpose of the contract." Its origins trace to *Krell v. Henry*. Henry rented a room from Krell for the purpose of viewing the coronation of English King Edward VII. But the King fell ill, and the coronation was postponed. The very purpose of the contract—a room with a view of the coronation—was frustrated, and performance was excused.

Frustration of purpose requires many of the same elements as the principles of impossibility or impracticability, but does not require an event impeding a party's performance: (1) an event substantially frustrates a party's principal purpose; (2) the nonoccurrence of the event was a basic assumption of the contract; and (3) the event was not the fault of the party asserting the defense. The question is whether the unforeseeable event has so altered circumstances that performance would no longer fulfill any aspect of its original purpose. Will cancellations in the supply chain render the object of a license agreement completely "valueless"? Maybe not.

There are two primary obstacles to successfully invoking this defense. First, courts interpret a party's "purpose" broadly. Merely being unable to take advantage of the agreement in an preferred or expected manner may be insufficient. Second, frustration must be near total. It generally is not enough that the activity in question has now become unprofitable. It is not considered a "basic assumption" that existing market conditions or the financial situation of the parties will not be disturbed. As a result, mere market shifts or financial inability to perform generally do not constitute unforeseen events the nonoccurrence of which was a "basic assumption" of the contract.

California and Other Statutes. Notwithstanding the absence of *force majeure* provisions in the agreement and the requirements under common law, some states have legislated remedies, such as California. California Civil Code 1511 provides that nonperformance/delay of performance under contract is excused when it is caused "by operation of law" or "by an irresistible, superhuman cause" "unless the parties have expressly agreed to the contrary."

A *FORCE MAJEURE* CLAUSE OVERRIDES COMMON LAW DEFENSES

If a contract *does* have a *force majeure* clause, most courts will rule that it overrides the impracticability and frustration of purpose common law defenses. The logic is that the parties are determining for themselves what delays or nonperformance will be excused, altering the common law default rules. The only requirement is that the events be beyond the parties' control, for obvious reasons. Foreseeability is viewed by a different lens as well. Unlike the common law defenses, a foreseeable event specifically identified in the *force majeure* clause will excuse performance.

If the clause lists specific events of *force majeure* (e.g. "strike, riots, war") those events will excuse or delay performance, even if foreseeable. On the other hand, a list of specific events is often interpreted by courts to limit the *force majeure* defense to events similar to those on the list. Other truly unforeseeable events, like COVID-19, if not similar or addressed, could well provide no defense. Look for references to "disease" or "epidemic" or "pandemic." Watch for notice requirements in the *force majeure* clause that must be met.

What if the license agreement is vague, simply referring to "acts of God" and "other similar events" and without specific examples? COVID-19 would then seem to be an unforeseeable event within the phrase, providing a likely defense.

A wild card with force majeure clauses is where they fail to specify the degree of difficulty required to excuse performance. Outcomes here may be difficult to predict, as courts and juries may vary on excuse even where performance is made materially more difficult, expensive or dangerous by COVID-19.

DRAFTING TIP AND BUSINESS INTERRUPTION INSURANCE

While there are many ways to include pandemic protection, one example is the following:

> "Force Majeure Event includes, but is not limited to, any intervening act of God or public enemy, war, invasion, act of terror, hurricane force winds, tornados, strikes or labor disputes, riot or other public disorder, **disease outbreak, epidemic, pandemic, or other declaration of public health emergency, quarantine restriction**, and any act of any governmental body or authority that results in the imposition of a tariff or duty on required imported materials, which was not applicable as of the Effective Date of this Agreement."

Last thought: Don't be limited by thoughts of contractual rules. Consider also the possibility that business interruption insurance should be looked at.

After addressing these preliminary thoughts, you will be better prepared to consider contacting counsel or address other initial steps.

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