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Contract Renegotiation Vs. Litigation In Wake Of COVID-19

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As COVID-19 has affected businesses globally, contractual defenses, such as force majeure and frustration of purpose, have gained increasing visibility. These doctrines are intended to be used as defenses in litigation. But, in these unprecedent times, companies are leveraging such defenses to renegotiate contracts rather than litigate their outstanding obligations.

An Overview of Contractual Defenses That May Excuse or Delay a Party's Performance Due to COVID-19

Force Majeure Clauses

Force majeure clauses excuse or delay a party's performance in the event of circumstances beyond a party's control, such as fire, flood, war, or acts of God. Under New York, New Jersey and Delaware law, a force majeure clause is limited to its express terms, meaning that only events specifically listed in the contract will excuse or delay a party's performance.[i] The event must also be unforeseeable.[ii]

Language that may cover COVID-19 includes public-health-related language, such as epidemic, illness, pandemic, outbreak or emergency. "Acts of government" may also excuse or delay a party's performance because government stay-at-home or pause orders and travel restrictions have affected many businesses during the COVID-19 pandemic.

Many force majeure clauses contain catch-all language, such as "or other similar causes beyond the control of such party"; however, New York, New Jersey and Delaware law interpret force majeure clauses according to the principle of ejusdem generis, meaning that catch-all language should not be construed to the broadest extent

possible but should be interpreted narrowly so that only events like those specifically enumerated are included.[iii]

New York and Delaware law also provide that a party can broaden a catch-all phrase through specific language. For example, in Castor Petroleum Ltd. v. Petroterminal De Panama, the court held that the catch-all provision — "or other similar or dissimilar events or circumstances" — included the attachment of the plaintiff's oil due to lawsuits when the force majeure clause only enumerated "government embargo or other interventions."[iv]

If a force majeure provision does not include public-health-related language or "acts of government," and includes a catch-all provision that courts have construed narrowly, like "for any reason," then the force majeure provision would likely not excuse or delay a party's performance due to COVID-19.[v] However, if a force majeure clause includes a broad catch-all provision, such as "any reason whatsoever beyond the control of [defendant]," then the clause could cover events related to COVID-19, even if public-health-related language or "acts of government" are not enumerated in the clause.[vi]

Frustration of Purpose

Frustration of purpose is a more difficult defense to prove because the principal purpose of the contract must be frustrated by an event the parties could not have contemplated when making the contract.[vii] COVID-19 is an event that the parties would likely not have contemplated when making the contract; however, in many instances the change in circumstances caused by COVID-19 will not render one party's performance completely worthless to the other party, as required by New York law.[viii]

Renegotiation vs. Litigation: A Balancing Test

When evaluating whether a company should attempt to renegotiate and settle outstanding obligations versus signaling that it wants to pursue litigation, the company should consider the following:

A company should assess whether it wants or needs an ongoing commercial relationship with the other party, and the other party's import to the company's business.

If the other party is a major player in the company's business and no other company can readily fill the same roll, then the company may want to work diligently to settle any outstanding obligations, even if its performance can be excused under the contract. However, if the company could continue with its business after COVID-19 without the opposing company, or with another provider that is readily available, then it may choose to assert contractual defenses right away to signal that it wishes to litigate the dispute.

The amount in dispute compared to the costs of litigating the matter.

First, a company or its inside or outside counsel should check whether attorney fees are recoverable by the prevailing party pursuant to the contract. If a company owes a relatively small amount, then it may attempt to renegotiate this amount because even if it has a strong defense that its performance was excused, the lawyer fees and costs necessary to litigate the dispute may be greater than its outstanding obligation.

On the other hand, if a company cannot pay a sizeable amount, has a strong defense that its performance was excused, and attorney fees are recoverable to the prevailing party, then it may choose to forego negotiation and assert its contractual defenses if or when the opposing party files a claim against it.

A company should consider whether there could be potential reputational costs to litigation.

If a company litigates a dispute, then other companies in the same business community may not want to work with it in the future because of a perceived risk that it does not pay its bills and that the company is litigious. The reputational risk of course depends on the size and general reputation of the company. For example, a large, successful company often does not have the same concerns as a smaller company that works with a small group of vendors and customers.

The strength of a company's contractual defenses factors into its assessment of these considerations, and so a company must weigh the above considerations against the strength of its contractual defenses and the amount in dispute. Of course, this analysis will differ in every case, but the following chart shows how the above factors are affected by either stronger or weaker contractual defenses:

Factors	Stronger Contractual Defenses	Weaker Contractual Defenses
Need/Want for an Ongoing Commercial Relationship	Whether a company has weak or strong contractual defenses, it will always need to assess its need/want for an ongoing commercial relationship with the opposing party because litigation would necessarily damage that relationship. However, a company with stronger contractual defenses should place less weight on this factor. While the company will still want to negotiate, it should be ready to assert its defenses and walk away from negotiations, if the opposing party takes an unreasonable stance.	A company with weaker contractual defenses, should give more weight to its want/need for an ongoing contractual relationship with the opposing party. Because the company will have less leverage in negotiations, its focus should be on settlement and preserving the existing relationship.
Amount in Dispute Compared to Lawyers' Fees and Costs	A company will always need to assess the amount in dispute versus the costs of litigating the matter because in many circumstances it makes little sense to litigate claims for very small sums of money. However, if attorneys' fees are recoverable to the prevailing party, a company with strong contractual defenses should place less weight on this factor.	A company with weaker contractual defenses, should place greater weight on this factor because it is in the company's best interest to settle. If attorneys' fees are recoverable to the prevailing party, this is an additional risk that the company should account for because it is less likely the company will prevail in litigation.
Potential Reputational Costs of Litigation	As the strength of a company's contractual defenses increases, the company should become less concerned with the potential reputational risks of litigation because any potential reputational risk could be mitigated by prevailing in the lawsuit.	As the strength of a company's contractual defenses decreases, the company should become more concerned with potential reputational risks because these risks could be compounded if it engages in litigation and loses.

Considerations for Invoking Contractual Defenses for Optimal Results

After a company has completed the assessment above, then it will have a better understanding of whether it aims to settle its obligations with the opposing party or whether it is ready to litigate the dispute. More likely, it will opt for some combination — perhaps engaging in negotiations unless the opposing company takes a hard-line or unreasonable stance.

Companies should consider the following questions when deciding how to assert contractual defenses in negotiations.

Should the company assert defenses early or hold its hand?

If a company is not interested in negotiating, then it may want to assert its contractual defenses at inception. On the other hand, a company that wants to maintain a commercial relationship with the opposing party may save mentioning its contractual defenses until it needs leverage in negotiations.

Should a company business person or counsel assert contractual defenses?

If a company business person is engaged in negotiations, or has a good working relationship, with the other company, then it would likely stall negotiations if the company's inside or outside counsel suddenly intervened to assert the company's defenses. However, a company may want its counsel to assert contractual defenses on its behalf, if the opposing party is unwilling to negotiate, if there is an imbalance of power between the company and the opposing party, or if the defenses need a detailed legal explanation to advance the negotiations.

Can contractual defenses be asserted without stalling negotiations or harming the business relationship?

As with all communications, tone is important. For example, if a company asserts its contractual defenses aggressively, this may signal to the opposing that it is ready to litigate the dispute. However, if a company mentions its contractual defenses while still inviting the other party to discuss the matter, negotiations will likely continue.

Practical Next Steps for Any Company Unable to Meet Its Obligations Due to COVID-19

Any company that is unable to meet its payment obligations due to COVID-19 will first want to assess all of its outstanding debt. This includes gathering relevant contracts and beginning to prioritize which debts should be tackled first, taking into account the amount at stake and the importance of business relationships.

Next, the company can have either inside or outside counsel assess whether any obligations are excused or delayed due to contractual defenses. To manage costs, a company could choose to have the most important contracts (i.e., higher amounts at stake, most important business relationships) evaluated first. This process can occur on a rolling basis.

The company can then proceed with the processes outlined in this article, which include (1) assessing whether to renegotiate or litigate outstanding debts by weighing the three factors discussed against the strength of the company's contractual defenses; and (2) evaluating the three questions discussed when deciding how to assert its contractual defenses.

When drafting new contracts, companies should also consider drafting force majeure clauses so such clauses will cover events related to COVID-19 or any future pandemic. Including public-health-related language and "acts of government" in future force majeure clauses, as well as a catch-all phrase that has been interpreted broadly, such as "or other similar or dissimilar events or circumstances," will help ensure that these clauses cover future events related to COVID-19 or a similar pandemic.

Additionally, because COVID-19 may not be considered an unforeseen event in the future, companies should consider including language that excuses or delays a party's performance due to an event "whether foreseen or unforeseen."

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[i] See Stroud v. Forest Gate Dev. Corp., No. Civ.A 20063-NC, 2004 WL 1087373, at *4 (Del. Ch. May 5, 2004); Facto v. Pantagis, 390 N.J. Super. 277, 232 (App. Div. 2007); Reade v. Stoneybrook Realty, LLC, 882 N.Y.S. 2d 8, 9 (1st Dep't 2009).

[ii] Stroud, 2004 WL 1087373, at *5; Team Mktg. USA Corp. v. Power Pact LLC, 839 N.Y.S. 2d 242, 246 (3d Dep't 2007).

[iii] Seitz v. Mark-O-Lite Sign Contractors, 210 N.J. Super. 646, 650 (Law Div. 1986); Team Mktg. USA Corp., 839 N.Y.S. 2d at 246; Kel. Kim Corp. v. Cent. Mkts., 70 N.Y. 2d 900, 903 (1987); see Stroud, 2004 WL 1087373, at *5 ("A 'catch-all' phrase, such as this, must be construed within the context established by the preceding listed causes.").
[iv] Castor Petroleum Ltd. v. Petroterminal De Panama SA, 968 N.Y.S. 2d 435, 498 (1st Dep't 2013). See also Stroud, 2004 WL 1087373, at *5.
[v] See Team Mktg. USA Corp., 839 N.Y.S. 2d at 246.
[vi] See Stroud, 2004 WL 1087373, at *5.
[vii] CRS Proppants LLC v. Preferred Resin Holding Co., No. N15C-08-111 MMJ CCLD, 2016 WL 6094167, at *7 (Del. Sept. 27, 2016) (citation omitted); Fifth Ave. of Long Island Realty Assocs. v. KMO-361 Realty Assocs., 621 N.Y.S. 2d 647, 647-48 (2d Dep't 1995).
[viii] PPF Safeguard LLC v. BCR Safeguard Holding LLC, 924 N.Y.S. 2d 391, 394 (1st Dep't 2011).