

Frustration, Force Majeure, and Rent Deferral

The Impact of COVID-19 on Commercial Contracts

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1. Introduction

The spread of COVID-19 throughout the world has taken a significant toll on all facets of our society. Canada's health care system is under siege, and the government, businesses and individuals have all taken widespread and unprecedented steps to limit personal interactions to attempt to slow the spread of the pandemic. The measures taken to protect our society have caused significant hardship, if not devastation, for numerous businesses, landlords and tenants across Canada.

When the pandemic significantly interferes with an agreement between two parties, who bears the cost of the fallout? The purpose of this article is to present the current state of the law as it relates to the impact of a catastrophic and unforeseeable event upon a business relationship, and to set out a framework of considerations and approaches in deciding how a business can best respond to the challenges presented by the current pandemic.

2. Frustration

When two parties enter into an agreement for the provision of services, rental of property, transfer of assets, or other obligations flowing between them, they are bound by the terms of their contract. However, there are times when supervening events conspire to make the performance of the contract impossible. A war could break out between two nations, and so a business in one nation is prevented from selling bullets to a customer in the other nation, even though their contract requires them to. A rail strike could shut down the flow of goods along a railway, preventing a manufacturer from sending its products to its consumers on the rail line. Or closer to home, a pandemic could shut down a private school, and so the school would no longer be allowed to teach students in the classroom.

When an unforeseeable event makes the performance of a contract impossible, what happens to the obligations of the party to provide the goods, to provide the services, to transfer the assets, or to make payments under a contract?

In some contracts, there is a specific term which addresses such an unforeseeable, supervening event, known as a *force majeure* clause, which often contains language specifying qualifying events, such as acts of god, war, terrorism, strikes, revolution, anarchy, or other major, unforeseeable events. A *force majeure* clause is a method by which the parties have agreed to allocate risk, and define whether

certain obligations will remain operative or become defunct, if an unforeseeable, supervening event occurs.

In many contracts, however, there is no specific clause addressing what will occur if the unthinkable happens, which raises the question of what the parties are obligated to do. The law holds that when an event occurs that makes performance of a party's obligations impossible, impracticable, or fundamentally different from what the parties expected, this may relieve the parties from their obligations. If such a circumstance occurs, and the court finds that the applicable threshold has been met, the contract would be considered to be "frustrated", and neither party would be held to the remaining obligations of their contract.

The test for frustration is whether a supervening, unforeseen event renders the performance of a party's obligations practically or legally impossible, or so significantly changes the nature of the obligations from what the parties originally intended that it would be unjust to hold them to those obligations.

The threshold for a court to find that a contract has been frustrated is a high one. Such an event must be one for which neither party is responsible, and the nature of the changed obligations cannot be that they are merely more expensive or onerous¹ - they must be radically different from what the parties initially intended.² The doctrine of frustration cannot be invoked where a contract is simply no longer advantageous for one party, or has become an uneconomic venture, and mere hardship in fulfilment of a contract alone will not amount to frustration as long as the contract could still be fulfilled according to its terms.³ Once a court has found a contract to be frustrated, both parties are discharged from fulfilling their obligations under the contract.

There is very little case law directly addressing whether a pandemic would frustrate a contract; whether a contract will be frustrated will depend on the specific kind of contract in question. In the case of *Li Ching Wing v Xuan Yi Xiong*⁴, a tenant of a 2-year lease sought to invoke the doctrine of frustration as a result of the SARS outbreak in 2003. Specifically, the tenant argued that a 10-day isolation order should render the tenancy frustrated, and relieve the tenant and landlord from their respective obligations. The Hong Kong District Court found that the 10-day order was insignificant in the context of the 2-year lease, and while SARS may have been an unforeseeable event, it did not "significantly change the nature of the outstanding contractual rights or obligations" of the parties.

Because the above case was in the jurisdiction of Hong Kong, it is not binding upon Canadian courts, and it provides limited assistance in assessing how the Canadian courts would approach the current pandemic. Based upon prior Canadian case law addressing frustration, the courts will consider the terms of the contract, the nature

¹ Swan, Angela, *Canadian Contract Law*, 4th ed, (Toronto: LexisNexis Canada, 2018) at 886

² *Naylor Group Inc. v. Ellis-Don Construction Ltd.*, [2001] 2 S.C.R. 943, 2001 SCC 58

³ Fridman, G.H.L., *The Law of Contract in Canada*, 6th ed, (Canada: Thomson Reuters Canada, 2011) at 619

⁴ [2004] 1 HKLRD 754

of the obligations of the parties, and the impact of the pandemic upon the nature of the remaining obligations, to assess whether the doctrine of frustration applies.

Certainly, COVID-19 will be considered to be an unforeseen, supervening event in most contracts, unless there are specific terms addressing an epidemic. However, whether the courts will find that the pandemic, or the society's actions in combatting it, have actually frustrated the contract will depend on the particular circumstances of each case. Where the pandemic renders the obligations of the parties impossible to fulfil, or radically different from what the parties intended, this would militate in favour of applying the doctrine of frustration. But when the obligations of the parties are merely more expensive, more onerous, or if the venture is merely uneconomic, this will not invoke the doctrine of frustration.

Whether your contract might be frustrated by the pandemic, the lockdown, or other measures undertaken by our society, is a fact-driven question based upon the terms of the contract, the nature of the obligations on you and the other party, and the change that the pandemic has had on your respective obligations. If a court does find that a particular contract is frustrated, this will relieve both parties to the contract of their obligations under the contract. If you think that your contract may have been frustrated by the pandemic, you should consider the above factors, and seek legal advice as to whether there is a strong legal basis for relieving the parties to the contract of their obligations.

3. Force Majeure

As discussed in the previous section, some contracts contain a specific clause which addresses an unforeseeable, supervening event, known as a *force majeure* clause. A *force majeure* clause is an express term in a contract which specifies what will occur during a frustrating event. *Force majeure* clauses typically contain language specifying qualifying events, such as acts of god, war, terrorism, strikes, revolution, anarchy, or other such events which neither party could foresee or prepare for. It should also be noted that a *force majeure* event cannot be one that is self-induced, such as a party finding it impossible to find a profitable market for its product due to poor business planning.⁵ The purpose of a *force majeure* clause is to set out what will happen to the contract, and to the obligations of the parties, in the event that such an event occurs.

In some contracts, a *force majeure* clause will specify that the parties to the contract are relieved of all of their obligations, some of their obligations, or that the obligations themselves will change. In a rental agreement, for example, a *force majeure* clause might indicate that while all obligations of the parties under the contract are suspended (such as repair, cleaning or administrative obligations), the rent still remains payable. It might also indicate that if such an event occurs, it will not act to frustrate the contract, and that all of the provisions remain in full force and effect. On the other hand, some *force majeure* clauses will hold that one party may terminate the contract, either immediately, or after a specific period of time.

⁵ *Atlantic Paper Stock Ltd. v. St. Anne-Nackawic Pulp and Paper Co. Ltd.* (1975), 56 D.L.R. (3d) 409 (S.C.C.)

The specific wording of a *force majeure* clause is therefore very important, and care should be taken both in drafting or relying upon such a clause. It should also be noted that *force majeure* clauses operate as exclusion clauses, excusing one or both parties of specified obligations under the contract, and it is therefore read very narrowly. Therefore, courts will look to the specific wording in the clause, and will construe strictly the terminology that is used in the clause.⁶

For this reason, *force majeure* clauses which include references to an epidemic, pandemic, or widespread disease will be much more likely to be upheld than catch-all references to unforeseen events outside of the control of the parties. If your contract contains a *force majeure* clause, you should seek legal advice to determine whether the clause might be applicable during the current pandemic, and if so, what the consequences of relying upon such a clause could be, and how relying on the clause may affect your business. Likewise, if you are considering entering into a contract, your lawyer will likely consider whether it would be appropriate to include a *force majeure* clause with a specific reference to a pandemic, to ensure that the rights and obligations under the contract are properly addressed if such an event occurs.

4. Rent Deferral Agreements in Commercial Tenancies

It is possible that a rental agreement might be frustrated by the pandemic, or might have an applicable *force majeure* clause, depending on the circumstances and the wording of the contract. However, even where the contract is not frustrated, or where it does not contain an applicable clause, there are still steps which can be taken to allow parties to lessen the impact of the pandemic on the parties, and to maintain the business relationship between the commercial landlord and tenant while ensuring that their respective rights and obligations are not waived.

A useful mechanism to manage the impact of the pandemic in commercial tenancy arrangements is a rent deferral agreement. Specifically, the parties to the original rental agreement can agree to defer payment of rent to a later date on terms and conditions that would allow the tenancy to continue, while also ensuring that the landlord is compensated fairly for monies due and owing.

As with *force majeure* clauses, significant care should be taken in the wording of such agreements for commercial tenancies, and to include terms which would protect your interests, whether that of a landlord or tenant. Parties contemplating such an agreement might consider whether it would be appropriate to have the payments deferred to a later date accrued over the balance of the lease term, or whether it should be due and owing in a lump sum on demand. A landlord might also consider thoroughly reviewing the tenant's financials, having the tenant sign a promissory note, or including additional guarantors or indemnitors to the lease for further protection. A tenant might consider offering to include a financial assistance clause, such that if the tenant received financial assistance under a government

⁶ Fridman, G.H.L., *The Law of Contract in Canada*, 6th ed, (Canada: Thomson Reuters Canada, 2011) at 621

program, the tenant could agree to allocate some of those funds towards payment of the rent. The parties might also wish to set out a confidentiality clause to ensure that privacy is protected, or a termination clause to ensure that one, or both, parties can exit the relationship upon a certain set of circumstances, or that no obligations or rights under the original lease are waived by the signing of the deferral agreement.

There are a myriad of options available to parties who wish to enter into rent deferral agreements to allow commercial tenancies to continue during the pandemic. As set out above, care should be taken in drafting up these agreements, and the parties should seek legal advice to understand which clauses should be included, and the impact of those clauses upon their rights and responsibilities under the contract. Parties should also be aware of, and look carefully at, the options being provided by the federal and provincial governments for various forms of assistance.

5. Conclusion

The pandemic, and the steps taken to combat it, will have repercussions on our society for months, if not years. Businesses with contracts currently in operation should consider whether the pandemic has caused those contracts to become frustrated, or whether those contracts contain a *force majeure* clause applicable in the current circumstances. Businesses entering into new contracts should have their lawyers consider whether it would be appropriate to incorporate a *force majeure* clause, and what the respective rights and obligations of the parties should be if the specified event occurs. Finally, parties to a commercial tenancy who wish to continue the tenancy, but also to allow for a deferral of rent payments due to the pandemic, should consider entering into a rent deferral agreement which properly addresses the respective rights and obligations of the landlord and tenant.

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⁷ BC: <https://www2.gov.bc.ca/gov/content/safety/emergency-preparedness-response-recovery/covid-19-provincial-support>
Federal: <https://www.canada.ca/en/department-finance/economic-response-plan.html>

NOTE:

The content of this article is provided for general information purposes only and does not constitute legal advice. Should such advice be required, the authors can be contacted to see how we can assist you and your business in navigating your response to the pandemic.