GOOD SMOKE? MORE GUIDANCE ON GOOD FAITH FROM THE ONTARIO COURT OF APPEAL

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In *2161907 Alberta Ltd. v. 11180673 Canada Inc.*[1] ("*Tokyo Smoke*") the Ontario Court of Appeal applied recent Supreme Court of Canada jurisprudence on good faith contractual performance in the context of a licensor's termination of several agreements with its licensee. While the decision does not create new law, it assists in fleshing out the often difficult-to-distinguish boundary between good and bad faith conduct.

Ultimately, the Court of Appeal held that although the licensor's termination of the relationship was invalid (and thereby constituted a breach of contract) it did not act in bad faith when doing so. Read on to find out why.

Background

As many readers know, the SCC's 2014 decision in *Bhasin v. Hyrnew*[2] ("*Bhasin*") established good faith performance as a "general organizing principle" of contract law and recognized, as a specific manifestation of this principle, the duty to act honestly in the performance of contractual duties. A few years later, the SCC further advanced the law of good faith contractual performance in *C.M. Callow Inc. v. Zollinger*[3] (which explained that silence which misleads a counterparty could breach the duty of honest performance) and *Wastech Services Ltd. v. Greater Vancouver Sewerage and Drainage District*[4] (which held that discretionary contractual powers must be exercised reasonably and in a manner connected with the purpose for which the discretion was granted). See our prior bulletins on these three decisions here, here and here.

The *Tokyo Smoke* decision[5] provides additional guidance to those exercising discretionary termination provisions and assists in demarcating the contours of bad faith conduct. In short, the Court of Appeal upheld the lower court's decision that a licensor had wrongfully terminated its agreements with its licensee, but overturned the finding that it had done so in bad faith.

Key Takeaways

More specifically, the key takeaways of the Tokyo Smoke decision are as follows:

- Misleading or misinforming a contractual counterparty about some matter related to the contract does

not amount to bad faith conduct unless it is done *knowingly*.

- Having a pre-existing desire to terminate a contract and "pouncing" on what turns out ultimately to be an incorrect basis for doing so does not necessarily constitute bad faith conduct.
- Manufacturing an artificial reason to justify terminating a contract and avoid one's obligations under the agreement most likely constitutes bad faith conduct. However, where a terminating party honestly believes it has the right to terminate, the fact that termination releases that party from its obligations under the agreement does not amount to bad faith, even where the court ultimately finds the termination to be invalid.
- Deliberately creating conditions that give rise to a right of termination may constitute bad faith conduct, but an honest misunderstanding of one's rights does not.

The Facts and Lower Court Decision in *Tokyo Smoke*

The appellant, 2161907 Alberta Ltd. (the "Licensor"), owns the rights to the "Tokyo Smoke" brand which it licenses to various retail operators. It entered into three agreements with the respondent, 11180673 Canada Inc. (the "Licensee"): 1) a license agreement to operate a cannabis store under the Tokyo Smoke banner in Toronto (which provided the Licensee with an up-front "branding fee" of about $2 m); 2) a sublease with respect to the store premises; and 3) a loan agreement by which it would provide about $1.5 m to the Licensee to cover start-up costs.

A dispute arose between the parties couple of days before the store was supposed to open. The Licensee asked for confirmation that it could draw on the loan to cover its first month rent of approximately $105,000. The Licensor mistakenly, but honestly, believed that the loan did not cover the first month's rent and advised the Licensee of such.[6] In response, the Licensee said that it would be laying off its staff and not opening the store. That night, the Licensor called the Licensee (in an effort to "calm" it down and "reassure it that everything was going to be OK") to advise that the Licensor would pay the branding fee shortly and seek a deferral of the first month's rent.

The next day, however, the Licensor reviewed the license agreement. It contained a right to terminate immediately if the Licensee "…ceases or *threatens to cease to carry on business*, or takes or threatens to take any action to liquidate its assets, or stops making payments in the usual course of business" (emphasis added). After obtaining legal advice on the termination right, later that day the Licensor terminated its relationship with the Licensee based on the threat it had made the previous day.

The Licensee did not follow through on its threat to refrain from opening the store. The day after it received the termination notice, it actually opened the store and began carrying on business.

Subsequently, the Licensor commenced proceedings seeking a declaration that it had validly terminated the

relationship, that the branding fee was not payable and requiring the Licensee to vacate the store.

The Licensee counterclaimed for payment of the branding fee and a declaration that the Licensor wrongfully terminated the agreements and breached the duty of good faith. More specifically, the Licensee focused on the duty of honest contractual performance and alleged that the Licensor knowingly misled it about the amounts available to it under the loan agreement, that the branding fee would be paid and that rent would be deferred. Then, after misleading it this way, the Licensor simply terminated the agreement in an effort to avoid having to pay the branding fee.

The lower court found that the Licensor's termination was not valid and constituted a breach of contract on the basis that the Licensee's statements were not an event of default, but rather "an emotional response to being given incorrect information at a critical time". It also went on to find that the termination was effected in bad faith (the Licensor admitted in cross-examination that it was looking for a way to terminate the relationship and avoid paying the branding fee).

The Licensor appealed.

The Court of Appeal Decision

The Ontario Court of Appeal upheld the lower court's decision that Licensor wrongfully terminated the relationship (thereby committing breach of contract), but overturned the finding of bad faith.

With respect to breach of contract, the Court of Appeal acknowledged that the Licensee's communications on their face constituted a threat not to open. However, it agreed with the lower court that, properly interpreted, the termination provision required the threat to be objectively credible in light of the language of the license agreement and the relevant context.[7] The Court noted that, "[T]aken as a whole" the termination right the Licensor relied upon can be viewed as a provision that seeks "to preserve [its] rights in the event of a looming insolvency"[8] and directed towards objectively credible threats to cease carrying on business. The Court of Appeal noted that, because the lower court's finding on this point is one of mixed fact and law, it is owed deference and there is no basis to interfere.

With respect to the lower court's findings on bad faith, the Court of Appeal held that the Licensor had not acted in bad faith principally because it had *honestly* misunderstood its rights and acted on a mistaken belief when it terminated the relationship. The Court noted that it was significant that the lower court at no point found that the Licensor had lied to the Licensee.[9] Although the Licensor's advice to the Licensee that the loan would not cover the first month's rent was false and misleading, it was based on the Licensor's honest but mistaken belief on the subject. Additionally, when the Licensor told the Licensee (in an effort to "calm" the Licensee down) that the branding fee would be paid soon and that it would seek a deferral of rent, this too was

not a lie. The Court found that these reassurances were based on the Licensor's honest belief at the time, and that it was not until the next day when it decided to terminate the relationship (after it had consulted with counsel about the above-noted termination clause). As the Court of Appeal put it, the Licensor did not actively mislead the Licensee – it "simply changed positions in light of new information".[10]

The Court of Appeal also held that the Licensor's "pouncing" on the Licensee's threat not to open did not, on its own, constitute bad faith. The Court put it this way:

> A party is not prevented from exercising a right of termination simply because it wishes to bring its relationship with the other party to an end. Nor should a party be prevented from ending a relationship because it will deprive the defaulting party of a payment that it would have received had the relationship continued. Where a party is anxious to end a relationship, and a valid reason to do so presents itself, that party is not, in the absence of some other relevant fact, prevented from "pouncing" on it.[11]

The Court held that the Licensor's understanding that the Licensee's threat not to open was the type of threat contemplated by the termination provision it invoked was wrong, but went on to state:

...absent a finding that it was a position manufactured to achieve [Landlord's] objective of ending the relationship, an unreasonable position, or a position taken capriciously or arbitrarily, it constitutes an error and no more.[12]

Therefore, while the Licensor's basis for terminating the relationship ultimately proved invalid, its decision to do so was not so unreasonable, capricious or arbitrary to warrant a bad faith finding.[13]

The Court further acknowledged that while *Bhasin* provides that contracting parties must not evade their contractual obligations in bad faith, and that manufacturing "an artificial reason to terminate a contract in order to avoid future payment obligations would likely be found to have acted in bad faith"[14], such was not the case on these facts. Here, the Licensor honestly believed the termination was justified, and the "fact that termination releases a party from making a significant payment does not amount to bad faith, even where a court later finds that the termination was invalid".[15]

In the end, because the Court of Appeal upheld the lower court's decision that the Licensor had breached the license agreement by invalidly terminating it (leaving the issue of damages for same to be determined at trial or by agreement of the parties), the bad faith findings were set aside.

Implications

The *Tokyo Smoke* decision confirms that, even though a party may be found to have terminated an agreement

invalidly, that does not necessarily mean that it violated its good faith contractual obligations when doing so. In distinguishing an honest mistaken belief from bad faith conduct, it confirms that courts will be less inclined to conclude a party violated its good faith duties where the termination arose from the terms of the contract and provided the termination decision is not made dishonestly, unreasonably, capriciously or arbitrarily.[16]

Although *Tokyo Smoke* involved a licensing relationship, its principles are generally applicable to any contract, including franchise agreements. Notably, at the lower court the parties made arguments about whether the license agreement constituted a franchise agreement as defined in the *Arthur Wishart Act (Franchise Disclosure), 2000*, S.O. 2000, c. 3. Because the license agreement contained an express provision requiring the parties to act in good faith, however, the lower court did not determine the issue (and the Court of Appeal did not address the point).

[1] 2021 ONCA 590.
[2] 2014 SCC 71.
[3] 2020 SCC 45.
[4] 2021 SCC 7.
[5] A copy of which can be found here.
[6] The Licensor admitted on cross-examination that it was mistaken, and that the loan should have covered the amounts sought by the Licensee.
[7] *Tokyo Smoke*, *supra*, at paras. 31 – 39.
[8] *Ibid*, at para. 31.
[9] *Ibid*, at para. 50.
[10] *Ibid*, at paras. 54 – 55.
[11] *Ibid*, at para. 57.
[12] *Ibid*, at para. 63.
[13] While the decision does not expressly analyze the facts through the lens of the duty to exercise contractual powers in good faith as established in Wastech, supra, had there been evidence that the Licensor's belief (it could terminate due to the Licensee's threat not to open) was manufactured, or a position taken unreasonably, capriciously or arbitrarily, the Court of Appeal would have undoubtedly done so.
[14] *Tokyo Smoke*, *supra*, at para. 63.
[15] *Ibid*, at para. 63.
[16] *Ibid*, at paras.72 - 73.

by Brad Hanna

A Cautionary Note