Contractual obligations: Lessons learned during the pandemic

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To say that times are challenging would be a serious understatement.

Countries are locked down. Healthcare systems are overtaxed. Businesses have been ordered to shut. Events have been cancelled. Schools have closed. Mass layoffs have occurred. Meanwhile, the number of people affected by COVID-19 continues to rise steadily day-by-day. There seems to be no end in sight.

We are seeing the firsthand impacts of the pandemic on our clients and an overwhelming number of questions have arisen regarding contractual obligations. In this article, we set out some lessons learned from the COVID-19 crisis to increase certainty as parties continue to negotiate and execute contracts going forward.

Implied and modified contractual obligations

The intentions of the contracting parties are reflected by the words used in their contract. From time to time, parties will disagree on whether certain terms that are not expressly set out in the contract form part of the agreement. These terms are known as “implied terms.” Implied terms are considered abundantly obvious, eliminating the need to be expressly addressed.

A party arguing that an implied term forms part of an agreement has a difficult battle. A term may only be implied if it reflects the actual but unstated intentions of the parties to the contract. It is not sufficient that they would have agreed on the point had they considered it, or that the term is a reasonable one. This analysis is not modified by common law duties of good faith and honesty in the performance of contractual obligations, which were recognized by the Supreme Court of Canada in *Bhasin v Hrynew*, 2014 SCC 71. With respect to modification or amendment of contractual duties, courts approach terms in these areas with caution, presuming that a clear statement of intent and agreement is required to prove an exception to the otherwise applicable performance obligations of the parties. Therefore, if parties intend to allow for modifications to their obligations in specific circumstances, this should be expressed specifically and clearly. Further, the method in which agreed amendments to the contract may be made, such as a requirement of writing, should also be specifically addressed to provide certainty to the contracting parties.

Below are a few examples of how parties could agree to modify their future obligations on a contingent basis:

- A landlord and tenant could agree that rent abatement be triggered when access to the leased premises is restricted or limited due to no fault of the landlord or tenant.
- A buyer's obligation to purchase a certain amount of product could be modified when demand is reduced due to health emergencies, including in a pandemic.
- Otherwise non-refundable deposits paid to service providers in respect of a certain event could be refunded when the event must be cancelled or postponed pursuant to government orders.

Force majeure clauses

A force majeure clause is a contractual term that allows contracting parties to allocate the risk of certain supervening events between them. When a force majeure clause is triggered, the party impacted by the supervening event may be discharged from contractual obligations, as long as performance is impossible or nearly impossible. The supervening event is generally one that strikes at the root of the contract and must be unexpected, and beyond reasonable human foresight and skill.

As force majeure clauses operate to relieve parties of their contractual obligations, they are construed narrowly by courts. Accordingly, when drafting a force majeure clause, there are a number of tips that parties should keep in mind to ensure they meet their objectives:

- **Triggering events**: Typically, a list of specific events (such as acts of God, civil disturbance, actions of military) is followed by a basket clause. The list of specific events should reflect the parties' circumstances and business operations. The basket clause should also be tailored to the parties' objectives and can be worded broadly, such as "including without limitation" or more narrowly, such as "or other like events." It often features a requirement that the events be beyond the control of the parties.
- **Threshold**: Parties should establish a threshold for force majeure to apply. That an obligation be "impossible" to perform is a high threshold to meet. Lower thresholds may be considered, such as "substantial interference with performance", depending on the parties' objectives. In the latter circumstance, parties may also wish to incorporate a reference to some external measure to increase contractual certainty as to when the threshold is met, including a financial measure.
- **Notice**: These clauses require a party relying on force majeure to give proper notice. Accordingly, parties should ensure the notice requirement is practical depending on the anticipated force majeure circumstances. For example, the current outbreak would make notice by registered mail difficult, due to self-quarantine and self-isolation measures. A more workable notice provision in the current circumstances would allow a party to give written notice electronically via email.
- **Mitigation**: The nature and extent of the obligations of the party relying on force majeure to mitigate the impacts on the other party should be defined. For example, the party may be required to use commercially reasonable efforts to continue to perform its obligations notwithstanding force majeure, or resume the performance of its obligations with reasonable dispatch following the force majeure event. It should be noted that force majeure mitigation obligations might be highly dependent on how contractual performance obligations are defined.

Termination or suspension of contracts

Regardless of whether parties have chosen to include a force majeure clause into their contract, they may choose to

incorporate clauses governing the termination of their contractual relationship.

When drafting termination clauses, there are various considerations to take into account, including:

- **Conditions of termination**: Parties should consider the conditions under which the contract may be terminated, including whether it may be terminated without cause.
- **Notice**: Parties should clearly set out how a terminating party is to give notice of termination. The clause should also expressly address when termination is effective after proper notice is given.
- **Damages**: Parties should consider whether the liability of the terminating party for damages should be capped at a specified amount or include only specific categories of loss. This may be accomplished by incorporating a liquidated damages clause quantifying the amount of compensation the terminating party is obliged to pay to the non-terminating party, or by an express exclusion of loss category.

Additionally, parties may choose to incorporate clauses allowing some or all contractual obligations to be terminated in certain circumstances during the notice period, while other obligations continue.

Conclusion

The aim of this article was to provide some basic and practical considerations for drafting contracts on a go-forward basis, based on recent experiences in the COVID-19 context. While none of these considerations will be new to parties negotiating complex agreements, they may take on greater significance in the future.

While contractual measures to mitigate COVID-19 impacts are important, it is usually best for parties struggling to meet current contractual obligations, or those seeking to manage challenges faced by counterparties, to reach out to the counterparty to have an honest and transparent conversation. A flexible approach is often the best way to advance the long-term interests of both parties in the unique and uncertain circumstances currently in play, regardless of the strict terms of a governing agreement.

For more information, please contact David Wotherspoon, Thomas P. O'Leary or another member of Dentons' Litigation and Dispute Resolution group.

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