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COVID-19: Contract and employment issues in the United States

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This guide highlights key contractual, labor and other considerations that may affect business operations in the United States due to the COVID-19 outbreak

How is the applicable law determined by the courts in the case of commercial contracts?

Because U.S. contract law is ordinarily a matter of state – rather than federal – law, our discussion focuses mostly on New York law, as that is the law most commonly chosen by commercial parties, in particular international parties, to govern their contracts. Generally speaking, however, the principles under New York law would likely be similar under many other states' laws.

Under New York statutory and case law, contracting parties' choice of New York law will generally be upheld. Section 5-1401(1) of New York's General Obligations Law (i.e., New York's statutory law on contracts) expressly provides that parties to a contract involving a transaction of at least USD 250,000 may choose New York law as the governing law, regardless of their contacts with the State. New York choice of law clauses in contracts that are not expressly governed by Section 5-1401(1) will also generally be upheld.

Parties active in the U.S. often choose New York law to govern their commercial contracts. A popular second choice to New York is Delaware law.

Except in very limited circumstances, a New York state or federal court should also uphold the parties' choice of foreign law. New York courts will generally enforce choice of law provisions provided that (i) the law of the state selected has a "reasonable relationship" to the agreement, and (ii) the law chosen does not violate a fundamental public policy of New York. If a court found that it could not enforce the parties' choice of law clause, then it would apply the law of the state with the most significant relationship to the transaction in question.

Are there any statutory provisions relating to *force majeure*?

New York statutory law on contracts does not contain any provisions relating to *force majeure*.

How are *force majeure* clauses in commercial contracts applied and interpreted in practice?

Force majeure clauses are contractual provisions that may excuse a party's non-performance when circumstances beyond the control of the parties prevent

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performance. New York courts have held that *force majeure* clauses must be narrowly construed, and that a party's performance under a contract will ordinarily be excused only if the event that prevents performance is explicitly mentioned in the *force majeure* clause. When an event is not enumerated in the *force majeure* clause, but the clause contains a catch-all phrase, such catch-all phrases – often using terms such as "act of God" or "matters beyond the parties' control" – are "not to be given expansive meaning; they are confined to things of the same kind or nature as the particular matters mentioned" (*Kel Kim Corp. v. Cent. Markets, Inc.,* 519 N.E.2d 295, 297 (N.Y. 1987)). Courts have further held that *force majeure* clauses should be interpreted in light of their purpose, which is to limit damages where the parties' reasonable expectations under a contract have been frustrated by circumstances beyond their control.

Ultimately, questions relating to the interpretation of a *force majeure* clause will depend upon the specific contractual language and the underlying facts and circumstances. Generally speaking, however, to invoke the protections of a *force majeure* provision, a party must (in addition to complying with any contractual notice requirements) demonstrate that:

- The event at issue falls within the scope of the *force majeure* clause;
- The precise event preventing full performance under the agreement was unforeseeable in light of the contract;
- It could have performed but for the triggering event; and
- The failure to perform could not have been overcome through alternative means.

Although certain *force majeure* clauses may specifically identify epidemics or pandemics as events that would excuse a party's performance, there is little precedent in New York examining such provisions. As regards to COVID-19, in the event of government-imposed quarantines or other restrictions, *force majeure* clauses with language relating to "acts of government" could be invoked to excuse a party's non-performance, depending on the specific circumstances. Otherwise, a broad catch-all provision may apply, subject to the limitations discussed above.

Traditionally, invoking a *force majeure* clause may permit either the aggrieved party or both parties to terminate the entire agreement. Alternatively, parties may temporarily suspend performance of the contract, and limit the scope and duration of the suspension, in the hopes that the *force majeure* event can be resolved and the contract can remain in force. Because of the potentially drastic consequences of invoking *force majeure*, parties may wish to explore alternative options to maintain the contract and the business relationship.

In the absence of statutory provisions and / or contractual arrangements on *force majeure*, which instruments are available to avoid the performance of contractual obligations?

In the absence of a *force majeure* clause or another specific contractual hardship clause, parties could attempt to rely on the doctrines of impossibility, impracticability or frustration of purpose to excuse their contractual performance. These doctrines can be raised either as a defense in a pending proceeding or via a declaratory judgement action, where the party asserting the defense seeks a ruling on whether contract performance may be excused.

Impossibility

Impossibility will excuse a party's performance only where "the destruction of the subject matter of the contract or the means of performance makes performance objectively impossible" and the impossibility results from "an unanticipated event that could not have been foreseen or guarded against in the contract" (*Kel Kim Corp.*, 519 N.E.2d at 296). Where impossibility is occasioned only by financial difficulty or economic hardship, even to the extent of insolvency or bankruptcy, performance will not be excused.

A defense of impossibility is rarely successful. Contract law is intended to allocate risks, and thus courts are reluctant to excuse performance based on the doctrine of impossibility. In addition, for the defense to be successful, the party pleading impossibility generally must take every step within its power to attempt performance.

Impracticability

Commercial impracticability is a doctrine similar to impossibility but is generally more flexible in its application. The doctrine of impracticability discharges a party's performance when it is made impracticable "without his fault by the occurrence of an event the non-occurrence of which was a basic assumption on which the contract was made" (Restatement (Second) of Contracts § 261). In other words, the doctrine applies where the agreed performance is made impracticable by the occurrence of an event that alters "the essential nature of [the contract]" (Uniform Commercial Code ("UCC") § 2-615, comment 4). To assert the defense, a party must demonstrate that (i) an event made the performance impracticable, (ii) the party's actions or inactions did not cause the event, (iii) the non-occurrence of the contingency was a basic assumption of the parties when the contract was formed, and (iv) the risk of the event occurring was not allocated to the party seeking excuse.

While commercial impracticability is a more flexible standard than the doctrine of impossibility, courts remain conservative in its application. For example, price changes or other events must be such that performance would create "extreme and unreasonable difficulty, expense, injury, or loss" (*Raytheon Co. v. White*, 305 F.3d 1354, 1367 (Fed. Cir. 2002)). Indeed, price increases of as much as 58% have been held by federal and state courts to be insufficient to excuse performance based on impracticability. Rather, the rare instances in which

courts have applied the impracticability doctrine to excuse performance generally involve either unique circumstances or extreme and unforeseen financial hardship.

Frustration of Purpose

Frustration is a common law doctrine that excuses a party's performance under a contract when an unforeseeable event destroys the underlying reasons for performing the contract. Although literal performance under the contract is still technically possible, the destruction of the purpose of the contract would leave no reason to want performance.

For the doctrine to apply, the "frustrated purpose must be so completely the basis of the contract that without it, the transaction would have made little sense" (*PPF Safeguard, LLC v. BCR Safeguard Holding LLC*, 924 N.Y.S.2d 391, 394 (App. Div. 2011)). As a result, one party's performance would be essentially worthless to the other. Moreover, the doctrine is not available where the intervening event was foreseeable and could have been provided for in the contract. In addition, the frustration has to be substantial; mere loss of profit is generally insufficient.

In light of these limitations, the doctrine of frustration will likely be of limited applicability in the COVID-19 context. Moreover, it could be argued that the presence of a *force majeure* provision represents the parties' contemplation of an occurrence such as COVID-19, thus making the doctrine of frustration unavailable because the intervening event (i.e., COVID-19) was contemplated and accounted for by the parties.

Consequences

The above-mentioned doctrines are often all-or-nothing in terms of loss allocation; either the party is fully excused from performance or fully obligated. The UCC does allow for certain situations in which a court may grant contract adjustments instead of total relief (see UCC § 2-615 cmt. 6), but courts rarely elect to do so. Specifically, in situations where neither "sense nor justice" is served by posing the relief in black-and-white terms of excuse or no excuse, adjustments to the contract can be made with "equitable principles in furtherance of commercial standards and good faith" (Id.).

As with *force majeure* clauses, parties must comply with any mandatory notice provisions imposed by their contracts if they intend to rely on these defenses.

What else needs to be considered by clients that are party to a contract which is affected by COVID-19?

Most considerations will depend upon the language of the contract and the facts of the case, including any relevant industry customs. Moreover, while New York law, as noted above, is commonly chosen by commercial parties and the principles may be similar from state to state, it is imperative that parties potentially affected by COVID-19 understand the specific common and statutory

law governing their agreements and how those laws may impact their contractual relationships.

A party seeking to rely on a *force majeure* clause generally must give proper and timely notice of the *force majeure* event (subject to the terms of the contract in question). Whether a failure to comply with the notice provisions of a contract will result in a waiver will depend on the specific contractual language. Notice provisions may require parties to provide additional information, such as specific details about the event, its effects and its expected duration.

Depending on the language of the contract, there may be a duty for an aggrieved party to use reasonable efforts to mitigate the effects of a *force majeure* event. This may also include an obligation to make good faith efforts to amend or modify the contract to compensate for the effects of a *force majeure* event. However, if a defense of *force majeure*, impossibility, impracticability or frustration is not accepted by the court, under New York law, aggrieved parties continue to have a duty to mitigate any potential consequential damages that they may incur as a result of a breach of contract.

Within a supply chain, the effect of non-performance based on a *force majeure* event can impact related and downstream contracts. Parties may be contractually obligated to make a good faith effort to mitigate the effects of non-performance or make reasonable adjustments to the contract to minimize disruption of the supply chain and compensate the aggrieved party for the effects of the *force majeure* event. Parties in certain industries, such as oil and gas, may also need to consider industry custom when reacting to a *force majeure* event and when interpreting a *force majeure* clause.

In addition to commercial contracts, COVID-19 could affect transactions by means of material adverse change ("MAC") or material adverse effect ("MAE") clauses. A MAC or MAE clause ordinarily permits a party to avoid performance or terminate an agreement because of a significant change in circumstances affecting transaction value. Similar to *force majeure* clauses, MAC and MAE clauses are construed narrowly, and analysis as to whether a MAC or MAE clause has been triggered by COVID-19 will depend heavily on the specific wording of the clause and the circumstances. For example, Morgan Stanley's recently announced acquisition of E*Trade specifically includes a carve out for any "epidemic, pandemic or disease outbreak (including the COVID-19 virus)" from its MAE clause (see Agreement and Plan of Merger § 1.01). Companies should also assess the financial impact that COVID-19 may have, if any, in light of the covenants, representations and warranties in their financial disclosures, contracts and other obligations.

What restrictions do laws of your jurisdiction place on an employer that wants to require employees to work remotely or from home during the COVID-19 outbreak?

Recent guidance from the U.S. Department of Labor encourages employers to be accommodating and flexible with workers impacted by government-imposed quarantines. Employers may offer alternative work arrangements, such as

teleworking and additional paid time off to such employees. But employers should consider establishing a remote working policy and updating their employment contracts.

However, U.S. states also have their own employment laws, and some states, such as California, have more stringent rules. While a company may already be aware of the local law issues in the state where the company's offices are located, it will also have to consider the law of the state where its employees are remotely working, particularly in areas where employees work in one state and live in another (such as New York/New Jersey/Connecticut, or Washington D.C./Maryland/Virginia).

May employers in your jurisdiction require employees to use their vacation time during a COVID-19 outbreak?

The Labor Department guidance states that an employer may encourage or require employees to telework as an infection-control or prevention strategy, including based on timely information from public health authorities about pandemics, public health emergencies or other similar conditions.

The guidance also says that a private employer may direct "exempt" staff (i.e., those exempt from the minimum wage and overtime pay requirements of the US Fair Labor Standards Act, such as executives, learned professionals and highly compensated employees) to take vacation or debit their leave bank account in the case of an office closure, whether for a full or partial day, provided the employees receive in payment an amount equal to their guaranteed salary. In the same scenario, an exempt employee who has no accrued benefits in the leave bank account, or has limited accrued leave and the reduction would result in a negative balance in the leave bank account, still must receive the employee's guaranteed salary for any absence(s) occasioned by the office closure in order to remain exempt.

Are there any restrictions on putting employees on unpaid leave for limited periods of time during the COVID-19 outbreak?

Under the FLSA, "non-exempt" employees (i.e., those protected by the FLSA wage and overtime regulations) in the United States are only required to be compensated for hours worked. Thus, an employee does not have to be compensated for any time spent in quarantine unless he or she works during that time. However, state employment laws may differ and require compensation even if a quarantined employee does not work.

Salaried exempt employees must receive their full salary in any week in which they perform any work, subject to certain very limited exceptions.

On March 18, 2020, President Trump signed the Families First Coronavirus Response Act (the "FFCRA") which temporarily expands the Family Medical Leave Act providing paid sick leave in connection with the COVID-19 outbreak. The FFCRA generally applies to smaller employers, employers with more than 500 employees are excluded from the law. In general, full time employees are entitled to up to 80 hours of paid sick leave at the employee's regular rate, if the

employee is not able to work due to the COVID-19 virus. There are reduced rates if the employee is unable to work to care for a family member with the COVID-19 virus. Part-time employees are also eligible for paid leave but subject to the number of hours typically worked over a two-week period. The FFCRA will become effective on April 2, 2020 and will be effective until December 31, 2020.

Are there any other key considerations for foreign companies operating in your jurisdiction relating to COVID-19?

Foreign companies should ensure that they are also taking state law into account when making decisions about contracts and employment, particularly during a time when the U.S. states are taking significant actions (which may differ from that taken by the federal government or other states) in response to the COVID-19 outbreak.

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