Frustrated contracts in pandemic times: Takeaways for financial institutions

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The COVID-19 pandemic has resulted in much uncertainty around how rarely invoked legal doctrines, legislation and contractual provisions are interpreted by the courts. Among these, the 1990 *Frustrated Contracts Act*, RSO 1990, c F.34, which has only been litigated a few dozen times, has become a common tool for litigants facing a breach of contract claim.

For financial institutions, cases interpreting this legislation will be of great interest. While the jury is still out, the first reported decision involving standard loan and security agreements, *Bank of Montreal v. 2643612 Ontario Ltd.*, 2021 ONSC 4401, seems to confirm it will be difficult for a debtor to fall back on the *Frustrated Contracts Act* as a result of the pandemic.

The decision

In 2018, the Bank of Montreal (the Bank) granted the defendant, a company operating a restaurant (the Company) a small business loan. The co-defendant, and president of the company, signed various security agreements, including a guarantee, in her personal capacity. The loan and security instruments contained the standard obligations including that in the event of a default, the balance of the loan became due and payable at the discretion of the Bank.

In April 2020, the Company experienced financial difficulties and the Bank agreed to defer payments for 6 months. In November of 2020, approximately 8 months later, the Bank demanded repayment of the loan from the Company and the guarantor, and ultimately commenced proceedings when the debtors failed to pay back the loan, and a summary judgment motion was advanced by the Bank.

To be successful, the Bank had to demonstrate there was no genuine issue for trial with respect to the defendants' obligation to repay the loan. The Company and the guarantor relied, among other arguments, on the doctrine of frustrated contracts in support of its position.

What is frustration of contract?

As outlined in the decision, in Ontario, the *Frustrated Contracts Act* applies to:

any contract that is governed by the law of Ontario and that has become impossible of performance or been otherwise frustrated and to the parties which for that reason have been discharged. R.S.O. 1990, c. F.34, s. 2 (1); 1993, c. 27, Sched.

The "law of frustration" applies "when a situation has arisen for which the parties made no provision in the contract and performance of the contract becomes "a thing radically different from that which was undertaken by the contract"".[1] Where a party's obligations are extinguished as a result of frustration, the obligations of each party under the contract are terminated.

Importantly, the party seeking to invoke the doctrine of frustrated contracts must demonstrate that the disruption is a permanent one, and that performance of contractual obligations is impossible – not simply impractical, not profitable, or difficult.[2]

The outcome

In *Bank of Montreal v. 2643612 Ontario Ltd*., the Court determined that the loan and security agreements had not been frustrated, given that "the pandemic and the ensuing lockdowns did not render the Loan Agreement and the related agreements substantially different from the agreements that the parties executed".[3] The Company's obligations to re-pay the loan were not contingent on the Company operating its restaurant. That is, the agreements did not specify how (i.e from what funds) the loan had to be repaid, but simply that they had to be paid per the specified terms of the agreement. The pandemic did not change the nature of these obligations, nor was the pandemic a permanent disruption.

Accordingly, summary judgement was granted in favour of the Bank.

Key takeaways

The Court's decision reaffirms that debtors who want to rely on such doctrines to excuse non-performance of their obligations under standard loan and security agreements will have a steep hill to climb.

A note of caution: as always, it will be important to consider the specific provisions in any contract in order to assess the strengths and weaknesses of this argument in any given circumstance, and whether it is possible to invoke this piece of legislation. Indeed, where the contract has anticipated the circumstances, such as by the inclusion of a force majeure clause, the *Frustrated Contracts Act* cannot apply, as confirmed by the Court in *Braebury Development Corporation v. Gap (Canada) Inc*., 2021 ONSC 6210.

[1] 2021 ONSC 4401, citing *Divisional Court in Cowie v. Great Blue Heron Charity Casino*, [2011] O.J. No. 5573, citing *Naylor Group Inc. v. Ellis-Don Construction Ltd*, 2001 SCC 58 (CanLII), [2001] 2 S.C.R. 943 at paras 5.

[2] 2021 ONSC 4401 citing *The Law of Contract in Canada*, 4th ed. (Scarborough: Carswell, 1999) at 679-680.

[3] 2021 ONSC 4401, at para 17.

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