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What You Need to Know About “Good Faith” and Your Business Contract

By Marco P. Falco

Since the Supreme Court of Canada’s ground-breaking decision, *Bhasin v. Hymew*, 2014 SCC 71, all commercial contracts in Canada are bound by the principle of good faith. This includes the duty by both parties to perform the contract honestly and to exercise any contractual discretion reasonably. The parties cannot “contract out” of these responsibilities.

When violated, the duty gives rise to a breach of contract and 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 evolved significantly. 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 underlying the agreement.

These developments have left Canadian Courts to balance the tension between allowing commercial parties to contract freely with the need to ensure that parties act according to a basic level of honesty in their contractual dealings.

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 the duty of good faith in commercial contracts.

A Contract “Up in Smoke”

Bhatnagar involved an application for damages by the vendors of a vape products company.

The vendors had sold their interest in the company to the original buyer pursuant to a share purchase agreement (the “SPA”).

Before 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”).

As a result, the respondent buyer became liable to the applicant vendors for any amounts owing to them under the SPA by the original buyer.

The vendors started the application, claiming 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. Specifically, the vendors alleged that they 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 ultimate operation of the business;
- Failed to approve new leases and new hires in a timely manner to support the business’ application for a required license; 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.

The Court dismissed the claims for breach of contract.

While holding that the respondent buyers had breached various aspects of the duty of good faith, the applicants had failed to establish the necessary evidentiary foundation for damages arising from the breach.

In reaching this conclusion, the Court established a number of key principles:

1. Three Aspects to the Duty of Good Faith

The Court recognized that the organizing principle of good faith governing commercial contracts includes three duties:

- 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 that the other party is operating under in respect of a matter that is directly linked to the performance of the contract”: 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 unreasonably...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. The Duty of Good Faith Is Not a Substitute for a Misrepresentation Claim

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).

In making this ruling, 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 of Honest Contractual Performance Includes an Obligation to Correct a Misapprehension

Following the principles established in *Bhasin* and *Callow, supra*, the Court in *Bhatnagar* made it clear 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.

Specifically, 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 words of the Court, 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 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 wanted to be compensated 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.

In other words, 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 Takeaways

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 lessons 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 co-operation under the agreement;
- The duty of good faith is not a substitute for tortious misrepresentation;
- Honest contractual performance includes a duty to correct the counter-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 case.

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