Business Contracts – Lessons Learned from COVID

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Several weeks ago, a client asked for advice with respect to this COVID induced situation. His best customer had retained his company to perform $2,000,000 worth of services to host an elaborate corporate party in May of this year. My client had already received $1,500,000 under the contract, and had spent about $1,000,000 in advance payments to vendors. Given COVID, the customer notified my client that the party was off and that it was cancelling the contract. The customer wanted his money back.

My client contacted the vendors he had retained to fulfill his contractual obligations. He had paid one vendor from Georgia $150,000. When he asked that vendor for a refund, the vendor refused. The vendor's position was that it would be able to perform its obligations in May, so it refused to cancel its contract with my client. The vendor said that there was no condition of *force majeure*. What should my client do?

Force Majeure

Force Majeure is the topic of the day. Everybody is invoking it. And those who are not invoking it are experts in denying its applicability. Before we take sides, it would be good to know what it means, and when it applies to a contract.

A *force majeure* clause is language in a contract. The purpose of a *force majeure* clause is to describe those circumstances which permit a contract to be cancelled. Cancellation of a contract is a vague term filled with ramifications that parties may not understand or intend. The more accurate description of the effect of invoking a *force majeure* clause is that it enables a party to be excused from performing its obligations. If a party is excused from performing, then the lack of performance must be factored into the machinations of the contract. Only then can an outcome be determined.

Let's be honest. Most lawyers have probably spent zero minutes in their careers drafting the language of a *force majeure* clause. *Force majeure* is usually considered "boilerplate" which means it is the last thing that gets thrown into a contract before it is sent to a client. Most lawyers simply take *force majeure* language from a prior contract, copy and paste it, and voila it is in the new contract. Very little time is spent fine tuning it.

So what is suitable language for a *force majeure* clause? One place to look is to the government. The Massachusetts legislature has passed statutes containing *force majeure* language. For example, one statute defines a *force majeure* condition this way: ***An uncontrollable force or natural disaster not within the power of the operator or the commonwealth*** (MGL CH. 6C, §62). Simple and to the point. This does the job of conveying fundamental concepts about events which trigger *force majeure*. They tend to be outside the control of the parties to the contract, frequently defined as acts of nature or of government, not foreseeable, and verifiable by both parties to the contract.

There is not a one size fits all definition of a *force majeure* event. A contract for software development might refer to Internet interruption as a *force majeure* event, while weather conditions might be irrelevant; however just the opposite might be true for a construction contract.

Force Majeure strikes – now what?

Let's say that a *force majeur*e event occurs, how does that affect a contract? If a *force majeure* event occurs and prevents a party to a contract from performing its obligations, then that party is excused from performance and the contract can be unwound. It is important to note that the *force majeure* doctrine can be invoked by just one party. It is irrelevant if the other party is unaffected by the events causing the *force majeure*. As long as just one party cannot perform, a contract may be cancelled.

The process of unwinding a contract can be very complicated. It all depends on the contract, and more importantly, what has transpired between the time the contract was signed and the time someone declares *force majeure*. The more that each party has performed, the more complicated unwinding becomes. The technical term for unwinding a contract is "rescission." When a contract is rescinded, it means that each party is to be put in the position it was in before it entered into the contract. Let's explore that with a hypothetical.

Assume Bill and Jane enter into a contract whereby Bill is going to paint the interior of Jane's house for $10,000. They sign the contract on March 1 and Bill is supposed to start painting the house May 1, when the weather is warm and windows can be left open for ventilation. Jane gives Bill an initial payment of $3,000. In anticipation of painting the house, Bill spends $1,000 on supplies. Then, COVID strikes and house painting is not deemed an essential business (interestingly, however, construction is essential, so perhaps painting is construction). Jane is perfectly capable of performing her end of the contract: the house is ready to be painted and she has the money. But Bill construes Governor Baker's orders to prohibit him from performing his job. Further, Bill relies on employees who refuse to work in close proximity to each other. So Bill has no other choice but to inform Jane that he can't perform his contract. Should Jane accept Bill's statement that the contract is voided, or should she challenge him and insist that he paint her house?

Clearly in today's climate, Jane would be foolhardy to insist that Bill perform. She should accept Bill's statement that, through no fault of his own, he cannot fulfill his obligations and therefore is invoking *force majeure*. Who would want to stand before a jury and argue otherwise? But what happens next? What about the $3,000 Jane pre-paid Bill? Should she get it all back? Jane probably thinks so. But not Bill. He thinks he should return only $2,000, because he spent the $1,000 on paint for Jane. That seems fair to Bill. But perhaps not to Jane. She might insist that Bill try to return the paint to get his money back so he can then refund it to Jane. Is Bill obligated to do that? What if the paint were a custom color, is the retail paint store obligated to accept the paint Bill offers to return? What if the paint has a shelf life of thirty days? What if the store refuses refunds 15 days after a product is purchased? Should the store be obligated to waive these conditions? Should Bill and Jane consider splitting the $1,000? It gets complicated.

What are some takeaways?

What advice can we give to Bill and Jane? How do parties unwind a contract? First, the easy part. Each party should return to the other party any property in its possession that it has received under the contract. That's easy. Now the hard part. What about money that has been spent? What about future obligations that each party is supposed to perform? There are no hard and fast rules. It would appear that each party should attempt to return products and recover any money that has been given to third parties. To the extent money is refunded, that money should be returned to the other party. In addition, it would appear that each party should make a good faith effort to attempt to extricate itself from any residual contractual commitments. To the extent that future contractual obligations are rescinded, funds set aside to pay for those future obligations should also be returned to the other party. But there are many permutations to these two scenarios and each will need to be considered carefully. It would be risky for a party that has a contractual obligation with a third party to assume that such contract will be voided until it has a written release from the third party. Thus funds might have to be held in escrow for a period of time pending resolution of all contractual obligations.

My client's situation

Let's revisit my client's dilemma described at the outset. Applying the above principles, I advised my client to refund to his customer most of the money that my client was holding. Not all the money. I advised my client that he had a right to retain funds to cover the transaction costs involved in the process of rescinding the contract, including paying for my services and for his administrative costs to supervise the process. Further, I advised my client to contact all third parties who had received funds and request refunds and releases. To the extent funds are returned and releases executed, I advised my client to return those funds to his customer. But not everyone will play ball. And for those who don't cooperate including his largest vendor from Georgia, my advice was simple. Sue. Because it was irrelevant to *force majeure* that the Georgia vendor could perform. The issue was that my client could not perform, and under *force majeure*, if one party to a contract cannot perform, the contract can be cancelled. As I told my client, with vendors like that, who needs enemies?

Pointers

What practical lessons can be learned from this experience? First, don't overlook the so-called "boilerplate" contract language. Even routine provisions can have substantial impact on how contracts are performed. Second, if you pay the other party money in advance of contract performance, be careful about what the other party can do with that money. If the contract is silent, as most are, then that money can be spent on anything, whether or not related to the contract. And then your chance of recovering that money is next to nil. A more prudent approach would be to stipulate in the contract that advance payments be held in an escrowed account and that withdrawal can be made only for the purpose of fulfilling contractual obligations. When you provide payments in advance of contract performance, the recipient of those funds is essentially holding those funds in trust for you. If you can't trust the recipient, make sure you spell out the rules for holding that money. Don't encourage a vulnerable party to turn rogue.

Finally, are you out of luck if your contract doesn't contain a *force majeure* escape clause? Not necessarily. All contracts are subject to certain overarching principles of contract law, whether or not these principles are stated explicitly in the contract. For example, a party may be excused from its obligation to perform, if performance of the contract is rendered impossible by certain events. A party may be excused from performance if its performance would cause it to commit a crime. Or a party may cite public policy as an excuse not to perform. Each of these principles resonates in our COVID world. But it may be more difficult to implement than language spelled out in a *force majeure* clause.

To keep things simple for my client, I suggested he adopt as a compass for guidance the old saw that says if you are not part of the solution, you are part of the problem.

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