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Cannabis, COVID-19 and Force Majeure

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Client Advisory

As we have covered at length in our advisories, the coronavirus (COVID-19) pandemic poses unprecedented challenges to businesses.[1] While certain cannabis operations have been deemed "essential" by some states, and thus allowed to operate on a modified basis in the face of stay-at-home orders, business has been anything but "usual." Businesses that have stayed open (and those that will reopen as stay-at-home orders are lifted) are forced to implement social distancing guidelines that undoubtedly slow down productivity and efficiency. Meanwhile, consumer spending is down, and the ripple effects will be felt throughout the economy for months to come.

Due to the federal illegality of cannabis, companies operating in the sector are caught between a rock and a hard place. As we previously wrote, neither federal aid (including Economic Disaster and Paycheck Protection Program loans), nor bankruptcy protection, are available.[2] Like many other businesses caught in the maelstrom, cannabis companies are no doubt scouring their leases and supply contracts for *force majeure* provision (or other similar provisions), to see if they provide any relief.

Although the law applicable to *force majeure* provisions is state-specific, we will review its broad outline through the prism of New York law (which still governs many contracts).

A. What Are *Force Majeure* Provisions

Traditionally *force majeure* provisions have been relegated to the status of boilerplate language buried in the "miscellaneous" section of a contract, often overlooked and rarely negotiated with any real vigor. Literally meaning a "superior force" in French, *force majeure* is used to refer to a contract provision that explicitly relieves a party from some or all of its contractual duties when the party's performance has been prevented by an unforeseeable force beyond its control. These provisions often encompass natural disasters, fires, war, terrorism, governmental prohibitions, labor strikes, technology or communications failures, loss of power, interruptions of supply chains or similar disruptive forces.

Now, more than ever, businesses are turning over their contracts to the back pages to see whether a *force majeure* provision grants some relief or, at the very least, bargaining leverage to address the immediate impacts of the coronavirus outbreak. However, the mere presence of a *force majeure* provision will not put businesses in the clear since courts strictly read such provisions and will not give greater relief than that explicitly agreed on by the parties when they entered the contract.[3]

B. Read Your *Force Majeure* Provision Carefully

As with many things, the answer as to whether the provision applies, is "it depends." Generally speaking, unless "pandemic," "epidemic" or "disease" are among the forces listed in the provision, it would be hard to argue that (without more) the coronavirus outbreak would trigger the provision. It does not appear that any published New York cases have dealt with whether an epidemic is covered under the generic term "act of God" or under a "catchall" phrase in a *force majeure* provision, although those litigations are certainly on the horizon.[4]

Although it is difficult to predict how courts will come down on interpreting *force majeure* provisions in light of the unprecedented challenges caused by global pandemic (particularly where many courts remain closed to nonessential business disputes), existing precedent shows that the general attitude is unforgiving.

For example, in the aftermath of the financial crisis in 2008, courts stood by the longstanding rule that *force majeure* provisions are inapplicable to changed financial circumstances. One New York Appellate Division case found that although a party "of course, had no control over the world economy, the decisions it made with respect to how to cope with the financial downturn–notwithstanding that its options may have been limited–remained within [the party's] power and control."[5]

Similarly, a *force majeure* provision will only provide relief where the triggering event was, in fact, unforeseeable and not within the control of the party relying on the *force majeure* provision.[6] Thus, one New York Appellate Division decision found that a snowstorm that led to a temporary plant shutdown was insufficient to invoke the protections of the *force majeure* provision because such winter storms were foreseeable.[7] That said, a court could conceivably find that a once-in-a-century economic shutdown due to a global pandemic was not something parties reasonably could have foreseen when they negotiated their contracts.

Businesses may nonetheless find at least some relief from their contractual duties under their *force majeure* provisions where "governmental orders" or similar language is included as a triggering event.[8] Much of the current disruption to businesses' operations is caused by statewide emergency orders restricting businesses from opening offices or disrupting their retail operations or distribution chains. The protections of such a provision may apply so long as there is an actual causal relationship between the emergency orders and the party's inability to perform under the contract.

C. The Harm Must Actually Be Caused by the Coronavirus Outbreak (or Governmental Closure)

Even if, as a pleading matter, a business can prove that its non-performance was excused under *force majeure*, it is critical to note that it will ultimately have to prove that there was a causal relationship between the *force majeure* event and the party's inability to perform.[9] Stated otherwise, the mere fact that a pandemic is taking place, without more, cannot trigger a *force majeure* provision.

This will be particularly important for cannabis related companies that may have started off the year already facing financial pressure (as many have been). Even if courts are willing to entertain a broad reading of a particular *force majeure* provision, the fact that the business was already struggling (and unlikely to perform before the pandemic even started) will make it hard to prove that the pandemic was the *cause* of the nonperformance.

D. If *Force Majeure* Is Unavailable, Look to Impossibility or Frustration of Purpose

Upon turning to the back of the contract, many business people will be dismayed to find no *force majeure* provision or one that does not explicitly contain "epidemic" language. Pandemics probably have not been on the top of most contract drafters' minds at any time in the last hundred years.

That does not mean that those businesses are without relief. The common law defenses of impossibility or frustration of purpose may still provide grounds for a claim that the coronavirus outbreak has rendered performance impossible. For example, in one Iowa case, the court found that even though "epidemic" was not listed as a *force majeure*, a seller of eggs may still try to prove that the Avian flu epidemic frustrated the purpose of a supply contract.[10]

In some states, like New York, the impossibility defense excuses a party's performance only when the triggering event is unforeseeable at the time the parties entered their contract and the event renders performance "objectively impossible."[11] Other states only require a showing that

performance would be "impracticable" under the circumstances because of the extreme and unreasonable difficulty, expense, injury or loss involved.[12]

Relatedly, frustration of purpose can only be invoked as a defense for nonperformance where one party's essential purpose in entering the contract is known to the other party and a change in circumstances makes the first party's performance virtually worthless to the other.[13] Again, this defense only applies to unforeseen events or where the party claiming its purpose has been frustrated did not cause the events.[14]

These defenses have broader application than *force majeure*, and may include situations where the outbreak has simply made it impossible to perform an obligation. This could include a situation where governmental shutdowns objectively prevent a party from fulfilling its duties or receiving the benefit of its bargain. For instance, the Second Circuit Court of Appeals has ruled that the intended recipients of money transfers could not sue banks for failing to transfer funds given that an act of a federal official made performance impossible.[15]

However, businesses must bear in mind that the defenses of impossibility and frustration of purpose are only applied sparingly. Courts have an especially unsympathetic track record for claims of economic loss that is claimed to render performance impossible. In an oft-repeated holding, the New York Court of Appeals stated that "where impossibility or difficulty of performance is occasioned only by financial difficulty or economic hardship, *even to the extent of insolvency or bankruptcy*, performance of a contract is not excused."[16]

In the wake of the 2008 financial crisis, one court harshly put it: "Succinctly put, that the [defendant] may be one of a multitude of business entities which has suffered severely as a result of the global financial crisis does not excuse its performance under the contract."[17] In a similar vein, in what appears to be the first coronavirus impossibility decision, one court opined that it would not undo a settlement agreement where a settling party claimed it could no longer abide by the financial terms of the settlement due to the ongoing coronavirus crisis.[18]

Conclusion

Much like the 2008 financial crisis, which resulted in parties litigating often overlooked conflicting priority of payment provisions in complex financial instruments, the current pandemic is bringing to the fore provisions that likely were not drafted with current circumstances in mind. While this will undoubtedly lead to better contract drafting in the future, current business owners need to carefully analyze their existing contracts in determining whether they provide any protection or leverage.

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For more information concerning the matters discussed in this publication, please contact the authors **Alexander G. Malyshev** (212-238-8618, malyshev@clm.com), **Jacob H. Nemon** (212-238-8728, nemon@clm.com), or your regular Carter Ledyard attorney.

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[1] *See generally* https://www.clm.com/practice/coronavirus.

[2] *See* "The Impact of COVID-19 On State-Legal Cannabis Companies," Client Advisory (March 26, 2020), *available at* https://www.clm.com/publication.cfm?ID=5693&Att=172.

[3] *Constellation Energy Servs. of N.Y., Inc. v. New Water St. Corp.*, 146 A.D.3d 557, 559 (1st Dept. 2017).

[4] In 1894, an Indiana appeals court found that a school that had been closed due to a diphtheria epidemic could not assert an impossibility defense in an action brought by a teacher for her salary because "the closing of a school by the order of a school board or a board of health is not the act of God, however prudent and necessary it may have been to make such order. It was one of the contingencies which might have been provided against by the contract but was not." *Sch. Town of Carthage v. Gray*, 10 Ind. App. 428, 431-32, 37 N.E. 1059, 1061 (1894); *accord Phelps v. Sch. Dist*., 134 N.E. 312, 314 (Ill. 1922) (teacher's lawsuit in the wake of the influenza epidemic finding closure was not an act of God regardless of whether the closure was by the school board or the department of health); *contra Sandry v. Brooklyn Sch. Dist.*, 182 N.W. 689, 692 (N.D. 1921) (concurring op.) ("The closing of the school was by compulsion and by act of God, and not by any action of the defendant.").

[5] *Route 6 Outparcels, LLC v. Ruby Tuesday, Inc*., 88 A.D.3d 1224, 1225-26 (3rd Dept. 2011).

[6] *Team Mktg. USA Corp. v. Power Pact, LLC*, 41 A.D.3d 939, 942-43 (3rd Dept. 2007).

[7] *Ahlstrom Mach. v. Associated Airfreight, Inc*., 251 A.D.2d 852, 854 (3rd Dept. 1998).

[8] *See, e.g., Harriscom Svenska, AB v. Harris Corp*., 3 F.3d 576, 577, 580 (2d Cir. 1993) (the U.S. government's passage of export controls for sales of radio equipment to Iran constituted "government interference" under a *force majeure* provision since the government's power to "compel compliance with its directives is an irresistible force").

[9] *See generally Parsons & Whittemore, Inc. v. 405 Lexington L.L.C.*, 299 A.D.2d 156, 157 (1st Dept. 2002) (rent setoff only applies to damages covered by *force majeure* event).

[10] *Rembrandt Enters. v. Dahmes Stainless, Inc.*, 2017 U.S. Dist. LEXIS 144636, at *40 (N.D. Iowa Sep. 7, 2017).

[11] *Kel Kim Corp. v. Cent. Mkts., Inc.*, 70 N.Y.2d 900, 902-03 (1987).

[12] *See, e.g., Hemlock Semiconductor Operations, LLC v. SolarWorld Indus. Sachsen GmbH*, 867 F.3d 692, 702 (6th Cir. 2017); *Opera Co. of Bos. v. Wolf Trap Found. For Performing Arts*, 817 F.2d 1094, 1099 (4th Cir. 1987).

[13] *PPF Safeguard, LLC v. BCR Safeguard Holding, LLC*, 85 A.D.3d 506, 508 (1st Dept. 2011).

[14] *Morpheus Capital Advisors LLC v. UBS AG*, 105 A.D.3d 145, 148 (1st Dept. 2013).

[15] *See Organizacion JD Ltda. v. U.S. Dept. of Justice*, 18 F.3d 91, 95 (2d Cir. 1994).

[16] 407 E. 61st Garage, Inc. v. Savoy Fifth Ave. Corp., 23 N.Y.2d 275, 281-82 (1968) (emphasis supplied).

[17] *Flushing Sav. Bank, FSB v. Yossi's Heimishe Bakery Inc*., 2011 N.Y. Slip Op. 32773(U), ¶¶ 3-4 (Nassau Co. Sup. Ct. October 18, 2011).

[18] *Dakey v. Dahlia, Inc.*, 2020 U.S. Dist. LEXIS 67931, at *7-8 (S.D.N.Y. Apr. 17, 2020).

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Carter Ledyard has created a COVID-19 Response Group to monitor the evolving legal landscape, address client questions and ensure client compliance with the laws and regulations issued in response to the COVID-19 pandemic. The Carter Ledyard COVID-19 Response Group consists of ***Jeffery S. Boxer*** *(212-238-8626, boxer@clm.com),* ***Judith A. Lockhart*** *(212-238-8603, lockhart@clm.com),* ***Bryan J. Hall*** *(212-238-8894, hall@clm.com),* ***Alexander G. Malyshev*** *(212-238-8618, malyshev@clm.com),* ***Melissa J. Erwin*** *(212-238-8622, erwin@clm.com), and* ***Leonardo Trivigno*** *(212-238-8724, trivigno@clm.com). Clients should contact the attorneys listed above or their regular CLM attorney for any questions concerning legal obligations arising from the COVID-19 pandemic.*

related professionals

Alexander G. Malyshev / Partner
D 212-238-8618
malyshev@clm.com

Jacob H. Nemon / Partner
D 212-238-8728
nemon@clm.com