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CONTRACT MODIFICATION OR CANCELLATION AND BREACH OF CONTRACT DEFENSES IN TIMES OF ECONOMIC CRISIS

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A. An Unforeseeable, Unprecedented Global Financial Crisis

Relentless stories of impending financial doom, unprecedented in contemporary memory – and sometimes accompanied by revelations of deeper problems and ever changing attempts by governmental authorities to solve the crisis – have consumed attention for weeks:

- "Extraordinarily turbulent conditions in global financial markets"[1]
- A "continuing series of financial institution failures and frozen credit markets that threaten American families' financial well-being, the viability of businesses both small and large, and the very health of our economy"[2]
- A "once-in-a-century credit tsunami"[3]

The eruption of destabilizing financial unrest into the fourth quarter of 2008 has been compared to two of the most devastating economic crises in modern history: the Great Depression and the railroad bankruptcies of the 1800s.[4]

Public fixation on stock and news reports may have subsided somewhat in the "relative" calm following the turbulence of the financial institution collapse and bailout. But comfort that business and financial markets have stabilized may be distant and elusive. Irrespective of whether stock and financial markets lead or reflect real-world business markets, in many sectors of the global economy corporate leaders are taking a penetrating look at whether their business plans formulated in a prior period can be realized. For many, there is a chilling reality; expectations are not encouraging. While there may be mood swings to optimism, indicators of a recession that could be deep and long have not dissipated and they pervade the strategic thinking in many boardrooms and executive suites.

EpsteinBeckerGreen partners with its clients to be in the forefront, exploring and initiating strategies as situations and prospects change. This **White Paper** looks beyond the conventional legal theories utilized in normal times to principles that corporate leaders and their counsel may invoke as aids in making and implementing hard decisions affecting employees and

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[1] Henry M. Paulson, Jr., U.S. Sec'y of the Treasury, *Testimony Before the Senate Banking Committee on Turmoil in US Credit Markets: Recent Actions Regarding Government Sponsored Entities, Investment Banks and Other Financial Institutions*, HP-1153, September 23, 2008, *available at* http://www.ustreas.gov/press/releases/hp1153.htm.

[2] *Id.*

[3] *Greenspan Says Economic Crisis Not His Fault, Calls It 'Once-in-a-Century Tsunami'*, Fox News.Com, Oct. 23, 2008.

[4] *See* Guy F. Erb, Josh Kamin, & Todd Holleman, *The Government's Takeover of Freddie Mac and Fannie Mae: An Immediate Look at the Legal, Governmental, and Economic Ramifications of the Federal Bailout of Government-Sponsored Enterprises*, 2008 Aspatore Special Report 19 (2008); Deborah Solomon, Damian Paletta, Jon Hilsenrath, & Aaron Lucchetti, *U.S. to Buy Stakes in Nation's Largest Banks*, Wall Street Journal, Oct. 14, 2008; 154 Cong. Rec. H10712, 10770 (daily ed. Oct. 3, 2008) (statement of Rep. Nadler).

others with whom they have contractual or other business relations – particularly as they anticipate and confront reverberations that may follow.

We will address the potential application – and shortcomings – of such longstanding common law concepts as *force majeure*, unforeseeable economic hardship, impossibility of performance, impracticability and commercial frustration of purpose as tools in the analysis of employment and other business relationships that must change in a uniquely stressful business environment.

B. Federal Government Intervention

Preceded by alarm that businesses "are at risk of shutting their doors and [that] every employee will be laid off,"[5] we have seen indicators of activism and intervention by the executive and legislative branches of the federal government, potentially unmatched in the lifetimes of even those who remember New Deal reforms of the Great Depression.

The major legislative response to the crisis has been passage of the Emergency Economic Stabilization Act of 2008 ("EESA"), Pub. L. No. 110-343, 122 Stat. 3765 (2008), enacted on October 3, 2008, with the stated purpose of "restor[ing] liquidity and stability to the financial system of the United States." The overall approach of the federal government to achieve this goal shows an extraordinary regression from a deregulated free market philosophy. Greater oversight is a certainty, and that initial measure could escalate to exertion of greater control over financial institutions, possibly preempting corporate decision-making prerogatives and authority. Some provisions of the EESA squarely regulate executive compensation. *See Id.*, §111 at 3776-77.

C. Legal Challenges to Managing Business Needs in a Changed Market and Regulated Environment

That the economic crisis and the free market's ability to control it rests far beyond the power of any single employer is evident from the fact that it took an act of Congress to attempt to turn the tide by implementing a $700 billion financial rescue effort. Nevertheless, whether publicly traded or privately held, businesses concerned about the best interests of their customers, employees and owners should not want to see the responsibility for managing their affairs delegated to outsiders.

Suffering from economic crisis and strapped for credit, employers may deliberate the options and wisdom of reducing employment costs with reductions in workforce, benefits or compensation or with the shifting or sharing of costs of employee benefits. Employers inclined to cut staffing, benefits or compensation need to assess whether such action, however expedient, contravenes any statutory obligation or any oral or written agreements or recruitment or hiring assurances.

Particularly when their options for finding replacement jobs are reduced, those impacted by involuntary reductions can be expected to examine any writings from more robust

[5] 154 *Cong. Rec.*, at H10794, (statement of Rep. Terry).

times that may be construed as an enforceable commitment of continuing employment and/or compensation entitlement. Employees or their resourceful counsel may look for theories to support claims that the changed conditions introduced by businesses endeavoring to cope with the economic crisis are not within management's exclusive prerogative. Citing commitments by way of statute, agreements, policies or practices, employees may seek judicial or administrative outlets for second-guessing the necessary and sound business judgments of management.

If a long and deep recession ensues from current events, as seems to be happening, those unanticipated events, entirely beyond the control of employers and wreaking havoc on financial and business markets, may come to be perceived as frustrating the underlying purposes upon which employment relationships were begun and maintained. The unforeseen "once-in-a-century credit tsunami," having made landfall in the business arena, may offer analogy to common law concepts that can excuse performance, but that have not been associated traditionally with employment considerations. If a physical, naturally occurring *force majeure* event will excuse a party's contractual obligations, why should a tsunami that strikes financial and business markets be treated any differently when its force can devastate an entire economy or individual businesses within it?

D. The Availability of Common Law Principles and Defenses Relieving Employer Obligations

1. Force Majeure

Force Majeure is defined as "an event or effect that can be neither anticipated nor controlled." *Black's Law Dictionary*, (8th ed. 2004). As a defense to contract claims, it often contemplates an unexpected act of god, such as an earthquake, a flood, or a tsunami, or of man, such as the outbreak of war or a strike – uncontrollable events that, in substance, affect and "pertain to a party's ability to conduct day-to-day commercial operations." *Team Mktg. USA Corp. v. Power Pact, LLC,* 41 A.D.3d 939, 943 (N.Y. App. Div. 2007). *See Kel Kim Corp. v. Central Mkts., Inc*., 70 N.Y.2d 900, 903 (1987). In consent decrees with the United States government, *force majeure* is often expressed as "any event arising from causes beyond the control of [the party] that delays or prevents the performance of any obligation…" *See United States v. Bridgeport United Recycling, Inc.,* No. 3:08CV247, 2008 WL 2073960, at *9 (D. Conn. May 2, 2008); *United States v. Custom Climate Control, Inc.,* No. 8:07-CV-2295-T-24TGW, 2007 WL 4557234, at *9 (M.D. Fla. Dec. 20, 2007).

Generally, to label an event as a *force majeure,* courts require three things: (1) the existence of an unanticipated situation; (2) that is beyond the control of the parties; and (3) that frustrates the reasonable expectations held by the parties at the time they entered into the relationship. *See Team Mktg. USA Corp.,* 41 A.D.3d at 943. Central to the *force majeure* defense is that the party did not either expressly or impliedly assume the risk of the contingency when it entered into the contract. *See Stand Energy Corp. v. Cinergy Servs., Inc*., 144 Ohio App.3d 410, 416 (Ohio Ct. App. 2001) ("When a party assumes the risk of certain contingencies in entering a contract…such contingencies cannot later constitute a 'force majeure.'") (citation omitted).

It is axiomatic that "[m]arket forces are by their very nature beyond the control of the parties." *Hearst Commc'ns, Inc. v. Seattle Times Co.*, 154 Wash. 2d 493, 509, 115 P.3d 262, 270 (Wash. 2005) (discussing *force majeure* in the context of the economic downturn following the terrorist attacks on September 11, 2001). Indeed, in *Hearst*, the court explained that events of this nature are "*force majeure* events in that they were extraordinary events beyond the control of the parties. They are also forces affecting the market and, potentially, the ability of [businesses] to survive…" *Id. See Hyatt Corp. v. Personal Commc'ns Indus. Ass'n*, No. 04 C 4656, 2004 WL 2931288, at *1 (N.D. Ill. Dec. 15, 2004) (where party alleged that "economic difficulties brought on by the September 11, 2001 terrorist attacks" implicated *force majeure*) (case dismissed on other grounds).

The term *force majeure* is rooted in common law. *See In re Bushnell*, 273 B.R. 359, 364 (Bankr. D. Vt. 2001) (considering a "primarily equitable" *force majeure* argument based upon the events of September 11, 2001, but ultimately finding that there was no nexus between the event and the nonperformance). However, the common law defense of *force majeure* has been replaced largely by contractual concepts. *See Sun Operating Ltd. P'ship, v. Holt*, 984 S.W.2d 277, 283 (Tex. App. 1998) (discussing the demise of the common law notion the court stated, "[f]orce majeure, is now little more than a descriptive phrase without much inherent substance. Indeed, its scope and application, for the most part, [are] utterly dependent upon the terms of the contract in which it appears."); *Perlman v. Pioneer Ltd. P'ship*, 918 F.2d 1244, 1248 (5th Cir. 1990) (finding *force majeure* to be purely a contractual concept). "While the theory of *force majeure* has been historically linked to impossibility of performance, the scope and application of a *force majeure* clause depends on the terms of the contract at issue." *Sherwin Alumina L.P. v. AluChem, Inc.*, 512 F. Supp. 2d 957, 966 (S.D. Tex. 2007).

In some jurisdictions, a defense of *force majeure* is limited strictly and specifically to the agreement between the parties. *See U.S. Bancorp Equip. Fin., Inc. v. Ameriquest Holdings LLC*, No. 03-5447, 2004 WL 2801601, at *6 (D. Minn. Dec. 7, 2004) (applying New York law) (*citing Kel Kim Corp.*, 70 N.Y.2d at 903) ("for *force majeure* to apply under New York law, such a clause must be present in the contract which specifically covers the event in question."); *Aquila, Inc. v. C.W. Min.*, No. 2:05-CV-00555, 2007 WL 3223416, at * 6 (D. Utah Oct. 29, 2007) ("the parties specifically set the terms and conditions, in the force majeure provisions of the [c]ontract").[6] Still, some courts have revitalized the common law utility of *force majeure* even where the parties do not specifically negotiate what would constitute a *force majeure* event. *See Pillsbury Co., Inc. v. Wells Dairy, Inc.*, 752 N.W.2d 430, 441 (Iowa 2008) (applying a common understanding of *force majeure* where a contrary meaning was not the subject of discussions); *Watson Laboratories, Inc. v. Rhône-Poulenc Rorer, Inc.*, 178 F. Supp. 2d 1099, 1110 (C.D. Cal. 2001) (applying a common law meaning of the term where a specific meaning was not negotiated by the parties).

[6] *See also Rohm & Haas Co. v. Crompton Corp.*, No. 215 Nov. Term 2001, Control 020435, 2002 WL 1023435, at *3 (Pa. Ct. Com. Pl. Apr. 29, 2002) (discussing treatment of *force majeure* outside of Pennsylvania to be "a term that describes a particular type of event which may excuse performance under a contract. To determine whether a certain event excuses performance, a court should look to the language that the parties specifically bargained for in the contract to determine the parties' intent, rather than resorting to any traditional definition of the term.") (internal quotations omitted). Indeed, "[c]ontractual terms are controlling regarding *force majeure* with common law rules merely filling in gaps left by the document." *R & B Falcon Corp. v. American Exploration Co.*, 154 F. Supp. 2d 969, 973 (S.D. Tex. 2001).

Depending upon how it thrashes and reverberates, the once-in-a-century global economic tsunami may come to be acknowledged as an uncontrollable, unforeseeable event that drastically alters the manner in which employers will be able to conduct day-to-day operations. If recovery – or a realistic hope of it – were to come swiftly, it might be problematic to argue there has been unexpected and unforeseeable devastation to our economy. A documented rise in mortgage defaults and a rapid decrease in available credit leading to government intervention on an historic scale to rescue struggling institutions may abate; cure may be in the works. But suppose the travails of the financial services industry are an early harbinger of, or even a trigger for, similarly cataclysmic eruptions in manufacturing, consumer products, retailing and consumer credit?

"A hurricane that causes unexpected and unforeseeable devastation with unprecedented wind velocity, tidal rise, and upriver tidal surge, is a classic case of an 'Act of God' or force majeure." *Dollar Thrifty Auto Group, Inc. v. Bohn-DC, L.L.C.*, No. 08-CA-338, 2008 WL 4415920, at * 3 (La. Ct. App. Sept. 30, 2008) (citations omitted). Where an unexpected crisis presents the same unforeseen barrier to performance of an employment agreement and produces the same economic harms as those more typical *force majeure* events, should the law not provide those affected by this uncontrollable global crisis with the same grounds to excuse performance? The event was neither anticipated nor planned for by parties entering into employment relationships, and its effects may prove severe. Where a risk is indisputably unforeseeable, no party could have assumed the risk of that contingency when it entered into the contract.

The surprise registered by such notables as Alan Greenspan and Henry Paulson, along with financial industry veterans whose careers have never before seen events so severe and fraught with the potential for imminent devastation, fairly indicates that the financial meltdown was so unanticipated that parties did not plan for this contingency, address it in their negotiations or provide for it in their agreement. The global crisis was not anticipated by either employers or employees. Indeed, world leaders, economists and heads of banking institutions could not and did not fully predict this severe global crisis. *See Greenspan Says Economic Crisis Not His Fault, Calls It 'Once-in-a-Century Tsunami'*, Fox News.Com (finding it "much broader than [he] could have imagined").

It has been observed that "the basic purpose of *force majeure* clauses...is in general to relieve a party from its contractual duties when its performance has been prevented by a force beyond its control or when the purpose of the contract has been frustrated." *Phillips Puerto Rico Core, Inc. v. Tradax Petroleum Ltd.*, 782 F.2d 314, 319 (2d Cir. 1985). If the very extreme and unimaginable magnitude of the triggering event was incapable of being anticipated, it would seem that the purpose of *force majeure* virtually necessitates its adoption and application by courts looking to an equitable or common law construction of obligations. When an employer – as a party to an employment contract – cannot conduct its day-to-day commercial operations as expected because of an unforeseeable economic crisis, it could be argued that requiring the explicit inclusion of this incredibly specific and entirely unpredictable event in a contract actually would operate to defeat the ultimate purpose of *force majeure*, rather than fulfill its purpose.

Whether explicitly included in any written agreement or not, to rely successfully on *force majeure* principles in a current employment context, an employer will need to demonstrate a sufficient connection between the unforeseeable economic event and its resultant inability to perform. If that nexus is demonstrated, then the occurrence of that triggering economic event may support a *force majeure* defense. *See Montgomery-Otsego-Schoharie Solid Waste Mgmt Auth. v. County of Otsego*, 249 A.D.2d 702, 704 (N.Y. App. Div. 1998) (declining to apply *force majeure* to an economic recession because party failed to show that the event was the actual cause of the inability to perform, where a change in law was actually the cause).

* * *

Essential to the formation of an employment relationship is the inherent assumption that the employer and employee will conduct ongoing business activities in furtherance of that business. The employer undertakes certain obligations to the employee with that assumption in mind. In this financial climate, neither employers nor employees may be able to continue to conduct their business enterprise as they had intended. Nevertheless, unless excused they may still be obligated to one another in a manner that no longer coincides with extant circumstances and resources. Where an unforeseeable economic event is beyond the control of the parties, an employer who can demonstrate that the event has frustrated reasonable expectations that were express or inherent assumptions in the employment relationship at the time of formation may find judicial receptiveness to an interpretation of the law that relies on the common law origins of *force majeure* as an excuse for performance.

2. Excusing Performance Based Upon Unforeseeable Economic Hardship or Catastrophe

If employment and its attendant terms and conditions are governed by a written agreement and not subject to the normal "at will" construction, strapped employers may seek relief from performance on the basis of unforeseeable economic hardship. Unprecedented circumstances visiting hardship on the company's business and dim prospects of rebounding may warrant inquiry into that hardship. Depending on the particular facts, they may serve as a basis for an unconventional borrowing of concepts that are grounded in common law outside of the employment context.

In a commercial context, absent a specific contractual provision or common law application providing for *force majeure* relief, financial adversity alone will not generally excuse contractual performance. *See Covenant Med. Mgmt., Inc. v. Knepper*, No. 3:06-CV-185, 2006 WL 3333021, at *5 (E.D. Tenn. Nov. 16, 2006) ("unexpected financial difficulty, expense or hardship does not excuse a contractual promisor from performing his undertaking when the contract does not provide otherwise") (citation omitted).[7] For such a defense to prevail, more is required than a change merely rendering the contract less financially desirable than the party

[7] *See also Moon v. Jordan*, 390 S.E.2d 488 (S.C. Ct. App. 1990) (performance will not be excused based upon an inability to obtain money or a financial panic in the absence of a contractual provision in that regard); *Ruff v. Yuma County Transp. Co.*, 690 P.2d 1296 (Colo. Ct. App. 1984) (declining to rescind a contract based upon a change in economic conditions); *Buffler v. Electronic Computer Programming Inst., Inc.*, 466 F.2d 694 (6th Cir. 1972) (a party would not be relieved of its contract based upon financial hardship).

intended. Pointing to market fluctuations affecting profitability will not suffice. *See Orlando Utilities Comm'n v. Century Coal, LLC*, No. 6:08-cv-1008, 2008 WL 4570270, at *2 (M.D. Fla. Oct. 14, 2008). "Although difficulty, hardship, and financial loss will not release a party from terms of a contract, a supervening and additional condition which alters terms will so excuse a party." *Elder v. Capps*, 622 S.W.2d 506, 507 (Ky. Ct. App. 1981) (lender's requirement of additional pre-closing repairs not initially contemplated in a contract between owner of real property and potential buyer).

In many commercial transactions, the potential for profit in market fluctuations may actually serve as the underlying motivator for parties to undertake risk (insurable or not) and enter into the agreement in the first place. With risk assumption at the core of such relations, the suffering of economic hardship is nothing more than the obverse of profitability – it is the downside that is experienced when the market turns in an opposite direction from that forecasted or hoped for by one of the parties. That the party undertook contractual obligations in pursuit of gain but encountered disappointment in loss is no reason to excuse its performance. Where the purpose of the agreement was to contend with the unknown *but foreseeable* fluctuation in the price of a good, no excuse from performance is available. *See Restatement (Second) of Contracts* ("*Restatement*") § 261 *cmt. d*. ("*A mere change in the degree of difficulty or expense due to such causes as increased wages, prices of raw materials, or costs of construction, unless well beyond the normal range*, does not amount to impracticability since it is this sort of risk that a fixed-price contract is intended to cover.") (emphasis added).

In non-employment commercial transactions, if a party were to want relief by way of avoidance of the consequences of a deal gone bad, it should be expected that there would be a party on the other side of the transaction ready to reap the benefits – even if unanticipated and in windfall proportions. Understandably, mere financial difficulty or economic hardship alone is insufficient to allow one party to avoid those contractual commitments. Knowing that they will not otherwise be relieved from their contractual commitments, parties are expected to provide for that foreseeable contingency if they wish to do so.

In the employment context, an argument that changed financial conditions should excuse performance could meet the same reception as elsewhere; courts may be reluctant to lavish sympathy on a contracting employer seeking relief from its freely undertaken obligations where contract terms do not specify untenable risks that the parties agree will excuse performance. For example, in *Bierer v. Glaze, Inc.*, No. CV-05-2459, 2006 WL 2882569, at *6-7 (E.D.N.Y. Oct. 6, 2006), an employer argument of financial difficulty in an action alleging wrongful termination in breach of an employment contract did not prevail where the plaintiff-employee was hired to market a line of products and was terminated after the employer lost its contract pertaining to that product line. *Id.* at *2-3. While the loss of the contract was a "negative blow to the company," it did not excuse performance. *Id.* at *7. The court explained that to be a sufficient excuse, "[it] must have been produced by an unanticipated event that *could not have been foreseen or guarded against* in the contract," which requires "quite a bit more" than a "change in market conditions" or a "desire to avoid the consequences of a deal gone sour," and that "frustration of purpose is *limited to instances where a virtually cataclysmic, wholly unforeseeable event renders the contract valueless* to one party." *Id. at *6-7.* (emphasis added; internal citations omitted). Essentially, courts are hesitant to permit a change in market conditions or financial hardship, even in the extreme, to excuse performance because markets do

change and financial hardship *per se* does occur, and parties to a contract are expected to protect against foreseeable events – if that is what they intend. *See Gurwitz v. Mercantile/Image Press, Inc.*, No. 051887A, 2006 WL 1646144, at *2 (Mass. Super. Ct. May 15, 2006) (declining to apply the defense because it "would allow businesses that have failed to anticipate or to protect themselves from market changes to avoid their obligations").

The underlying predicate of an employment relationship is fundamentally different from commercial transactions valuing the contracted item as a commodity offered in the marketplace with bidders taking risks on items, whether they be fungible or unique. Because of the novelty of the defense in an employment context, it is not certain whether courts will find unforeseeable hardship or catastrophe any more appealing as a basis for contractual avoidance. There is no perfect transfer of precedent from commercial transactions to employment contracts. If markets for which the employment relationship was created are pummeled because of an unexpected, cataclysmic global event that could not have been foreseen or guarded against and if the changes this event is producing are well beyond a normal range, the defense may win judicial acceptance. The employer who asserts such intense financial hardship does not seek to be excused from a contract merely because the contract is no longer as financially beneficial as once hoped. The employer is not attempting to duck a "negative blow." Rather, the previously unimaginable has occurred, the entire global economy has been pounded head-on by the full force of a "once-in-a-century credit tsunami." Far from merely causing a deal to go "sour," this tsunami may have altered the essential way in which business can be conducted. If the resulting financial hardship is truly unforeseeable, it could serve as a ground for excuse under common law principles.

3. Impossibility of Performance

Relief from performance of contractual obligations may be obtained by reliance on the defense of impossibility of performance, when one of two conditions is met: (1) the subject matter of the contract is destroyed; or (2) the means of performance is destroyed so as to make performance objectively impossible. *Kel Kim Corp.*, 70 N.Y.2d at 902.

The event that renders performance impossible must have been unanticipated such that it "could not have been foreseen or guarded against in the contract." *Id.* *See Sub-Zero Freezer Co., Inc. v. Cunard Line Ltd.*, No. 01-C-0664-C, 2002 WL 32357103, at * 5 (W.D. Wis. Mar. 12, 2002) (explaining that while the parties might not have foreseen the specific events of September 11 and the war that followed, that did "not make the risk unforeseeable under the law" where the party knew of the general risks of war and terrorism). Thus, it will be essential to differentiate mere market shifts and economic fluctuations or general risks of market forces from other, more compelling crises. Even if an employer can identify a qualifying destruction of the subject matter or the means of performance, as distinguished from more ordinary circumstances, the ability to rely on this defense will be challenging. *See Kel Kim Corp.*, 70 N.Y.2d at 902 ("performance should be excused only in extreme circumstances"). While it can be argued that a cataclysmic economic tragedy was unanticipated and extreme, a court would likely disagree with a claim that market forces or market conditions have rendered performance objectively impossible; impossibility requires more than economic hardship. *See 407 East 61st Garage, Inc. v. Savoy Fifth Ave. Corp.*, 23 N.Y.2d 275, 281 (N.Y. 1968) ("[F]inancial difficulty or economic

hardship, even to the extent of insolvency or bankruptcy", are not sufficient circumstances for a finding of impossibility.).

Indeed, even while acknowledging the seriousness of the event or the hardship it imposes, courts show reluctance to find the impossibility of performance defense applicable. Again, discussion surrounding the events of September 11, 2001, is instructive:

> Here, Defendants do not argue that the subject matter of the contract – the airplanes – was destroyed. Rather, Defendants contend performance was rendered impossible by the events of 9/11. Following 9/11, the airplane and airline market around the world suffered immense losses. Numerous airlines went bankrupt (including U.S. Airways), while other airlines simply ceased operations. While the Court is sympathetic to Defendants' plight, the crash of the airline and airplane industry does not rise to the level of impossibility demanded by New York law.

U.S. Bancorp, 2004 WL 2801601, at *5. Continuing, the court stated, "[a]s New York courts have made plain, the fact that a contract proves to be unprofitable or onerous for one party does not excuse performance." *Id.* (*citing 407 East 61st Garage*, 23 N.Y.2d at 282). *See Lowe v. Feldman*, 168 N.Y.S.2d 674, 685 (N.Y. Sup. Ct. 1957) ("Investments gone bad due to unforeseen market forces undoubtedly are also captured in this rubric."); *Wizard v. Clipper Cruise Lines*, No. 06 Civ. 2074, 2007 WL 29232, at *5 n.3 (S.D.N.Y. Jan. 3, 2007) (discussing the fact that the doctrine of impossibility could not excuse a breach where, in the wake of the September 11th attacks, performance was still clearly possible, just not profitable). As a result, an employer should be prepared for judicial resistance to an impossibility of performance defense.

4. Impracticability

Absent circumstances making performance impossible, the doctrine of impracticability may be available. *See Restatement* § 261 *cmt. d.* ("Performance may be impracticable because of extreme and unreasonable difficulty [or] expense…[or a] *severe shortage* of raw material or of supplies *due to…unforeseen shutdown of major sources of supply,* or the like, which either causes a marked increase in cost or prevents performance altogether." (emphasis added). On the other hand, if performance remains practicable, and it is merely beyond that given party's capacity, then contractual obligations will not ordinarily be discharged. *Id*.

Traditionally, the defense of impracticability has been applied in circumstances of supervening death or incapacity of a person necessary for performance, supervening destruction of a specific thing necessary for performance, and supervening prohibition or prevention by law. *Restatement* § 261 *cmt. a*. Nevertheless, *Restatement* section 261 speaks more expansively and without attempting exhaustive expression of contingencies:

> Where, after a contract is made, a party's performance 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, his duty to render that performance is discharged, unless the language or the circumstances indicate the contrary.

Id., *cmt. a.*

From the text and comments to *Restatement* section 261, the contours of the impracticability defense crystallize as: (1) the non-occurrence of the supervening event must have been a basic assumption on which both parties made the contract; (2) it must render performance impracticable; and (3) the party must make reasonable efforts to overcome the obstacle preventing performance. *Restatement* § 261. Under certain circumstances, a party may be excused from a contractual obligation, even without express protection against that risk. *Restatement* § 261 *cmt. a.* ("Even though a party, in assuming a duty, has not qualified the language of his undertaking, a court may relieve him of that duty if performance has unexpectedly become impracticable as a result of a supervening event."). But mere market shifts or financial inability generally will not effect discharge under the doctrine of impracticability because the continuation of existing market conditions and of the financial situation of the parties are ordinarily not considered to qualify as basic assumptions on which the contract was made. *Restatement* § 261 *cmt. b*. Nor are newly adopted governmental regulations which render the fulfillment of employment obligations unprofitable likely to excuse employer performance. *Id*.

The success of the defense of impracticability will turn on whether a crisis rendering performance impracticable was so beyond the realm of possibility that nonoccurrence of events as they have come to exist was an assumption of the employer and the employee. Then, the employer would need to demonstrate that the crisis has caused an extreme and unreasonable difficulty in a manner that renders performance impracticable and that nothing the employer is capable of doing will allow the employer to perform. These showings are necessarily particularized to individual circumstances and fact-intensive. In considering the utility of the defense of impracticability, reliance on Alan Greenspan's observation that, "all those extraordinarily capable people were unable to foresee the development of this critical problem…" may be a very useful starting point. Jim Puzzanghera, *House Panel Heaps Blame on Alan Greenspan for Financial Crisis,* L.A. Times, Oct. 24, 2008.

5. Commercial Frustration of Purpose

Unlike the doctrines of impossibility and impracticability of performance, commercial frustration of purpose "assumes the possibility of literal performance but excuses performance because supervening events have essentially destroyed the purpose for which the contract was made." *Perry v. Champlain Oil Co.*, 101 N.H. 97, 98, 134 A.2d 65, 66 (N.H. 1957). *See St. Paul Mercury Ins. Co. v. Capitol Sprinkler Inspection, Inc*., 573 F. Supp. 2d 152, 172 (D.D.C. 2008) ("Under the frustration [of purpose] defense, the promisor's performance is excused because changed conditions have rendered the performance bargained from the promisee worthless") (internal quotation omitted). Assessing the defense, a court may excuse

obligations under a contract where both parties understood that the principal purpose of the agreement was to enable activity, but following a supervening event, activity cannot proceed. In *City of Savage v. Formanek,* 459 N.W.2d 173, 176 (Minn. Ct. App. 1990), the court reasoned that the excused party would have "little use" for the benefit of the agreement if the principal purpose was so frustrated. *Id*. The court explained that both parties "would have likely assumed market risks and normal risks connected with [the agreement]. However, they did not assume the risk that [the purpose of their agreement] would not [come to fruition]." *Id.* at 176-77.

To successfully argue frustration of purpose, a party must identify an event and demonstrate that "the event substantially frustrated his principal purpose [and that] the nonoccurrence of the supervening event was a basic assumption on which the contract was made" *Wheelabrator Envtl. Sys., Inc. v. Galante*, 136 F. Supp. 2d 21, 34 (D. Conn. 2001) (*quoting O'Hara v. Connecticut*, 218 Conn. 628, 638 n.7 (Conn. 1991) (*citing Restatement* § 265)). The event cannot be one that the parties could have reasonably foreseen at the time they entered into the employment relationship. *See O'Hara*, 218 Conn. at 638. Further, "[t]he principal purpose: must be so completely the basis of the contract that, as both parties understand, without it the transaction would make little sense." *Pieper, Inc. v. Land O'Lakes Farmland Feed, LLC*, 390 F.3d 1062, 1065 (8th Cir. 2004) (*quoting City of Savage*, 459 N.W.2d at 176 (*quoting Restatement* § 265) (internal quotation omitted)).

The ultimate question for the court will be whether the frustration is "so severe that it is not fairly regarded as being within the risks assumed under the contract." *17A Am. Jur. 2d Contracts* § 653. On this issue, "the evidence must be clear, convincing, and adequate." *Days Inn of America, Inc. v. Patel*, 88 F. Supp. 2d 928, 934 (C.D. Ill. 2000). "[A] contract is to be considered subject to the implied condition that the parties shall be excused in case, before breach, the state of things constituting the fundamental basis of the contract ceases to exist without default of either of the parties." *Id*. (internal quotation omitted) (applying New Jersey law). This arises where there is an event "so severe that it is not fairly to be regarded as within the risks that [the parties] assumed under the contract." *Unihealth v. U.S. Healthcare, Inc.*, 14 F. Supp. 2d 623, 634-35 (D.N.J. 1998) (citation omitted).

If carrying on business in the manner that the parties initially anticipated would not be possible, an employer may not be able to continue its obligation to employees for future services or levels of compensation because that obligation is no longer consistent with the foreseeable expectations and risks present at the time the obligation was formed.[8] The purpose or economic foundation of the employment relationship would be frustrated. *See Wheelabrator*, 136 F.Supp.2d at 34 ("The doctrine of frustration of purpose...excuses a promisor [from its obligations under a contract] in certain situations where the objectives of the contract have been utterly defeated by circumstances arising after the formation of the agreement.") (quoting *Hess v. Dumouchel Paper Co.*, 154 Conn. 343, 350-51 (Conn. 1966)).

Employers hire employees for the purpose of carrying out the functions necessary to their business, an inherent assumption between parties to any employment relationship. If

[8] Of course, under federal and state wage payment laws, employees remain entitled to wages for services previously rendered, and bankruptcy law will govern the claims of employees as creditors.

global economic crisis or some similar catastrophe were to prevent employers from gathering the capital or other means needed to conduct their business, the result could be a domino effect and systemic disruption. *See* 154 *Cong. Rec.,* at H10768 (statement of Rep. Miller) ("many [employees] are going to get laid off, because [employers'] lines of credit have been dramatically reduced, and without credit in this country, it is going to have an impact on businesses"); Reed Abelson, *Disappearing Credit Forces Hospitals to Delay Improvements*, N.Y. Times, Oct. 14, 2008 (describing recent "credit squeeze" as being in a "full state of crisis" and its effect on the ability to conduct operations). If, for example, the federal government declared an urgent need to preempt contractual decision-making and the operation of free markets – even in the face of a pre-existing obligation – the doctrine of frustration of purpose might be available. *See Norfolk S. Ry. Co. v. Reading Blue Mountain & Northern R. Co.,* 346 F. Supp. 2d 720, 728 (M.D. Pa. 2004) ("The doctrine [of frustration of purpose] ultimately represents the ever-shifting line, drawn by courts hopefully responsive to commercial practices and mores, at which the community's interest in having contracts enforced according to their terms is outweighed by the commercial senselessness of requiring performance.").

The fundamental purpose for which an employment relationship is formed is a productive economic exchange enabling the business to conduct operations. If parties have entered into an employment agreement on the very assumption that the economy would continue within a corridor of normalcy, an economic occurrence of unprecedented scale may be construed as an event that has defeated the contractual objective of conducting ongoing business operations – effectively destroying the purpose for which the contract was made.

The ability to conduct business operations is the contractual objective and basis of every employment relationship. It would make little sense for either employer or employee to enter into an employment relationship where neither intended to conduct that business. Yet, if clear evidence demonstrates beyond cavil a severe, unforeseen crisis that may prevent employers from conducting their day-to-day business operations, employers and the employees with whom they have contracted may be in the unfortunate position of observing a destruction of the purpose for which their contract was made. "Once the purpose is frustrated the contractual obligations end." *Norfolk S. Ry. Co.*, 346 F. Supp. 2d at 729. Depending on the particular facts, the frustration of purpose paradigm may be the most promising theory for employers caught in the worst economic crisis since the Great Depression.

E. Conclusion

The employment relationship is rooted in intentions, expectations and measures of performance that are substantially different from other business matters. Provisions of employment agreements and arrangements take account of those material differences, and courts tend to acknowledge the uniqueness the parties attach to the realities of personal service and interaction in a work context. Nevertheless, when catastrophic occurrences turn conventional expectations and processes upside down, the tried and true principles for assessing legal obligations and risk may thwart realization of necessary, non-optional objectives. If available precedent does not deliver helpful resolution, it becomes essential to resort to alternate theories allowing creative borrowing from concepts not typically seen in the employment context.