Contractual and Extra-Contractual Defenses Implicated by Response to COVID-19 in Washington

Legal Alert
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On Monday, March 16, Washington State Governor Jay Inslee announced emergency proclamations mandating the closure of restaurants, bars, and entertainment and recreational facilities, and prohibiting all gatherings with more than 50 participants.[1] These and other measures enacted by local, state and the federal government are certain to significantly affect the ability of parties in Washington state to perform contractual obligations. It will be particularly important in the coming weeks and months for individuals and businesses in Washington state to understand the contractual provisions and extra-contractual defenses that may be implicated by the response to COVID-19.

Relevant Contractual Provisions

Termination

Whether seeking to enforce performance or seeking to be excused from performing under a contract, parties should be aware of their and their counterparty's ability to terminate the agreement and the limitations and/or restrictions placed on this ability. Depending on the context of the agreement, parties may have the ability simply to terminate the agreement for convenience, which will discharge the parties from all obligations under the contract except those that by their terms survive termination of the contract. Usually, these surviving obligations relate to warranties and indemnities. Note that such termination rights usually require the terminating party to provide advance written notice to the non-terminating party prior to such termination becoming effective.

Force Majeure

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"Force Majeure" clauses generally provide that a party that has been unable to perform under a contract due to the occurrence of certain events may suspend or delay, or even terminate, its performance and will not be liable for costs or damages due to suspension, delay or failure of performance caused by the event. A typical force majeure clause will specifically define the events or types of events that will be considered "force majeure events," which will typically include strikes, work stoppages, acts of war or terrorism, civil disturbances and natural disasters. Some force majeure clauses will include a "catch-all provision" which may provide that in addition to the specifically enumerated events, events that are unforeseeable and outside a party's control will also be considered force majeure events.

The party seeking the protections of the force majeure clause will bear the burden of establishing (i) that the event in question caused the inability to perform and (ii) that the event in question is a force majeure event under the applicable clause. If the event in question is specifically identified within the clause, it will be relatively easy for the party to establish the event is a force majeure event. Considering the COVID-19 crisis has resulted in a multitude of varied responses, both governmentally mandated and voluntary, parties seeking the protection of a force majeure clause may be able to identify several different "events." However, if the event in question is not specifically identified in the clause, the party seeking the protection of the force majeure clause may have to rely on the catch-all provision, assuming there is one, which generally requires proof that the event in question was unforeseeable and beyond the party's control. Whether the non-performing party will be able to meet this burden will depend on the precise wording of the force majeure clause, but the Washington Supreme Court has indicated that force majeure clauses will be read narrowly, and that public policy considerations will not cause a court to alter the plain language of the clause.[2] No Washington state court has examined a force majeure clause in the context of a pandemic, and courts in general have provided little guidance in determining whether a particular event was foreseeable in the context of a force majeure clause. Parties should thus bear in mind that, unless the event is identified in the clause itself, a trial would likely be necessary in order to resolve ambiguities regarding foreseeability and control. Considering that several court systems have decided to limit their operations, the availability of near-term relief via traditional litigation may also be limited.

Assuming that a party is entitled to relief on the basis of a force majeure clause, the next item to consider is the scope and duration of the relief available, and what the non-performing party must do to obtain this relief. Typically, a force majeure clause will allow a party to suspend its performance *during* the time of the force majeure event, provided that such party makes a good faith effort to continue to perform during the force majeure event, and begins required performance as soon as possible following the force majeure event.

Extra-contractual Defenses

If a party seeking to avoid performance is not able either to terminate the agreement or to assert a force majeure clause as a basis for suspending, delaying or terminating its performance, the party may still be able to assert one of the extra-contractual defenses available under Washington law. These extra-contractual defenses include "frustration of purpose," and "impossibility or impracticability of performance."

Frustration of Purpose

The doctrine of "frustration of purpose," sometimes referred to as the "commercial frustration defense," exists to deal "with the problem that arises when a change in circumstances makes one party's performance virtually worthless to the other, frustrating his purpose in making the contract."[3] Washington state follows the Restatement (Second) of Contracts formulation of the defense, which is as follows:

"Where, after a contract is made, a party's principal purpose is substantially frustrated without his fault by the occurrence of an event the non-occurrence of which was a basic assumption on which the contract was made, his remaining duties to render performance are discharged, unless the language or the circumstances indicate the contrary." The Restatement explains that "the purpose that is frustrated must have been a principal purpose of that party in making the contract . . . without [which] the transaction would make little sense."

Imagine, for example, a theater patron agreed to purchase a ticket from a theater to see a play, but shortly after entering into this agreement, the performance was cancelled. Although the theater patron would still be able to pay for his ticket, and although the theater would still be able to provide the patron with a seat in the theater at the agreed upon time, the purpose of the agreement would no longer exist. In this example, absent contractual language committing the patron to purchase the ticket irrespective of the performance's cancellation, the theater patron would be able to assert frustration of purpose as a defense to his obligation to purchase the ticket.

Washington courts have examined the frustration of purpose defense in several cases. *See Washington State Hop Producers, Inc., Liquidation Tr. v. Goschie Farms, Inc.*, 112 Wash. 2d 694, 773 P.2d 70, (1989) (holding that purpose of agreement to buy hop allotments was frustrated following USDA's repeal of allotment system); *Weyerhaeuser Real Estate Co. v. Stoneway Concrete, Inc.*, 96 Wash. 2d 558, 637 P.2d 647 (1981) (upholding lessee's assertion of frustration of purpose defense where lessee was prevented from obtaining permits necessary to use the leased premises for strip mining); *but see Felt v. McCarthy*, 78 Wash. App. 362, 898 P.2d 315 (1995) (holding that frustration of purpose defense is not applicable to real estate contract when buyer became unable to develop the property due to passage of wetlands regulations).

It is important to keep in mind that a frustration of purpose defense cannot be based simply on a bargain becoming less profitable or less beneficial to one party. Rather, the principal purpose of the contract must be destroyed. In the context of COVID-19, it may also be difficult for a party asserting this defense to show both that the parties based their agreement on the assumption that a health crisis would not occur during the term of the agreement, and that this risk is not fairly allocated to the promisor. Whether a party is able successfully to assert this defense will depend largely on the purpose of the contract, which is a highly fact specific inquiry.

Impossibility or Impracticability of Performance

In Washington state, the doctrine of supervening impossibility or impracticability of performance discharges a party that has not agreed to bear the risk of the unexpected occurrence from contractual obligations when a basic assumption of the contract is destroyed, rendering performance impossible or impracticable.[4]

The burden on the party asserting this defense is high, and involves a highly fact-specific inquiry. A defense of impossibility or impracticability of performance will only be successful upon a showing of objective impossibility, or that the performance would require extreme and unreasonable difficulty, expense, or injury. Although cases vary, Washington state courts generally require those asserting a defense of impossibility or impracticability to show that the impossibility or impracticability is due to the nature of the performance itself, rather than the subjective inability of the individual promisor.[5]

The Washington Supreme Court has explained that "[c]ourts cannot set aside contracts because the performance of them becomes more difficult or more expensive than when they were entered into. If it were so, few contracts would survive the seasons of depression that periodically recur in the business world."[6]

Bankruptcy and Financial Distress Implications

Since the conclusion of the financial crisis of 2008-2009, the rate of bankruptcy filings has remained relatively stable and low. The impact of COVID-19, while still uncertain, substantially elevates the probability that the number of bankruptcy, receivership, or related insolvency proceedings will spike. It is important to note, however, that, except with respect to leases for which there are special rejection rules, both the federal Bankruptcy Code and the Washington Receivership Law generally prohibit a party from modifying, terminating, or canceling a contract on account of the other party seeking such legal protection. Additionally, the automatic stay that arises in such insolvency proceedings may halt or inhibit any efforts by a party to enforce the terms of the contract or seek legal or equitable relief with respect thereto.

Conclusion

Washington state has been among the states most impacted by COVID-19, and the response measures have been largely unprecedented. It currently is unclear if new measures will be implemented, and whether the existing measures will be extended. In this time of uncertainty, parties should be aware of their legal options, but should also be aware that Washington state courts have not previously had occasion to offer guidance on how the various doctrines discussed in this article will apply in the event of a worldwide crisis which may impact every aspect of the American economy. Parties should understand that the applicability of each of the doctrines discussed in this article will depend substantially on the precise language of the contract, the subject matter of the contract, and how the COVID-19 response relates to the promisor's ability to perform.

1 Proclamation by the Governor Amending Proclamation 20-05; Proclamation by the Governor Amending Proclamations 20-05, 20-07, and 20-11

2 Hearst Commc'ns, Inc. v. Seattle Times Co., 154 Wash. 2d 493, 511, 115 P.3d 262, 271 (2005)

3 Restatement (Second) of Contracts § 265 (1981)

4 *Tacoma Northpark, LLC v. NW, LLC*, 123 Wash. App. 73, 81, 96 P.3d 454, 458 (2004); *Pub. Util. Dist. No. 1 of Lewis Cty. v. Washington Pub. Power Supply Sys.*, 104 Wash. 2d 353, 363, 705 P.2d 1195, 1204 (1985); Restatement (Second) of Contracts § 261 (1981).

5 *See Cannon v. Huhndorf*, 67 Wash. 2d 778, 783, 409 P.2d 865, 867 (1966) (citing Restatement, Contracts s 455 (1932)) (holding that defendants' promise to provide financing for real estate project was not legally impossible despite defendants having been rejected by every conceivable lending and financing institution); *but see Oneal v. Colton Consol. Sch. Dist. No. 306*, 16 Wash. App. 488, 489, 557 P.2d 11, 12 (1976) (holding that teacher becoming blind prior to school year supported an impossibility of performance defense).

6 *Brown v. Ehlinger*, 90 Wash. 585, 588, 156 P. 544, 545 (1916).