



Article

Litigation

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Top four things to know about 'good faith' and commercial contracts

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The Supreme Court of Canada's precedent-setting decision, *Bhasin v. Hrynew*, 2014 SCC 71, established that all commercial contracts in Canada are bound by the principle of good faith. This includes an obligation by both parties to perform the contract honestly, to exercise any contractual discretion reasonably, and to cooperate to fulfil the objects of the agreement.

When violated, the duty gives rise to an ordinary breach of contract claim; the aggrieved party can start an action for damages or specific performance, as with any other breach of contract.

Since *Bhasin*, however, the concept of good faith has developed. The nature of what constitutes a "dishonest" performance of the contract has broadened, as has the recognition that any discretion under the contract must be exercised in accordance with the parties' intentions.

This evolution in good faith jurisprudence has left Canadian courts to balance a delicate tension between allowing commercial parties to contract freely against the need to ensure that parties act with a basic degree of good faith.

A recent decision of the Ontario Superior Court, *Bhatnagar v. Cresco Labs Inc.*, 2022 ONSC 1745, addresses this tension head-on in the context of a share purchase agreement. *Bhatnagar* provides four key lessons on the nature and scope of breach of contract claims based on the duty of good faith.

A 'smokin' agreement

In *Bhatnagar*, the vendors of a vape products company brought an application for damages arising from alleged breaches of a share purchase agreement (the SPA).

The vendors had sold their interest in the company to the original buyer pursuant to the SPA. Prior to

closing, the respondent cannabis operator (the "respondent buyer") acquired the original buyer's shares in the company pursuant to an arrangement agreement dated April 1, 2019, (the

arrangement agreement). The respondent buyer therefore became liable to the applicant vendors for any amounts owing to them under the SPA by the original buyer.

The vendors started the application, alleging they were still owed various "revenue milestone" and "license milestone" payments under the SPA. The vendors also alleged that the purchaser breached its duty of good faith, i.e. that the vendors were hindered in trying to implement various business measures which would have resulted in the vendors receiving their "revenue milestone" payments in 2019. The allegations against the buyers were that they had:

- Misrepresented the degree of autonomy and discretion that the vendors would have in the operation of the business;
- Failed to approve new leases and new hires in a timely manner to support the business' application for a required licence; and
- Failed to advise the vendors that the respondent buyers intended to delay the closing of amalgamation transaction with the original buyer, which was expected to close in 2019.

1. The three facets of good faith so far

The court recognized that the organizing principle of good faith governing commercial contracts includes at least three duties thus far:

- A duty of honest contractual performance, which includes the obligations not to lie and to perform contractual duties honestly and reasonably. While this does not include a duty of loyalty or disclosure to the counter-party, or require the counter-party to forgo advantages flowing from the contract, it includes an obligation to "speak up (or make disclosure) to correct a misapprehension": citing *Bhasin v. Hrynew*, *supra*; *C.M. Callow Inc. v. Zollinger*, 2020 SCC 45
- A duty to exercise any discretion under the contract reasonably. This obligation is breached where the "discretion is exercised ... in a manner unconnected to the purposes underlying the discretion": citing *Wastech Services Ltd. v. Greater Vancouver Sewerage and Drainage District*, 2021 SCC 7; and
- A duty to "cooperate in good faith to achieve the objects of the contract": citing *Dynamic Transport Ltd. v. O.K. Detailing Ltd.*, [1978] 2 S.C.R. 1072.

2. Do not use good faith as a surrogate for tortious misrepresentation

At its core, a breach of the duty of good faith amounts to a breach of contract.

In *Bhatnagar*, the court declined to assess the allegation about the buyers' failure to give the vendors sufficient autonomy to implement the business expansion plan. In the court's view, this was a misrepresentation claim (in tort).

The court noted that the duty of good faith in contract could not be used to circumvent the requirements of advancing a tort action for misrepresentation, particularly in the face of an "entire agreement" clause in the contract:

... While [the allegations of misrepresentation regarding the business expansion plan] may add some colour, the vendors have not advanced a misrepresentation claim and the duty of good faith and honest performance of contractual obligations *is not a way around the requirements for proving such a claim in the contractual context*.

An application predicated on the interpretation of a contract that contains an entire agreement clause is not the appropriate forum or legal analytic framework in which to dive into these sorts of allegations and I do not propose to do so. [emphasis added]

3. The duty to correct a misapprehension

Following the principles established in *Bhasin* and *Callow*, *supra*, the court in *Bhatnagar* echoed the proposition that the failure to correct the counter-party's misapprehension as to a state of affairs regarding the performance of the contract may very well amount to a breach of the duty of honest contractual performance.

In *Bhatnagar*, the failure by the respondent original buyer to advise that the arrangement agreement would not close until January 2020 was a breach of contract:

I find that [the original buyer] breached its duty of good faith and honest performance of the SPA by having advised the vendors repeatedly until October 2019 that the Arrangement Agreement would close in 2019 and [by] *not correcting or updating that advice when Origin House was informed [by the respondent buyer] that the closing date would be pushed out to January of 2020. The obligation was not greater than one of disclosure to correct the misinformation...* [emphasis added]

4. Proof of loss and damages for breach of good faith

Although there was a breach of the duty of good faith and honesty in *Bhatnagar*, the court rightly

observed that the applicants still had an obligation, as with any breach of contract, to prove causation and damages.

In the court's words, these requirements "do not change just because the alleged breach is of the duty of good faith and honest performance of the contract."

In *Bhatnagar*, the vendors' damages claim was premised in part on the fact that, had they been advised of the revised closing date of the arrangement agreement, as set out above, they would have taken steps to ensure that they were nonetheless entitled to receive certain milestone payments under the SPA. In other words, the vendors sought compensation for their lost opportunity.

The court rejected the vendors' position on the basis that the vendors failed to provide "some evidentiary foundation" for the available opportunities they lost as a result of the defendants' breach of good faith.

Even where expectation damages are sought for breach of good faith on the basis of lost opportunity, there must be a minimum evidentiary threshold that has to be met:

The court does not need to know precisely what the vendors would have done and whether they would have succeeded [had they known of the changed closing date], but *there needs to be some evidentiary foundation upon which the court can conclude that there was a credible opportunity that could have resulted in the closing date being changed, or some other outcome could have been achieved to make up for their loss of the Revenue Milestone Payment ...* [emphasis added]

Accordingly, no damages could be inferred or proven from the buyers' breach of honest contractual performance.

The lessons of Bhatnagar

Bhatnagar offers important lessons about how Canadian courts will approach breach of contract claims grounded in the duties of honesty and reasonable contractual discretion. These include:

- There are at least three aspects to the duty of good faith, i.e., the duty to perform the contract honestly, the obligation to exercise contractual discretion reasonably, and a general duty of cooperation under the agreement;
- The duty of good faith is not a substitute for tortious misrepresentation;
- Honest contractual performance includes a duty to correct the other party's factual misapprehensions about the contract; and

- There must be a minimum evidentiary foundation to prove damages for lost opportunity claims arising out of a breach of good faith, as with any other breach of contract.

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