FORCE MAJEURE, FRUSTRATION, CANCELLATION, MATERIAL ADVERSE CHANGE

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As COVID-19 continues to develop and move to new geographic locations, affected communities face many new challenges. In the business and legal context, many organizations and individuals have questions about their existing arrangements in light of this pandemic, such as:

- What are my (or the other party's) contractual obligations?
- What can I do to protect myself in the event that I might not be able to meet my contractual obligations (or someone else may not be able to keep theirs)?
- What is a *force majeure* clause and can it protect me?
- Is there anything that can protect me if my contract does not have a force majeure clause?
- As a business owner, what are my obligations to customers who visit my store?

CONTRACTUAL IMPLICATIONS

In the context of COVID-19, the following four general mechanisms can allow parties to be released from their obligations under a contract:

1. Cancellation Clauses
2. *Force Majeure* Clauses
3. Frustration of Contract
4. Material Adverse Changes.

An overview of each of these legal mechanisms, followed by an analysis of each as they apply to COVID-19 follows.

CANCELLATION CLAUSES

The first, and most obvious option, is a cancellation clause (sometimes referred to as termination clauses). These are clauses that set out the circumstances in which a party may cancel the contract, and the effects of cancellation (including any financial penalties, forfeited deposits, or otherwise). In deciding whether to invoke a cancellation clause, consider the cost consequences or whether a wait-and-see approach might be more appropriate. We can assist in reviewing your current cancellation clauses and discussing the pros and cons of invoking a cancellation clause now, or whether another approach might be more appropriate, such as invoking a force majeure clause.

FORCE MAJEURE CLAUSES

A second type of contractual provision which may allow a party to be released from obligations under the contract, is a *force majeure* clause. A *force majeure* clause can be included in contracts to protect parties, when extraordinary or extreme events make it very difficult or impossible to perform their obligations under the contract. The clause will often use language that defines what will or will not constitute a *force majeure* event, and may include such things as war, hurricanes, or "acts of God".

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As with a cancellation clause, whether this solution is available will depend on how the *force majeure* provision is worded – you will need to consider whether the clause applies to the event that has occurred (for example, a pandemic or a government order that restricts travel) and if so, what the clause indicates will happen once a *force majeure* event occurs. Parties are also expected to take steps to avoid being impacted by reasonably foreseeable events – *force majeure* clauses only excuse performance under a contract where the event is beyond a party's control. Provisions dealing with *force majeure* will be set out in the contract's terms and conditions, and may include a requirement to provide prompt notice to the other party, once a *force majeure* event occurs.

Where a *force majeure* clause is applicable, the party that cannot perform its obligations is entitled to suspend and/or cease performance, without incurring any additional liability. The extent of what may be suspended or ceased, and for how long, will depend on the language of the *force majeure* clause, and the circumstances surrounding the contract.

FRUSTRATION OF CONTRACT

A third mechanism for relieving parties of their obligations under the contract is the legal doctrine of frustration of contract. Unlike cancellation and *force majeure* provisions, frustration of contract is established by common law, meaning a party can attempt to rely on frustration of contract, without there being a provision in the contract that explicitly addresses the issue.

Frustration arises when an event occurs after the agreement is entered into, which so significantly changes the nature of the outstanding contractual rights and/or obligations from what the parties could reasonably have contemplated at the time it was made, that it would be unjust, in the new circumstances, to hold them to its literal wording. Frustration can also occur where the performance of the contract has become illegal (for example, because it is contrary to a public health order to hold gatherings above a certain number of people).

Two notes about frustration: (1) The event or circumstances which make the contract "frustrated" must not be the fault of either party; and (2) The contract must lack a provision which specifically addresses the issue. Otherwise, the terms of that provision will apply and govern the parties' rights and obligations.

Obligations being more expensive or more difficult to perform under the contract will typically not be enough to meet the threshold of frustration. Frustration of contract is a high bar.

If frustration of contract is found, it allows a party to cease performance of its obligations under the agreement, without incurring any additional liability. The contract is treated as being terminated, without the fault of either party.

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MATERIAL ADVERSE CHANGE (MAC)

Even if *force majeure* or frustration of contract are not applicable, your contract may have a clause allowing termination or adjustment of obligations in the event of a "material adverse change" (MAC) or a "material adverse effect" (MAE) on the business or its operations. MAC clauses are regularly found in acquisition, sale of goods, financing, and other commercial agreements.

For example, in the context of merger and acquisition agreements, a MAC clause might allow a buyer to walk away from a deal if there is a major negative event that has adversely affected the target business. Similarly, a loan agreement will often document that a lender has no obligation to lend if a borrower suffers a MAC.

PRACTICAL IMPLICATIONS IN THE CONTEXT OF COVID-19

COVID-19 AND *FORCE MAJEURE*

Turning to COVID-19, whether the novel coronavirus constitutes a "*force majeure* event" that can trigger a *force majeure* clause in a business contract, will depend on the language of the clause itself. Increasingly, it is not uncommon for force majeure provisions to include specific references to terms such as "plague", "epidemic" or "communicable disease outbreaks" when describing force majeure events. The first step, for those looking at the availability and enforceability of a *force majeure* provision, will be to look at the specific language of the provision. Absent such specific language, courts may be reluctant to recognize COVID-19 as a *force majeure*. For example, if your contract includes "public health emergency" in the definition of a *force majeure* event, it will be a question of fact whether the outbreak of COVID-19 constitutes a relevant public health emergency.

Provided COVID-19 is found to meet the definition of a *force majeure* event, there will still be a question as to whether COVID-19 caused the party to be unable to perform their obligations under the contract. Where there are underlying business problems outside of COVID-19 that lead to a party's inability to perform their obligations, that party may not be able to rely on *force majeure* to excuse their non-performance. For instance, where a business lays off workers due to a reduced demand for their services, the business may not then be able to claim an inability to perform its obligations under its contract due to a shortage of workers, if there were other options available to it, such as reduced work weeks in order to maintain the required work force (rather than simply laying off the workforce). Each instance will be case-specific and will depend on the context.

In terms of a business's inability to perform its obligations, while force majeure in the context of COVID-19 is still uncharted water, the general approach to *force majeure* is that where there are legal restrictions that prevent a party from performing an aspect of a contract, these will typically qualify as *force majeure* events. However, where performance is more expensive, more difficult, or simply more undesirable, these will typically not meet the threshold required to be released from obligations, unless the event and those impacts are specifically accounted for in the contract. Again, whether something is a "*force*

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majeure" will depend on how that term is defined in the contract. Thus, whether or not COVID-19-related events are sufficient to trigger *force majeure* clause protections must be determined on a case-by-case basis. *Force majeure* clauses are usually interpreted narrowly, with close attention paid to the specific language of the impugned clause.

A party seeking to rely on COVID-19 as a *force majeure* must also try to mitigate foreseeable impacts of the pandemic. While some contracts may specify the level of mitigation required, others will not, and will be dependent on what is reasonable in the circumstances.
A party must also keep in mind that *force majeure* clauses often require that notice be given to the other party in order to rely on that clause. Your legal advisor can discuss strategies around when notice ought to be given, what that notice ought to contain, or whether other options might be available to address the problem.

If your contract has a *force majeure* provision and you would like to know whether it has been triggered in the current circumstances, what your (or the other party's) obligations are, or what strategies might be available to you, we would be pleased to assist you.

COVID-19 AND FRUSTRATION

Where a contract does not have an explicit *force majeure* provision, a court may nonetheless find the contract unenforceable based on the concept of frustration of contract - in essence, frustration acts in these circumstances like an implied *force majeure*, the triggering events and parameters of which will be defined by common law.

As discussed above, frustration takes place when an event supervenes (without the fault of either party, and for which the contract makes insufficient provision) which so significantly changes the nature of the parties' rights or obligations from what they could reasonably have contemplated when executing the contract, that it would be unjust to hold them to its literal stipulations in the new circumstances. In such situations, both parties are released from further performance of their obligations under the contract. A finding of frustration of contract will bring the entire contract to an end rather than excuse a party only from *force majeure* related obligations.

In frustration cases, a court will render its decision as to whether to excuse an impacted party's performance during the event based on the foreseeability of the event.

Frustration can be found, for example, where parties are unable to meet their obligations under the contract due to unforeseen changes in law that occur after contract formation, and which render performance of the contract's obligations illegal. Such supervening illegality occurs when, after the making of a contract, a change in the law renders it illegal to perform the contract in accordance with its terms. To qualify as a frustrating event, the change in the law must be one which was not foreseen by the parties and for which no express or implied provision is made in the contract.

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If the event is foreseeable, frustration will not apply and the parties will be considered to have bargained for whatever potential risk the event brought to them. That is, they will still be obligated under the contract that they entered into and will be responsible for performing their obligations under the contract notwithstanding the unfortunate circumstances. As above, difficulty, expense, or undesirability will not meet the requirements of frustration where the event causing such difficulties was reasonably foreseeable by the parties.

In relation to COVID-19, whether an event was foreseeable will likely depend on when the contract was entered into. For contracts in Canada entered into prior to January 2020, the current climate would likely not be deemed to be a foreseeable event. If so, then a court may find the contract frustrated, but only if the parties are truly unable to meet their obligations (not where they simply prefer to avoid their obligations under the contract).

For example, if there are restrictions preventing events of a certain size from taking place, mandated quarantine or travel restrictions, a contract related to a conference hosting out-of-town speakers and guests may be deemed to be frustrated if these restrictions prevent parties from attending the conference. Again, this will be fact-specific and will depend on the scope of services or responsibilities under the contract. If it is no longer possible to perform one's obligations due to COVID-19, the parties will likely be discharged of their respective responsibilities under the contract. However, where parties are still able to perform their obligations under the contract, then parties may be obligated to perform their requirements under the contract, notwithstanding risk to health, potential increases in costs, or other unwelcome challenges of the current environment.

While finding frustration of contract is a higher bar than force majeure, frustration is a fluid concept. What is considered "frustration" may shift as factors in our environment change over time, particularly in light of COVID-19 and its ever-changing impacts on our lives.

COVID-19 AND MAC

While MAC clauses are another means of exiting obligations under a contract, invoking a MAC clause due to COVID-19 may be difficult since the virus' long-term effects on market conditions in Canada and elsewhere are currently unknown. A MAC is typically considered to be a high threshold. MAC provisions vary widely and should be read carefully. Narrow MAC clauses carve out certain situations, while broad MAC clauses allow the parties to terminate the agreement in a wide array of circumstances.

Of note, Canadian courts have held that MAC clauses can extend to matters "external" to internal operational matters. Ultimately, the wording of the agreement will determine the rights of the parties. The party invoking the MAC clause must show that the crisis has caused an adverse change which is so substantial and important that it would have influenced the mind of a prudent and reasonable person in deciding whether or not to sign the agreement.

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CLOSING COMMENTS

If a party is considering cancelling a contract, or making a *force majeure*, frustration of contract, or MAC claim, they should begin dealing with the matter promptly. It is not uncommon for suppliers to issue force majeure notifications in anticipation of potential supply issues. If received, it is advisable that these be responded to promptly. This may require seeking legal assistance to determine whether a force majeure or frustrating event has or will actually occur, and whether the contract or common law provides any remedies. Depending on the situation, it may be advisable to challenge the validity of the notification.

On the other hand, sending of notices such as these can trigger serious contractual consequences (including terminating the contract, meaning a separate agreement would be required to "re-start" the agreement). Any decisions should not be made hastily, especially if there are no immediate cancellation notice windows which are in play.

The above is a general outline of some of the applicable legal principles, only. A more detailed analysis should be conducted for each situation, including a review of any relevant agreements or policies. We would be pleased to provide legal advice related to these or other COVID-19 legal issues.

Please do not hesitate to contact your relationship partner or lawyer if you have any questions or if we can be of assistance in guiding you through these new challenges.

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