WE WILL NOT BE ABLE TO FULFILL CONTRACTUAL OBLIGATIONS – WHAT ARE OUR LEGAL RIGHTS AND OPTIONS?

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The COVID-19 emergency, and resulting measures put in place by governments across Canada, will make it difficult for some companies to fulfill existing contractual obligations.

The purpose of this bulletin is to outline some of the relief that may be available to defaulting parties. Specifically, we will address force majeure clauses, frustration of contracts, and relief from forfeiture in common law jurisdictions in Canada (not Quebec), with a focus for discussion on Alberta and B.C.

We will use a few hypothetical situations to help illustrate the legal principles. Our application of the law to these scenarios should not be relied on as legal advice. The options and strategy in relation to any given contract will be fact- and contract-specific.

Scenario #1: **WasherCo** manufactures washing machines. It supplies washing machines for sale in B.C. and Alberta by **RetailerCo** an appliance retailer with multiple stores. The parties' contract stipulates that **WasherCo** will supply a minimum of 10,000 units per month. **WasherCo**'s supply of a key component for manufacture has dried up due to the COVID-19 crisis in China and the U.S. It cannot supply more than 2000 units a month to **RetailerCo** for the next three months and may not be able to supply any after that.

The contract contains the following clause:

> Performance will be excused, and the parties shall not be liable for any failure to perform under this Agreement, when (1) such performance is prevented or delayed by any cause or condition of force majeure. The term "force majeure" means any contingency beyond the reasonable control of Supplier or Customer (such as war or hostilities, Acts of God, accident, fire, explosion, public protest, breakage of equipment, governmental actions or legislation, or labour difficulties such as strikes) that interfere with the Supplier's production, supply, transportation or consumption practice or with the Customer's ability to operate its retail outlets. A party will be excused from performance only for so long as the force majeure condition continues. A party affected by a force majeure condition shall notify the other party with 7 days of the existence of the condition.

In a related clause, the parties have agreed to the amount of $100,000 as liquidated damages, in the event that **WasherCo** cannot supply the requisite number of machines to **RetailerCo** in a given month. This clause is expressly subject to the force majeure clause.

Scenario #2: **RestaurantCo** operates a fine-dining restaurant in Vancouver. In light of directives from the public health authorities, it has had to close its doors. It cannot realistically provide take-out or delivery service (as still permitted). Its lease with **LandlordCo** does not include a force majeure clause. **RestaurantCo** expects that it will not be able to pay its rent going forward and is concerned about the consequences of breaching the lease.

Force Majeure Clauses

Commercial parties may choose to include terms in their contracts that provide relief for a party who is unable to perform its obligations due to events outside its control. These clauses are often referred to as "force majeure" clauses. Such clauses may relieve a party entirely from performance obligations, but more often operate to suspend performance obligations or extend deadlines for performance.

It is up to the parties to a commercial contract to define what will constitute a force majeure event, how such an event is to be triggered and the consequences of it being triggered. The clause set out in Scenario #1 above is simply an example; there are many variations used in commercial practice, with varying degrees of detail.

Interpretation of a given contract, and the force majeure clause in it, will depend on the wording of the clause and the factual matrix underlying the contract.

There are some general principles, however, that a party considering invoking a force majeure clause should keep in mind.

- The burden of proof is on the party seeking to rely on the force majeure clause. That party must prove the following:

    1. the occurrence of one of the events listed in the clause, or an event that could fit within the general description of force majeure if one is provided, such as "any event beyond the party's reasonable control". So-called basket or catch-all clauses of this type that precede or follow a list of force majeure events can expand the possible types of triggering events.

    2. that he or she has been prevented, hindered or delayed from performance by reason of that event. Note that the choice of verb or verbs matters. For example, "prevent" will be construed more strictly than "hinder", typically requiring the party invoking the force majeure clause to prove that performance was physically or legally impossible.

    3. that his or her non-performance was due to circumstances beyond his or her control. Force majeure clauses usually contain language to this effect, although courts may imply this requirement in any event. A party will not usually be able to rely upon a force majeure clause to excuse its own acts or failure to act.

    4. that there were no reasonable steps that he or she could have taken to avoid or mitigate the event or its consequences.

- Economic or market conditions generally will not be construed as appropriate grounds for invoking a force majeure clause that does not expressly enumerate such conditions as constituting force majeure.

- Where appropriate, in the face of an ambiguity, courts may construe the clause against the drafter (*contra proferentem*).

- The effect of a triggering event will usually be stipulated in the contract; most often it is a suspension or relaxation of performance rather than a termination of the contract.

- Courts may impose obligations on the party being excused from performance to take reasonable steps to mitigate the effects of the force majeure event (the clause may well include such an express obligation).

- If the force majeure clause contains a notice requirement, that requirement may be construed as a condition precedent, failure to comply with which may disentitle the party from relying on the force majeure event. Giving notice within the stipulated time period and in the form required can therefore be critical.

In Scenario #1 above, a health emergency, epidemic or pandemic is not specifically listed as a force majeure condition. If the reason for the inability of **WasherCo** to source components is a government shutdown or restrictions on **WasherCo**'s own suppliers, it could point to the words "government action or legislation". Otherwise, **WasherCo** would rely on the basket clause ("any event beyond the party's reasonable control") to take the position that a force majeure condition was present.

Assuming that **WasherCo** has multiple customers, it should come up with a reasonable method for allocating product among them, since the force majeure clause does not deal with this issue. If the methodology is deemed reasonable by a court, **RetailerCo** should not be able to argue that the allocation method disentitles **WasherCo** from relying on the force majeure clause.

WasherCo will want to investigate other sources of supply for the key components to demonstrate that it is taking reasonable steps to mitigate the effects of the force majeure condition.

WasherCo will want to ensure that it gives notice of the force majeure condition as soon as possible. **RetailerCo** obviously will be aware of the COVID-19 crisis, but that awareness should not relieve **WasherCo** of its obligation to give notice. In any event, **RetailerCo** may not be aware of how COVID-19 is affecting **WasherCo**'s ability to supply washers. The notice provision does not set out a form of notice; the rest of the contract would have to be consulted to see if there is a general provision for forms of notice. If not, written notice (or email) would ensure **WasherCo** has a record of notice being given.

In Scenario #2, the lease does not contain a force majeure clause. **RestaurantCo**, therefore, would have to consider whether it could rely on the doctrine of frustration of contract or could seek relief from forfeiture.

<u>Frustration</u>

The doctrine of frustration forms part of the common law of contracts and, therefore, parties can rely upon it even where they chose not to include a force majeure clause in their contract. The practice of including force majeure clauses is directly related to the high standard that a party has to meet to rely on the doctrine of frustration. If an event is covered by an applicable force majeure clause, the doctrine of frustration will not apply and the parties' rights and obligations will be governed by the force majeure clause.

A contract may be frustrated where its performance becomes impossible or events transpire in such a manner as to result in a significant change in the original obligations assumed by the parties. The event which makes the contract either impossible or radically different is commonly called the "supervening event". The performance of the contract must be "substantively different" than the parties had bargained for. This doctrine arises in diverse situations and its elements are as follows:

1. A supervening event occurs:

    (a) after the formation of the contract;

    (b) for which the contract makes no provision; and

    (c) which is not the fault of either party, which is not self-induced, and which was not foreseeable.

2. The supervening event so significantly changes the nature of the contractual rights/obligations which the parties could reasonably have contemplated at the time of execution, that:

    (a) the contract is now totally different from what the parties intended; or,

    (b) a fundamental contractual term has become incapable of being performed; or,

    (c) new circumstances in which performance is called for would render it a thing radically different from that which was undertaken by the contract; or,

    (d) the thing undertaken would, if performed, be a different thing from that contracted for; or,

    (e) it has totally affected the nature, meaning, purpose, effect and consequence of the contract so far as concerns either or both parties.

3. The differences between the contract before the supervening event, and after:

    (a) must be permanent, not temporary or transient;

    (b) are not mere inconvenience, but fruitlessness;

    (c) are not merely expense or onerousness.

Where frustration is established, both parties are discharged from further performance. Both B.C. and Alberta (as well as most Canadian jurisdictions) have frustrated contracts legislation, which does not purport to define frustration, but instead operates to mitigate the effect of the common law by providing a system of rules to define the positions of the

parties to a contract that has been prematurely brought to an end by the application of the common law doctrine of frustration.

The various *Frustrated Contract Acts* help answer questions as to how the parties should be treated with respect to what has gone on before the frustrating event occurred by dealing with such things as the sums paid and expenses incurred under the contract upon the parties being discharged. The threshold question that the Acts do not help solve, however, is whether the contract has in fact been frustrated – and this poses a considerable hurdle.

For a court to find that a contract was frustrated, the supervening event a party relies on to make out frustration cannot simply make performance of the obligation impracticable. A contract will only be frustrated when performance of the contract has become impossible, illegal or radically different from that initially contemplated (not merely more expensive or onerous). The case law offers no test for determining what the turning point is for something possible becoming impossible, but there is Canadian case law indicating that "impossibility" can encompass impracticability because of extreme and unreasonable difficulty, expense, injury, or loss involved. Further, the disruption cannot be "temporary" or "transient". Older case law suggests that the interruption cannot be one of an "interim character". For example, a strike of ten days duration, and a suspension of two or three days from work, were not considered to be frustrating events.

This prompts the question – if the COVID-19 emergency is a "supervening event", has it been sufficiently permanently disruptive to give rise to contractual frustration? Obviously the answer will hinge on the nature and wording of each individual contract, but when faced with this question, a court is likely to ask something along the lines of whether the interruption of performance "was so critical or protracted as to bring an end in a full and fair sense the contract as a whole, so superseded it that it can be truly affirmed that no resumption is reasonably possible".

In Scenario #1, provided the COVID-19 crisis falls within the force majeure clause, **WasherCo** will not have recourse to the doctrine of frustration.

In Scenario #2, **RestaurantCo** will want to consider whether it can rely on the doctrine of frustration since there is no force majeure clause in the lease. Note however that frustration will not be found where performance would simply be more expensive or onerous for the contract to be performed – there must be an utter and complete transformation of contractual circumstances.

<u>Relief from Forfeiture</u>

Relief against forfeiture is a discretionary equitable remedy arising from the disproportionate consequences of a breach of contract. A party who has breached a contract and suffered a forfeiture may apply to the court for this form of statutory relief that is codified in statute. We stress that this remedy can only be granted by the courts and, at present, most Canadian courts have ceased operations during the COVID-19 pandemic and are hearing only the most urgent cases (such as cases involving persons in custody or children in need of protection).

In British Columbia, the equitable doctrine of relief from forfeiture has been statutorily codified by s. 24 of the *Law and Equity Act*, R.S.B.C. 1996, c. 253. Section 24 states:

> 24. The court may relieve against all penalties and forfeitures, and in granting the relief may impose any terms as to costs, expenses, damages, compensations and all other matters that the court thinks fit.

Similarly, the Alberta *Judicature Act*, R.S.A. 2000, c. J-2, provides the following in section 10:

> 10. Subject to appeal as in other cases, the Court has power to relieve against all penalties and forfeitures and, in granting relief, to impose any terms as to costs, expenses, damages, compensation and all other matters that the Court sees fit.

What is meant by forfeiture? Broadly speaking, relief from forfeiture refers to the court's power to protect a person against the loss of an interest or a right because of that person's failure to perform a contractual obligation or covenant. The most common examples of forfeiture arise in agreements such as leases, which stipulate that the landlord has the right to terminate the lease upon the tenant's failure to pay rent, or insurance contracts, which allow the insurer to cancel the insurance coverage upon the insured's failure to pay the premiums. The courts have also granted relief from forfeiture in cases involving options to purchase, and royalty agreements.

When exercising their discretion to grant or deny relief from forfeiture, the courts will consider the conduct of the applicant seeking the relief, the gravity of the breaches of the agreement, and the disparity between the value of the property forfeited and the damage caused by the breach. If the breach was failure to make a periodic payment such as rent, the breaching party will often make that payment prior to the court date in an effort to tip the balance towards relief.

Where a contract contains a clause setting out a specified amount payable on breach (a "consequences upon breach" clause), there is some conceptual confusion in the law in terms of what test the breaching party must meet to be relieved from that payment.

Many contracts contain "liquidated damages" clauses, in which the parties to the contract agree that if one party does not perform its obligations (or a specific obligation), the appropriate remedy is an amount to be paid as a genuine pre-estimate of damages caused by the breach. Under a classic common law approach, the court will consider the circumstances existing when the parties entered the contract to determine if the amount is truly an appropriate amount of liquidated damages, or if it is an unenforceable penalty clause. The essence of a penalty is a payment of money as a threat to induce compliance; the essence of liquidated damages is a genuine covenanted pre-estimate of damage. At common law, a contractual clause was considered an unenforceable penalty, as opposed to enforceable liquidated damages, when the sum in question was extravagant and unconscionable in comparison with the greatest loss that could possibly follow from the breach.

Under this approach, if the clause is found to impose a penalty it is unenforceable.

In some more recent cases, courts have shifted their focus away from strict characterization of clauses as providing for liquidated damages or a penalty. Instead, they focus on whether the clause in question is unconscionable and then, if they conclude that it is, consider relief from forfeiture.

Under either approach, the court would assess whether the amount sought to be forfeited, or said to be a penalty, is "out of all proportion to the loss suffered", and whether it is evidence of unequal bargaining power that resulted in a substantially unfair bargain.

Adding to the jurisprudential confusion is the fact that a third approach to clauses that stipulate for a remedy on breach was adopted by a dissenting judge in the Alberta Court of Appeal and then argued before the Supreme Court of Canada early this year (that judgment is under reserve). Under that approach, the court will ask whether the clause in question is oppressive, that is whether it is manifestly, grossly one-sided such that the enforcement would bring the administration of justice into disrepute.

In Scenario #1 described above, the parties to the washing machine supply contract have agreed to an amount $100,000 as liquidated damages, in the event that **WasherCo** cannot supply the requisite number of machines to **RetailerCo** in a given month. It is unlikely that the liquidated damages clause in this scenario is an unenforceable penalty clause. **WasherCo** would have to establish that at the time the parties entered the agreement, there was inequality between the parties regarding their respective bargaining power and that $100,000 is an unfair or unconscionable amount in the context of the agreement.

Even if the clause was characterized as a penalty (under the common law test) or as otherwise unconscionable, it would be a challenge for **WasherCo** to persuade a court to grant relief from forfeiture. Although **WasherCo** will likely be able to establish that at the time it failed to provide the requisite washing machines, it was acting reasonably in the circumstances of the COVID-19 pandemic, its failure to supply the machines is a breach of the agreement. The court will also consider whether $100,000 (the value of the property forfeited) reflects the damage caused by **WasherCo**'s breach.

Finally, the clause is also unlikely to be characterized as oppressive and therefore unenforceable or amenable to relief from forfeiture (if the third approach outlined above is applied).

In Scenario #2 described above, the lease between **RestaurantCo** and **LandlordCo** contains a provision that if **RestaurantCo** is unable to meet its rent obligations, **LandlordCo** is entitled to terminate the lease. This scenario fits within cases in which relief may be granted. The court may grant **RestaurantCo** relief from the forfeiture of its lease, particularly if **RestaurantCo** can demonstrate that its conduct was reasonable (*e.g.*, it approached the landlord to seek an abatement or reduction of its rent in the circumstances, or it attempted to provide take-out services), it had never defaulted on its rent prior to the COVID-19 pandemic, and it would be disproportionate to terminate the lease for failure to pay a month or more rent.

<u>The Law May Evolve and Adapt</u>

The effects of the COVID-19 pandemic are, by and large, unprecedented, and are changing daily. Where parties cannot cooperate to deal with the reality that one or both parties will be unable to fulfill their performance obligations, then there could be a flood of cases before the courts where one party seeks relief. In scenarios where one party is seeking to take financial advantage of the pandemic, the courts may be nimble in applying or reformulating the law to these types of situations. Further, jurisdictions may decide to legislate to limit the

ability of contracting parties to strictly exercise their rights in the face of another party's default caused by COVID-19.

For more information or to obtain an opinion on your contractual rights and obligations, please contact Lisa A. Peters, Q.C. at lpeters@lawsonlundell.com, or any member of the firm's Research and Opinions Group.