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Contractual Relations and COVID-19

The spread of the novel coronavirus, COVID-19, has triggered the exercise of numerous emergency powers by the Federal, Provincial, and Municipal governments. Changes to legislation and regulations to address rapidly evolving health and economic threats have been announced and directions issued, with more continuing to follow.

At the same time, the legal landscape for commercial enterprise is shifting. As the economic realities of social distancing directives begin to manifest, straining companies' cash flow and balance sheets, these unprecedented circumstances are raising legal issues that infrequently arise for many businesses.

In this article, we consider the immediate contractual issues companies are likely to encounter as everyone adjusts to the rapidly changing business realities of operating during the COVID-19 pandemic.

The specific application of the legal principles set out below will depend on the particular circumstances of each case, any applicable contracts, and the parties involved. If your business is faced with complex decisions in responding to the unprecedented challenges posed by COVID-19, be sure to seek legal advice from legal counsel for advice on navigating this turbulent business environment.

Breakdowns in contractual relationships

One of the immediate risks to business operations is likely to come from disruptions in the supply chain. While contracting parties have a basic obligation to fulfill their promises in the contract, as the economy slows down and they are unable to do so, there are existing mechanisms in some contracts and at law to address non-performance in the face of COVID-19.

a) Force Majeure

"Force majeure" provisions in contracts are designed to address extreme and unanticipated risks that prevent a party from fulfilling its obligations for reasons beyond its control. If applicable, a force majeure clause excuses a party's non-performance of its contractual obligations. The following is an example of a more comprehensive force majeure clause:

> Notwithstanding anything to the contrary contained herein, neither party shall be liable for any delays or failures in performance to the extent such performance is hindered, delayed or prevented by acts beyond its reasonable control including, without limitation, acts of God, acts of war or terrorism, shortage of supply, breakdowns or malfunctions, interruptions or malfunction of computer facilities, or loss of data due to power failures or mechanical difficulties with information storage or retrieval systems, labor difficulties or civil unrest. Notwithstanding the foregoing, in the event of such an occurrence, each party agrees to make a good faith effort to perform its obligations hereunder. A Party claiming the benefit of this provision shall, as soon as reasonably practicable after the occurrence of any such event, (a) provide written notice to the other Party of the nature and extent of any such Force Majeure condition; and (b) use commercially reasonable efforts to remove any such causes and resume performance under this Agreement and the Ancillary Agreements, as applicable, as soon as reasonably practicable.

Whether the provision applies, however, will depend on the scope of the language in the clause, including the (i) risks covered by the clause, (ii) the extent of the impact of the event on the contract, (iii) the cause of the non-performance, and (iv) any notice and mitigation obligations placed on the parties.

(i) Risk: As seen above, some force majeure clauses explicitly identify the risks that may excuse non-performance. Adjectives such as “pandemic”, “epidemic”, “quarantine” etc. make it more likely that a party will be entitled to rely on such a clause in the contract in the context of COVID-19. Similarly, the specificity of provisions that reference, government actions, declarations of emergency or the “non-availability of markets” would likely support a party’s reliance on the clause. Broader terms, such as “plague” or “Act of God”, and “circumstances beyond a party’s reasonable control” are less specific, but may still support a party seeking to rely on the clause in the face of COVID-19. The interpretation of force majeure provisions in past cases has been highly fact specific, and there is virtually no jurisprudence in Canada, addressing the application of force majeure clauses in the context of a pandemic.

(ii) Impact: Force majeure clauses also generally specify the extent to which the impact of the event must impede the party’s ability to perform its obligations before it can excuse non-performance. Contractual language may range from the more permissive “substantially hinders or delays” to the restrictive “renders impossible”.

In *Atlantic Paper Stock Ltd. v. St. Anne-Nackawic Pulp & Paper Co.*[1] the Supreme Court of Canada directed courts to take a narrow approach to interpreting the terms within force majeure provisions. Within the limits of the wording of the contract, force majeure events require a “supervening, sometimes supernatural, event, beyond control of either party” that “makes performance impossible [and which was] unexpected, something beyond reasonable human foresight and skill.”[2]

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[1] *Atlantic Paper Stock Ltd. v. St. Anne-Nackawic Pulp & Paper Co,* 1975 CanLII 170 (SCC)
[2] *Atlantic Paper*, at p. 583.

Importantly, “force majeure” is not a term of art. Whether such a clause is triggered will depend on the interpretation of the particular language of the contract. Whether performance becoming commercially impracticable, or dramatically more expensive, will be sufficient to trigger a force majeure provision will depend on what the impact language of the contract permits. For example, depending on the contract language, global price changes through supply chains in response to COVID19 and added costs to businesses may not trigger a party’s right to rely on a force majeure event.[3] That being said, while the exposure of the Canadian market to the risks of widespread viruses is not new (we have seen SARS and H1N1 relatively recently), the scope and severity of the anticipated economic impact, combined with an oil-war between Russia and Saudi Arabia, and the declared states of emergency, certainly makes COVID-19 unprecedented. In this way, COVID-19 may present a novel legal interpretation issue.

(iii) Causation: It is also incumbent on the party seeking to rely on the clause to show that the event caused its inability to perform its obligations under the contract. Some impacts on business will be immediate, direct and obvious, such as emergency government orders directing businesses to shut down. The economic impact on other areas of the economy will be secondary, resulting from long chains of causation that appear more similar to expected volatility in the marketplace; an impact not ordinarily considered sufficient to trigger force majeure provisions. In these situations, demonstrating causation will be centrally important if a business wishes to rely on COVID-19 to trigger a force majeure clause.

(iv) Notice: Finally, as seen in the sample clause above, parties seeking to rely on a force majeure clause are frequently required to provide formal written notice of their intent to rely on the provision in accordance with procedural specifications in the contract. Business owners should review the contractual requirements and consult counsel to understand if this may be applicable.

In such unprecedented circumstances like the present, clear and open communication between contracting parties is an advisable best practice, particularly in light of the parties’ ongoing obligations to mitigate damage caused by such supervening events[4] both at law and as may be provided in the force majeure clause, and the potential for cooperative resolution as businesses are forced to adjust across the economy.

Documenting the reasons COVID-19 renders fulfillment of contractual obligations impossible, impracticable, or to the extent it is hindered, delayed, or prevented (as the case may be depending on the particular wording of the clause), and efforts to mitigate any damages, will be important in addressing any disputes that may arise from future reliance on a force majeure provision.

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[3] *Domtar Inc. v. Univar Canada Ltd.,* 2011 BCSC 1776 (BCSC).

[4] *Atcor Ltd. v. Continental Energy Marketing Ltd.,* 1996 CarswellAlta 642 (ABCA).

b) Material Adverse Change

Another provision available in some contracts is a "Material Adverse Change" or "Material Adverse Effect"[5] clause (together "MAC"). A MAC clause defines the threshold for when an adverse event will permit a party to terminate or modify its obligation under the contract. For example, in a purchase agreement a MAC clause may allow a buyer to terminate a purchase if an event arises that falls within the definition of, and rises to the level of, a materially adverse change. Alternatively, a vendor may be excused from consummating a sale in the event of a material adverse event to its business.

The definition of a MAC in a contract is typically structured in two parts. The first part defines the types of potential harm which could fall within the scope of a materially adverse event. For example, a material adverse change could be defined as any event, occurrence, fact, condition or change, such as supply chain disruptions caused by COVID-19, that is materially adverse to (a) the ability of the Vendor to consummate the transactions contemplated in the contract or (b) the business operations of the Purchaser.

The second part of a MAC definition then modifies the first by excluding certain materially adverse events which would otherwise fall within the parameters of the first part. The exclusions are often adverse changes that are outside the control of either party such as changes to applicable laws, changes in market conditions, acts of war or unrest, or "acts of God". Often the exclusions are qualified such that the exclusion applies unless the noted change has a disproportionately adverse impact on the subject party compared to other businesses of that same type in the market.

COVID-19 may constitute an event, occurrence, fact or condition that is materially adverse to a party's ability to fulfill its obligations under the agreement. However, the exact answer will depend on the scope of the MAC definition in the contract and the interpretation of materiality. Materiality has frequently been interpreted by courts as instances in which the change or event would otherwise induce a reasonable party not to enter into the contract, had they known or anticipated it at the time the contract was formed.

Even if an adverse change like COVID-19 is captured within the scope of a MAC clause, and the impact is material, it will still not permit the party to escape or modify its obligations under the contract if the event or change is caught under the exceptions carved out by the second part of most MAC definition clauses. Again, however, whether this is the case in any given circumstance will depend on the specific language of the contract and the factual circumstances of the parties.

Businesses should recognize that contractual provisions to manage the risks and impacts of disruptions to a party's ability to meet its contractual obligations are only one element of an

[5] Material Adverse Effect may be construed more broadly, given that an event, as opposed to a change, may arise from any cause.

effective approach to contractual dispute resolution. Your contracts may require that the parties engage in negotiation, or alternative dispute resolution mechanisms, and may impose deadlines on raising disputes, limitations on making claims or triggering provisions under a contract. The best practice will involve seeking strategic advice from legal counsel to navigate the available options.

Frustration: A Common Law remedy to address supervening events

If the contract does not contain force majeure or material adverse change provisions, a party may need to turn to the common law doctrine of frustration to excuse non-performance.

The doctrine of frustration is a narrow but flexible rule applicable to contracts, including commercial contracts and contracts for the sale of real estate. The rule excuses a party from performing its contractual obligations where, through no fault of the parties and due to an unanticipated or unforeseeable event arising after the contract is formed, a party's principal reason for entering into the contract is obviated or destroyed. Unlike force majeure or MAC clauses, this doctrine is not dependent upon a particular clause being written into a contract.

While the doctrine evolved in the context where an event arose which rendered it impossible for some or all of the parties to perform the contract, frustration can still arise where the contract can both physically and legally be performed.[6]

The question to be considered is whether "a situation has arisen for which the parties made no provision in the contract and the performance of the contract becomes 'a thing radically different from that which was undertaken by the contract."[7] In other words, it is not what the parties had promised to do. Importantly, a contract is not frustrated if the supervening event was contemplated by the parties at the time they formed the contract and which was provided for or deliberately chosen not to be provided for in the contract.[8]

A party claiming that a contract has been frustrated has the onus of proving the constituent elements necessary to establish frustration. In *KBK No. 138 Ventures Ltd. v. Canada Safeway Ltd.*[9] the British Columbia Court of Appeal, in finding a real estate agreement of purchase and sale to be frustrated, adopted a prior British Columbia trial decision which described the elements of frustration as:

a. The event in question must have occurred after the formation of the contract and cannot be self-induced;
b. The contract must, as a result, be totally different from what the parties had intended being more than mere inconvenience;

[6] Gerstel v Kelman, 2015 ONSC 978.
[7] *Naylor Group Inc. v Ellis-Don Construction Ltd.,* 2001 SCC 58;
[8] Bang v Sebastian, 2018 ONSC 6226.
[9] KBK No. 138 Ventures Ltd. v. Canada Safeway Limited, 2000 BCCA 295 (CanLII).

c. The disruption must be permanent, not temporary or transient;
d. The change must totally affect the nature, meaning, purpose, effect and consequences of the contract so far as concerns either or both parties; and
e. The act or event that brought about such radical change must not have been foreseeable.[10]

Although COVID-19 is unprecedented, whether a party may be entitled to rely on the doctrine of frustration is a highly fact specific determination. Frustration will depend on the nature of the impact of COVID-19 on the core or foundation of the contract, and the expected change in the bargain contemplated therein. Of note, it has been held that there is a difference between frustrated expectations and a frustrated contract – as one court explained, "…it by no means follows that disappointed expectations lead to frustrated contracts".[11] Thus, even if a party is not obtaining the value or benefit they had anticipated, it does not mean that the contract cannot be performed as intended.

For example, while numerous emergency directives to shut-down businesses have been issued in light of COVD-19, prior case law has found that parties seeking to rely on the doctrine of frustration did not meet their onus to prove the constituent elements when changes in municipal by-laws or legislation changed. This was because, while the changes hampered the ability of the purchaser to carry out its development objectives, the changes did not go to the heart of the contract and it could still be performed (i.e. the property could be sold).[12] Likewise, in a trilogy of decisions in 2018 and 2019 from the Ontario Superior Court, it was determined that a sudden decline in real estate markets (i.e. resulting in lost value to one or both parties) between the signing of an agreement of purchase and sale and closing cannot constitute contract frustration.[13]

Relatedly, a significant factual matter may also be whether the disruption caused by COVID-19 is permanent, as the pandemic is certainly not going to last forever, but it (and its impacts) could very well last for a significant period of time which is beyond what many would consider temporary or transient. The most significant lesson from the case law is that meeting the onus of proving the elements of frustration can be a difficult task.

Where a contract is deemed frustrated, the party's obligations are extinguished as of the supervening event. Ontario's *Frustrated Contracts Act,* governs the administration of contracts found to be frustrated which are subject to the law of Ontario, and prescribes what is recoverable, and what is severable where the balance of a contract has been frustrated, but parts have already been substantially performed.

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[10] The BC Court of Appeal's approach to the doctrine of frustration was cited with approval by Justice Sanfilippo in 2284064 Ontario Inc. v. Shunock, 2017 ONSC 7146.
[11] *KBK No. 138 Ventures Ltd. v. Canada Safeway Ltd.,* 2000 BCCA 295.
[12] *Victoria Wood Development Corp. v. Ondrey,* (1978), 22 O.R. (2d) 1, 7 R.P.R. 60 (ONCA)
[13] Bang v Sebastian, 2018 ONSC 6226; Paradise Homes North West Inc. v. Sidhu, 2019 ONSC 1600; and Forest Hill Homes v. Ou, 2019 ONSC 4332.

How should your business respond to contractual breakdowns caused by COVID-19

A pandemic of the scale and significance of COVID-19 has not been seen since the 1918 Spanish Flu. The unprecedented nature of the emergency, societal, and governmental responses make the application of contractual principles, and legal norms, highly uncertain.

Business owners should take a collaborative and proactive approach to their business relationships. We believe that parties should identify creative approaches to their contracts by bargaining with their counterparty and being open to modifications. This is a strategically intelligent business approach that will mitigate the risk of future litigation.

Businesses should also recognize their continuing obligation to mitigate the damage and harm caused by COVID-19, and proactively identify ways to reduce the contractual and economic harm caused not only to their own operations, but also those of their contractual counterparties.

As the business fallout from COVID-19 evolves, the lawyers of Robins Appleby have the necessary experience and expertise to review contractual protections and obligations, and offer sound strategic advice to navigate these issues.