

CLIENT ALERT

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COVID-19/CANADA

PRACTICAL BUSINESS ISSUES AND COVID-19

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In this series, DW LLP will explore different issues related to the financial impact of COVID-19 on businesses, employment, financial matters, and commercial issues. We aren't giving you legal advice but rather some practical tips about dealing with events as they arise. This article will cover debtor-creditor matters and we intend periodic alerts to cover other topical issues related to the on-going pandemic.

The Implications of COVID-19 on Creditors and Borrowers in Canada

In the current crisis, there has been much discussion about the availability of remedies under Force Majeure and Material Adverse Change (MAC) clauses in respect of COVID-19.

Force Majeure and MAC clauses are remote provisions in agreements that lawyers love to debate. At a very high level the principle behind such provisions is that a party should not be obligated to perform its obligations under the contract if a material event (such as an 'act of the almighty') has changed the environment in which the agreement was originally drafted. Litigation around these provisions is scant although when it is engaged it is understandably highly contentious.¹

The most typical example in a debtor-creditor context permits a lender to deny funding on the occurrence of Force Majeure event or MAC to the borrower. As lender friendly provisions these clauses do not generally protect borrowers from paying creditors or suspending default rights in lending arrangements.

Why is COVID-19 Different?

We do not have any precedent for the entire shut-down of sectors of the economy that parallels what we are experiencing with COVID-19. The two events most often cited for comparison, namely the attacks on the World Trade Centre and the Pentagon in 2001 and the SARS Pandemic in 2003, were relatively short in duration and isolated geographically. Neither event involved a prolonged disruption to the supply chain. What makes COVID-19 unique is the unknown duration of the disruption, the global geographic spread and the fact that it is not sector specific.

In this environment, what steps can parties take to ensure that once the crisis passes, their contractual rights remain in force?

Non-executory arrangements typically have time-sensitive obligations, for example interest and principal payments, rent, reporting requirements (financial statements or otherwise) which cannot easily be waived, or which one party, or the other, may, for commercial reasons, desire not to waive.

Absent contractual protection, or government decree, or a negotiated waiver, some commercial parties may be surprised to learn COVID-19 does

not provide relief from the risk of a default by one party or the ability of another to call a default.

Never waste a good crisis....

A typical small business is an intertwined market participant. It will owe money to its various suppliers, the landlord, the bank and employees; in turn these parties will owe money to their suppliers, lenders, banks, employees and so on. But what happens when the supply chain breaks down (not merely slows down) and payments are not flowing at all?

Absent COVID-19 and in an isolated incident, the business example may face all manner of remedies including notices of default or enforcement actions brought by its creditors. It would have similar remedies against parties that owed it money.

But when the system breaks down, what can a creditor really do, and what do borrowers have to do? While remedies through the courts may be forestalled, can creditors really rely on defaults caused by events beyond the borrower's control after the dust has settled?

Courts in Canada have been trending, albeit in varying circumstances, to a broader obligation of good faith in the course of commercial conduct. There is no reason to believe that coming out of the COVID-19 crisis this trend will reverse or moderate and the crisis may give judicial authorities more opportunity to push the law in this area even further. Parties that are advancing claims or relying on events that occurred as a result of the current crisis should be extremely careful in their conduct.

In *Bhasin v Hrynew* the Supreme Court recognized an organizing principle of good faith. Contracting parties are expected to have appropriate regard to the legitimate contractual interests of the contracting parties, not seek to undermine those interests in bad faith, and act honestly in the performance of contractual obligations. This duty of good faith and honest performance extends to the exercise of contractual discretion and may include situations where a creditor is contemplating advancing a default.

In *Greenberg v Meffert*, a real estate company refused to pay an ex-employee commissions he had earned while he was employed. The company relied on the terms of the employment agreement which gave it sole discretion to decide whether to pay commission earned by an ex-employee. Notwithstanding the language of the agreement, the Ontario Court of Appeal found the company exercised its discretion improperly after previously reassuring the plaintiff he would receive the commission. The Court noted that provisions which make payment or performance subject to the discretion of a party must be exercised reasonably. Moreover, any discretion must always be exercised honestly and in good faith.

While the law in Canada is evolving, courts in the United States have imposed a requirement to act reasonably when exercising a contractual discretion. In *Legend Autorama Ltd v Audi of American Inc.*, the New York Court of Appeal found that notwithstanding the words "sole discretion," every contract contains an implied covenant of good faith and fair dealing,

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which encompasses any promise that a reasonable person would understand to be included. Some American courts have held that this duty does not prevent a lender from enforcing the terms of the contract as written; however, it appears that lenders must still act in good faith.

Another concept that may be relevant in evaluating the risk of exercising discretion is the concept of lender's liability which is a well-developed in the United States. For example, in *Koontz v Wells Fargo, N.A.*, a lender had the sole discretion to modify the terms of a mortgage or close on the property after the borrower had defaulted. The U.S. District Court of West Virginia found that despite having sole discretion, the lender was confined by the covenant of good faith and was required to act toward the borrower in a commercially reasonable manner. In the United States, lenders who have been found to act in bad faith can be liable for compensatory damages and consequential damages.

Being on the right side of the point...

Given the current climate, parties should be careful when advancing on defaults. While a contract may specify a right or remedy a court may disagree, often with disastrous results. Advancing or relying on a default that occurred in the middle of an ongoing pandemic may be considered unreasonable.

Commercial parties should assume that in the event of a subsequent dispute their actions will be closely scrutinized after the fact by persons that may not be overly-sympathetic to their contractual rights in making choices. A party should consider the following advice:

- 1. Act Reasonably** – Notwithstanding what the commercial agreement states or a party's rights and obligations – if your decision is challenged before a court or tribunal in the future, will you be able to convincingly explain why your actions were reasonable and in good faith given the COVID-19 crisis?
- 2. Consider the Broader Implications** – Often there is a broader context to your arrangements. Does 'squeezing' one aspect of the supply chain potentially negatively affects other parties? You do not want to be the poster child for shutting down an entire business operation or sector.
- 3. Document, Document, Document** – Write everything down; communicate via email; and if you agree to waive or alter the strict terms of your agreement, specify that it is temporary and not a waiver. Also, keep a record.

Finally, how can we help? In uncertain times it's often not just legal advice you need. Checking your decision-making can provide comfort in your choices and avoid longer-term issues. If have an issue that sounds similar to the above, or you just want a second view, give us a ring...

¹ The ABCP in Canada involved considerable discussion about the ability of liquidity providers to rely on MAC provisions to avoid providing liquidity in strained credit markets.

This client alert is published by Dickinson Wright PLLC to inform our clients and friends of important developments in COVID-19. The foregoing content is informational only and does not constitute legal or professional advice. We encourage you to consult a Dickinson Wright attorney if you have specific questions relating to any of the topics covered.

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