The Canterbury earthquakes and the effect on landlords and tenants with commercial leases

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ABSTRACT

The Canterbury earthquakes in 2010 and 2011 had a significant impact on landlords and tenants of commercial buildings in the city of Christchurch. The devastation wrought on the city was so severe a cordon was erected around the central business district for two and a half years while buildings were demolished, repaired or rebuilt. This was an unprecedented response to a natural disaster in New Zealand. Nevertheless, despite the destruction not all buildings within the cordon were damaged; many were still capable of being occupied and used. The difficulty was that tenants could not access them. As time went on and it became clear the cordon would be in place for a significant period, tenants did not want to pay rent for buildings they could not use. They wanted to end their leases to set up business elsewhere. The problem was that landlords and tenants were unclear about their legal rights because the law was unclear; their leases did not cover an inaccessible building and neither did the legislation. This paper argues there is a possible solution: the application of the doctrine of frustration. This doctrine enables contracts to be terminated in situations where an extraordinary event has such an effect on a contract that it radically changed the parties' contractual obligations. It is argued the doctrine should apply to enable landlords and tenants with commercial leases of buildings affected by the Canterbury earthquakes to terminate them.

Introduction

In the years following the Christchurch earthquake disaster, research was undertaken to look at how commercial landlords and tenants were affected by the earthquakes. Landlords and tenants directly affected and lawyers who had experienced earthquake-related lease issues were interviewed. The most common problem raised by participants was that their building was inaccessible.

Hundreds of buildings were damaged in the February 2011 earthquake and an extensive cordon was set up around the central business district (CBD) closing off 75 blocks. Entry to this restricted area was manned by the New Zealand Defence Force and the Christchurch Police. Over time, the cordon reduced in size as buildings were demolished or made safe. However, it was not until June 2013, nearly two and a half years later, that the cordon was completely removed.

Despite the devastation, there was a large number of buildings that were not damaged. They could have been used except that they were located behind the cordon. Landlords and tenants did not know their legal rights in this situation. Did tenants have to continue paying rent? Could the lease be terminated? Some tenants just stopped paying rent and set up business elsewhere. Others were told by their landlords they had to pay rent. One tenant, a charity, reported the following:

> *I contacted the landlord and said I have signed up a lease for another building. I said I understand we are not going to be able to get back into the building for some time so we would no longer be paying the rent. He said 'Read your contract; your contract states that if you don't pay you will have penalties to pay as well'. I made a decision to continue paying the lease because the penalty was 25 per cent and we were paying nearly $9,000 a month for our lease, so it was a lot of money to be penalised if we didn't pay.*
> [Participant FQ208]

Tenants, more than landlords, wanted to terminate their leases. They did not want to pay rent for, or be held to, a lease of a building they could not use for a prolonged period. Most simply could not afford this expense. Yet they were unable to end their leases because their leases did not provide for termination in this situation and nor did the legislation. The law was unclear.

One possible solution could have been to apply the doctrine of frustration. If it had been applied it would have terminated the leases and freed the parties from their obligations under them.

The doctrine of frustration

The doctrine of frustration is a principle developed by the common law over many years. It applies in situations where a supervening event affects a contract in a way that prevents one or both parties from being able to carry out their obligations. It was established to provide justice in cases that would have produced unfair results had the terms of the contract been literally and strictly applied.

The doctrine was first recognised in 1863 in *Taylor v Caldwell*.[1] A party contracted to use the Surrey Gardens and Music Hall for the purpose of giving four concerts over a period of three months. Six days before the first concert the Music Hall was destroyed by fire although neither party was at fault. There was no express provision in the contract to cover this situation. If the terms of the contract had been strictly upheld the hirer would have been liable for the rental of the hall even though it had been destroyed. The court decided that as the hall was no longer in existence the contract came to an end. In other words, the contract was frustrated.

Many attempts have been made to define the doctrine of frustration. The most often quoted definition is that of Lord Radcliffe. He said:[2]

> ***… frustration occurs whenever the law recognises that, without default of either party, a contractual obligation has become incapable of being performed because the circumstances, in which performance is called for, would render it a thing radically different from that which was undertaken by contract.* Non haec in foedera veni; *It was not this I promised to do.***

The doctrine has been applied in many situations where a contract has been affected by a supervening event the parties had not contemplated and therefore had not provided for. Owing to the variety of situations that could potentially arise to frustrate a contract, every case has to be determined on its own facts.

When considering whether a lease has been frustrated, there are added complications. A lease is not only a contract but also a vested interest in land that can be registered under s 115 *Land Transfer Act 1952*. Furthermore, a lease is an ongoing contract where the parties' rights and obligations continue for many years. It is not just a one-off transaction like a contract for the sale of goods. Owing to these differences, there has been much debate over the years about whether a lease could ever be frustrated. Fortunately the law has now been clarified by the House of Lords in *National Carriers Ltd v Panalpina (Northern) Ltd*,[3] when it confirmed that the doctrine of frustration applies to leases as to any other contract. It did, however, restrict its application by saying that the circumstances in which it would apply to leases would be rare. In that case, a warehouse became inaccessible for 20 months when the local council closed the only access road to it. The tenants claimed the lease was frustrated. Despite having confirmed the application of the doctrine to leases, the House of Lords decided the lease in this case was not frustrated. The disruption of 20 months of a lease for ten years was insufficient to cause frustration, particularly when there was still five years of the lease to run.

The test for the doctrine

The leading case on the doctrine of frustration in New Zealand is a recent 2013 decision of the Supreme Court in *Planet Kids Ltd v Auckland Council*.[4] This case did not involve a lease but is nevertheless important because it clarified the test to be applied to determine if frustration has occurred. The test requires a multi-factorial approach which involves consideration of the following factors:

- the terms of the contract, its matrix or context, the parties' knowledge, expectations, assumptions and contemplations, in particular as to risk, as at the time of the contract, the nature of the supervening event and the parties' reasonable expectations and objectively ascertainable calculations as to the possibilities of future performance in the new circumstances
- the demands of justice
- a number of tests put forward by judges over the years, and affirmed by the courts[5]
- the test to be applied is an objective one
- the court identifying, and taking into consideration, the circumstances in which the parties intended the contract to operate.

When the contract is a lease there is one other important factor the courts must consider as part of the assessment and that is the effect of the disruption on the lease. This involves a comparison of the length of the term of the lease, the length of the disruption and the length of the term remaining after the disruption ceases. The longer the term of the lease, the less likely any disruption will be considered frustration because even a lengthy disruption is unlikely to have much of an impact on the lease. Alternatively, a lease with a short term is more likely to be frustrated because even a small disruption could have a significant impact. It depends on the facts of each case.

The nature of the earthquake

For the doctrine of frustration to apply there must have been a supervening event that changed the nature of the obligations under the contract in a way the parties had not contemplated.

1 *Taylor v Caldwell* (1863) 3 B&S 826.

2 *Davis Contractors Ltd v Fareham UDC* [1956] 1 AC 696 at 729.

3 *National Carriers Ltd v Panalpina (Northern) Ltd* [1981] 1 AC 675.

4 *Planet Kids Ltd v Auckland Council* [2013] NZSC 147.

5 Construction of contract theory by Lord Reid in *Davis Contractors Ltd v Fareham Urban District Council* [1956] 1 AC 696; the 'radically different' test by Lord Radcliffe also in the *Davis Contractors Ltd* case and quoted earlier; the 'significant change' test by Lord Simon in *National Carriers Ltd v Panalpina (Northern) Ltd* [1981] 1 AC 675 and Lord Sumner's 'common object' test in *Hirji Mulji v Cheong Yue Steamship Co Ltd* [1926] AC 497.

The essence of a lease is that a landlord provides a building for a tenant to use and in return the tenant pays rent. The cordon in Christchurch meant tenants could not access their buildings and therefore could not use them. In this way they were not receiving what they had expected or contracted for. Furthermore, landlords and tenants had never contemplated their leases being affected in this way. One landlord said:

> ***I had never considered the city would be damaged in such a way by an earthquake. The main reason I would have thought the building might be damaged would be by a fire or maybe temporarily inaccessible due to a flood.***
> [Participant FQ200]

The earthquake and its consequences were not foreseeable

Previous cases had raised the question of whether the doctrine of frustration would apply if the supervening event was foreseeable; the rationale being that if it was foreseeable the parties could have, and should have, provided for it in their contract. In the Planet Kids case, the Supreme Court confirmed that foreseeability is not decisive on its own; it is but one of a number of factors that must be considered. Moreover, the court confirmed it is not just the supervening event that must be foreseeable but also the consequences of the event.

In New Zealand, earthquakes have been held to be a foreseeable risk.[6] However, it could be argued that a number of unusual features made the Canterbury earthquakes different and therefore unforeseeable. These include the cumulative effect of a number of significant aftershocks, their occurrence in a low-to-moderate zone of seismic activity on unknown faults close to a high density urban area, a high amount of energy was released for earthquakes of their size, the vertical accelerations were extreme and the faults were shallow. In particular, the February 2011 aftershock was centred close to the city centre and caused significant damage. Nevertheless, even if the earthquakes were foreseeable, the consequences must be too. Here, there is a strong argument the erection of the cordon was not. This is supported by evidence from all participants who said they never expected nor contemplated the CBD being cordoned. One tenant commented:

> ***Nobody could have foreseen that a whole city would be fenced off. Whether your building was damaged or not, you wouldn't be able to access it and if you could access it, you couldn't use any of the services because your toilets wouldn't work, you wouldn't have water coming in, there was no power, gas pipes were ruptured ... it's a whole new world.***
> [Participant FQ306]

Furthermore, the participants did not expect to be denied access to their buildings for such a long time, in some cases nearly two and a half years.

The leases and the legislation

The doctrine of frustration will not apply to a contract that has provision covering the situation that has occurred. It will also not apply if there is applicable legislation. In Christchurch, neither the leases nor the legislation dealt with the issue of an inaccessible building.

A standard form lease, the Auckland District Law Society lease (2008, 5th edition), used extensively throughout New Zealand, was the lease most commonly used by landlords and tenants in Christchurch at the time of the earthquakes. This lease contained provision that covered buildings if they were destroyed or damaged. If the building was destroyed or untenantable, the lease would terminate. If the building was only damaged, the rent would be abated until the building was repaired or reinstated. However, the lease did not cover the situation of an inaccessible building. This was a problem because landlords and tenants looked to their lease for answers. One lawyer said:

> [The lease] ***was more unhelpful as an immediate source of guidance for tenants who were facing a practical lock-out situation, not knowing what to do when the circumstances were not described in the lease at all. Their building might have been fine but they weren't allowed to get anywhere near it. The lease just didn't have answers for that.***
> [Participant FQ002]

There was no provision in the legislation that covered an inaccessible building either. *The Property Law Act 2007* governs commercial leases unless specifically excluded, as does the *Property Law Act 1952* (repealed) that still applies to leases entered into prior to the enactment of the current legislation. They imply certain covenants into leases where the leases have no provision.

In relation to the 2007 Act, two of the covenants specifically refer to earthquakes; one providing for the payment of rent and the other requiring the lessee (or tenant) to keep and yield up the premises in their existing condition. The covenant that provides for the payment of rent simply states that rent is payable unless the premises are destroyed or damaged by certain causes, one of which is an earthquake.[7] In this situation the rent will abate until the premises are repaired and are fit for occupation. However, there is nothing in this covenant that allows either party to terminate the lease.

The other covenant requires the lessee to keep and yield up the premises in their existing condition.[8] However, the lessee is not bound to repair damage caused by any of a number of listed causes, one of which is an earthquake. But this covenant does not help landlords or tenants if they want to terminate the lease either.

6 *Hawkes Bay Electric Power Board v Thomas Borthwick & Sons (Australia) Ltd* [1933] NZLR 873.

7 *Property Law Act 2007*, s 218(1), Schedule 3, cl 4 and *Property Law Act 1952* (repealed), s 106(a).

8 *Property Law Act 2007*, s 219, Schedule 3, cl 13(1) and *Property Law Act 1952*; *Property Law Act 1952*, s 106(b).

There are three other covenants that might apply in an earthquake. The first allows the lessee to terminate the lease if it is an express or implied term that the leased premises may be used for one or more specified purposes and the premises cannot be used for those purposes.[9] This covenant would probably apply where, for example, local government made zoning changes which, as a consequence, meant changes were made to the permitted use of the premises within the new zone. This issue, however, does not relate to access to the premises; it relates to legal use of the premises which is different. Therefore it is unlikely this covenant could be used to terminate leases where premises were inaccessible.

The second and third covenants can be grouped together as they are similar in effect: the covenant that the lessor will not derogate from the lease and the covenant of the lessor to ensure the tenant shall have quiet enjoyment of the leased premises.[10] The covenant not to derogate from the lease means the landlord may not do anything that is inconsistent with the purpose for which the premises were let. The covenant of quiet enjoyment protects the tenant from interference with possession of the premises by the landlord. In both of these situations the covenant is breached where the landlord has done something that has interfered with the tenant's rights to the property. This was not the issue in the case of an inaccessible building. It was not the landlords' fault the earthquake occurred and the cordon was erected. It was not the landlords who had interfered with tenants' rights to use the buildings. Tenants would be more likely to claim a breach of this covenant if landlords carried out noisy or lengthy repairs to their buildings.

The property law legislation was clearly drafted in contemplation of earthquakes. However, it is not comprehensive in its coverage. Like the Auckland District Law Society lease, it only applies to buildings that are damaged and does not cover an undamaged, inaccessible building.

Risk at the time of the contract

Landlords and tenants had not turned their minds to the problem of an inaccessible building. When the issue did arise, they were surprised the lease did not provide for it. The ADLS lease was widely used and considered to be a good document prepared by a committee of specialist property lawyers. However, the risk that the parties might not be able to access their buildings was not considered nor provided for in the lease. In this way the risk was not allocated to either party.

Future performance of the contract

Tenants were also surprised their leases did not provide for termination in the event their building became inaccessible. They were certainly very clear that they did not expect to keep paying rent for a building they could not access. One tenant's view was shared by many:

> ***I did not look at the terms of the lease. I just assumed that anyone in their right mind would know that if you can't occupy a building then you shouldn't have to pay rent. It was only later that I realised from stories in the press that some tenants had to keep paying rent. The building might be able to be used but the cordon prevented them from using it; so they were liable to pay.***
> [Participant FQ214]

Tenants were also keen to end their leases. They wanted to set up business elsewhere and enter into new leases. They did not want to be liable for two leases. One said:

> ***If I hadn't got new premises that would have been the end of my business. If the landlord had required me to go back into the building after its repair, I don't know what I would have done.***
> [Participant FQ214]

A lawyer said:

> ***I don't see much point of having leases that [mean the tenants] will go and lease somewhere else for six months while the work is done and then come back. It just seems, in most cases, tenants will want to find another place and keep going from the [new] place … they would rather terminate and move on.***
> [Participant FQ005]

Tenants were also concerned at how long it would take to clean up the CBD and did not want to return until there was business for them in the city centre.

The majority of landlords did not consider that leases should be terminated if the buildings were inaccessible. However, they held mixed views about whether rent should be paid. Some thought that, on a moral basis, they could not charge rent in such circumstances. Others relied on the fact that there was nothing in the lease that imposed the risk on them. Their argument was they should not have to bear that risk:

> ***… we are strongly of the view the landlord is only responsible for erecting the building and maintaining essential services. A landlord should not provide a warranty as to continued occupation … The inability to access the premises does not directly relate to the fabric of the building and is in essence a business risk. Those business risks should be borne by the tenant and not the landlord.***
> [Participant FQ301]

Effect of the disruption on the lease

The majority of tenant leases were for terms of between three and six years while landlords reported longer

9 *Property Law Act 2007*, s 218(1), Schedule 3, cl 10(1).

10 *Property Law Act 2007*, s 218(1), Schedule 3, cls 8 and 9.

leases of six to ten years. The length of time tenants were unable to use their buildings varied from six weeks to four years. For those leases of three years or under, a disruption of six months or more would likely have had a significant impact, as would a disruption of two years or more for leases of six years and upwards.

The demands of justice

The final overarching consideration in the test for the doctrine of frustration is the question of what does justice demand be done in this situation? Should the doctrine be applied to terminate the leases in these circumstances?

Tenants were generally the owners of small to medium-sized businesses. They suffered financial hardship when they were unable to terminate their leases. They had costs to cover such as relocation expenses and rent for new premises. In some cases tenants were also required to pay for the lease of their inaccessible building. Those whose rent had been abated on the inaccessible building were still potentially liable for two leases once the cordon was removed and the CBD was accessible again. This is because new landlords signed tenants up for lengthy terms knowing it was likely they would move back to the CBD once it reopened.

Tenants also faced uncertainty about their future. They did not know how long the cordon would remain in place. They did not know if they would have to return to their buildings in the CBD. They did not know what the city would be like when they returned and whether there would be any business there for them.

Landlords also suffered hardship after the earthquakes. Their hardship, however, related to tenants not paying rent. If they did not have insurance or the insurance was insufficient to cover the length of time the rent remained unpaid, it had a financial impact on them. Landlords were keen to keep the leases in force and collect rent.

It is clear that justice demands tenants be granted relief in these circumstances. Tenants should be released from leases where their rights and obligations have substantially changed from those originally contracted for and where they could suffer serious financial hardship. Landlords, being in the business of leasing, are in a better position to protect themselves and should therefore be responsible for insuring against the risk of an inaccessible building.

Conclusion

Landlords and tenants of commercial buildings were significantly affected by the CBD cordon set up after the Canterbury earthquakes. Their buildings became inaccessible. However, they did not know their legal rights because their leases did not provide for this situation and the law was unclear. The application of the doctrine of frustration to leases was not decisively tested after the Canterbury earthquakes. The uncertainty in the law meant litigating the issue was risky. However, it continues to be a potential solution for future events. For example, as a consequence of the 2016 north Canterbury earthquake, cordons were erected around various dangerous buildings in Wellington. This restricted access to office blocks and shops that could otherwise have been occupied and used. The earthquake also caused landslips across State Highway One to the north and south of Kaikoura, which meant the town became inaccessible. Although tenants were still able to access their buildings, the lack of access to the town affected their ability to conduct business and pay their rent. Landlords and tenants would have relied on insurance to cover their losses in these situations.

The doctrine could also be helpful to landlords and tenants in urban areas damaged by flooding or fire if buildings are cordoned for a prolonged period. Similarly it might apply in other situations such as the threat of a volcanic eruption or its actual occurrence, or the threat of or an act of, terrorism, a global epidemic or any other situation that might result in an urban area being closed for a lengthy period.

It is vital the law provides certainty in uncertain times. In this paper it is argued that the doctrine of frustration remains a viable solution for landlords and tenants whose buildings are affected by a disaster. This is important to know to be prepared for the future. For it is not if the next disaster should happen, it is when.

References

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