

A GOOD LIABILITY EXCLUSION CLAUSE CAN PROTECT YOU FROM A BAD TERMINATION OF CONTRACT

Posted on August 24, 2016

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Break-ups are often expensive, but they do not always have to be. A recent Ontario Court of Appeal case provides clarity to those seeking to terminate a business relationship and avoid exposure to a claim in the process. In *Chuang v Toyota Canada Inc.*,^[1] the Ontario Court of Appeal upheld a contractual liability exclusion clause in circumstances where the defendant had terminated a contract improperly.

Chuang v Toyota Canada Inc. dealt with Toyota's decision to terminate a Letter of Commitment ("LOC") it had entered into with the plaintiff, a prospective dealer. The LOC stated that Toyota would make the plaintiff a Lexus dealer if it built a new facility by a certain date. When the dealer failed to reach certain project milestones, Toyota terminated the LOC. The prospective dealer sued, alleging that the LOC was terminated improperly and in bad faith.

This bulletin summarizes the trial and appeal decisions in *Chuang v Toyota* and identifies some important takeaways, including how to exercise a discretionary termination right; insights on the developing duty of good faith; and the importance of including a robust liability exclusion clause in commercial contracts.

The Facts

Toyota and Chuang entered into a LOC pursuant to which Toyota agreed to appoint Chuang as a Lexus dealer if he built a new dealership facility within a certain time frame. The LOC required Chuang to, among other things, tender the project by February 28, 2005, obtain financing by March 30, 2005 and complete the new facility by March 31, 2006. It also expressly permitted Toyota to terminate the LOC "in its sole discretion" if these deadlines were not met and provided further that Lexus is not liable for any losses, damages or expenses in the event of the termination of the LOC or the Lexus dealer agreement. When Chuang missed the deadlines for tendering and obtaining the financing commitment by a few weeks, Toyota terminated the LOC on April 20, 2005.

In its termination letter, Toyota also noted that the financing Chuang secured after the deadline for doing so had passed required him to personally fund any cost overruns (which Toyota believed would occur, in part because the property needed extensive environmental remediation). So, Toyota cited as a further ground for

termination that it believed that construction was unlikely to commence in a timely manner, and that there would likely be additional problems that might further delay or jeopardize the project.

Chuang claimed that Toyota unlawfully terminated the LOC and sued Toyota for \$20 million.

The Trial Result

The trial court dismissed Chuang's case. In doing so, the court considered three issues: (1) whether Toyota improperly terminated the LOC without a lawful basis for doing so; (2) whether Toyota terminated the LOC in bad faith; and (3) whether the damages exclusion clause effectively insulated Toyota from liability for improper termination.

The trial court held that Toyota had failed to exercise its discretion reasonably and that, as a result, its termination was improper. The court went on to find, however, that Toyota did not act in bad faith and that, in any event, Toyota was fully protected by the liability exclusion clause contained in the LOC. More on all three of these issues, below.

The Discretion to Terminate Must be Exercised Reasonably

Although the LOC permitted Toyota to terminate the LOC "in its sole discretion" if the various milestone deadlines were not met, the court concluded that Toyota's termination was not a reasonable exercise of that discretion.^[2] The court had no trouble concluding that the nature and purpose of the LOC are consistent with a requirement that Toyota exercise its discretion to terminate in a reasonable manner.^[3] The court assessed "reasonableness" by considering the specific terms of the LOC viewed in the context of the agreement as a whole as well as the purpose of the LOC. In particular, the court considered the following factors to determine whether Toyota exercised its discretion reasonably:

- How the delays affected the timing for the accomplishment of the ultimate objective of the LOC (being, opening the dealership by March 30, 2006);^[4] and
- How Chuang's activities at the time of termination affected the prospect of accomplishing the ultimate objective of the LOC.^[5]

With respect to these factors, the court found that: as a result of the delays, completion of the new facility was only likely to be delayed by 5 – 7 months and there was no particular reason why the dealership had to open by March 31, 2006;^[6] when it entered the LOC, Toyota was itself willing to accept a delay of this amount of time as long as it saw Chuang actively advancing the project; and when Toyota terminated, Chuang was not procrastinating – rather, he was actively trying to advance the project.^[7] Accordingly, the court concluded that Toyota did not act reasonably in terminating the LOC and that it violated the LOC by terminating as it did.

Good Faith Termination Means Tell No Lies

Chuang also alleged that Toyota did not terminate the LOC in good faith. Among other things, he claimed that Toyota did not like him and doubted his ability to operate the dealership once it was built and that these were the real reasons that motivated Toyota to terminate the LOC. The evidence supported his contention, and the trial court found that the animating reason behind the termination was Toyota's lack of confidence in Chuang and his ability to ultimately manage and operate the dealership over the long term. Chuang also alleged that Toyota initiated steps to terminate the LOC in March, but did not actually send the notice of termination until April 20, 2005.

The court, however, dismissed the claim of bad faith. Relying on the recent Supreme Court of Canada decision in *Bhasin v. Hrynew* (a case involving the non-renewal of an agreement in bad faith), the court noted that the duty of honesty in contractual performance means that parties must not lie or otherwise knowingly mislead each other about matters linked to the performance of the contract. In *Bhasin*, the defendant told multiple lies to the plaintiff. But in this case, the trial court found no evidence that Toyota had lied to Chuang or otherwise failed to provide Chuang with information it was required to provide. The court held that Toyota was under no obligation to tell Chuang that it had reservations about his financial and management capabilities.^[8]

The Enforceability of the Damages Exclusion Clause

Despite finding that Toyota had improperly terminated the LOC (but not in bad faith), the trial court dismissed the case against Toyota solely on the basis of the liability exclusion clause. The exclusion clause provided that:

In the event of the termination of this LOC and/or the Lexus Dealer Agreement, Lexus and its directors, officers and employees shall not be liable for any losses, damages and/or expenses of any kind whatsoever, suffered or incurred by you directly or indirectly in connection with this LOC and/or your Lexus Dealer Agreement.

Chuang made two arguments that the exclusion clause does not apply and that, properly interpreted, Toyota should not be permitted to rely on this provision. First, he argued that Toyota cannot have the benefit of this provision because Toyota itself breached the LOC by improperly and unlawfully terminating it. He urged the court to read the provision to really mean "In the event the LOC is *lawfully terminated in accordance with its terms*...". The court found no basis for reading the provision this way.^[9] In effect, the court ruled that the exclusion clause applied regardless of whether the termination itself had been effected lawfully or unlawfully. Second, Chuang argued that by terminating the LOC, Toyota also terminated the damages exclusion clause with it. The court disagreed, primarily because the damages exclusion clause expressly states that it applies "...in the event of the termination of this LOC...".

In finding the exclusion clause to be enforceable, the court relied on an earlier Supreme Court of Canada case which confirms that such exclusion clauses are to be enforced according to their terms unless: (i) the clause was unconscionable at the time the contract was entered; or (ii) there is some overriding public policy reason that outweighs the public interest in enforcement of contracts.^[10] Given that the trial court found the exclusion clause to be applicable, and that Chuang neither argued that the clause was unconscionable nor void on the basis of public policy the court concluded the clause was enforceable.

Chuang's Unsuccessful Appeal

Chuang appealed, arguing that the trial judge failed to properly: (1) interpret the exclusion clause by not giving adequate effect to the requirement that Toyota act reasonably in exercising its termination right; and (2) consider the nature of the commercial relationship between the parties or the business efficacy of the interpretation of the exclusion clause. In essence, Chuang argued that the exclusion clause could only assist Toyota if it acted reasonably in terminating the LOC, and because Toyota did not act reasonably when terminating, it should not be insulated from liability.

The Ontario Court of Appeal rejected Chuang's arguments, dismissed his appeal and upheld the trial decision.^[11] The Court of Appeal noted that sophisticated parties operating on a level playing field are "free to allocate risk as the parties see fit " in their agreements.^[12]

The court went on to note that the exclusion clause is broadly written, and found the inclusion of the word "damages" to be "particularly telling".^[13] The court held that the exclusion of liability for "damages... of any kind whatsoever, suffered or incurred" in addition to the exclusion of liability for "losses" or "expenses" indicates that it protects Toyota from liability even in circumstances where it did not properly terminate the LOC.^[14]

As an aside, the Court of Appeal also noted that the liability exclusion clause is not so broad that it permits Toyota to escape all liability. For example, the court observed that the language of the clause does not affect Chuang's ability to seek other remedies for improper termination, such as specific performance.^[15] Chuang had initially sought specific performance, but abandoned that request after entering an agreement with another automotive manufacturer to operate a dealership on the same site.

Key Takeaways

This decision provides valuable guidance to those seeking to terminate contracts. Some of the key takeaways are as follows:

1. When exercising the discretion to terminate an agreement, you must do so "reasonably". "Reasonableness" will be measured in any particular case by considering specific language of the contract viewed in the context of the agreement as a whole as well as the purpose of the contract.

2. To avoid a finding that you terminated an agreement in bad faith, ensure that your termination letter sets out the real reasons for termination and do not mislead or lie to your counterparty. It is important to be honest when responding to any direct questions posed by your counterparty. It is better to simply respond by saying you are not going to answer a question than to answer a question with a lie or in a misleading way. Further, after making a termination decision, but before communicating it, do not mislead your counterparty into believing everything is fine.
3. Whenever possible, include a robust liability exclusion clause in your agreements. Provided the clause is worded sufficiently broad (and that it is not unconscionable) it can protect you against damages claims (and potentially, specific performance if the clause includes this) even when you exercise a termination right unreasonably or improperly. And if you are dealing a less sophisticated party, it is strongly advisable to require that it obtain (and acknowledge having obtained) independent legal advice before it signs the contract.

by Brad Hanna and Mitch Koczerginski

1 2016 ONCA 584 [Appeal Decision], affirming *Chuang v Toyota Canada Inc*, 2015 ONSC 885 [Trial Decision].

2 Trial Decision at para 75.

3 Ibid at paras 38-43.

4 Ibid at para 53.

5 Ibid at para 53.

6 Ibid at paras 60-64.

7 Ibid at paras 65-71.

8 Ibid at para 102.

9 Ibid at para 106.

10 Ibid at para 111, citing *Tercon Contractors Ltd v British Columbia (Transportation and Highways)*, [2010] 1 SCR 69 at paras 122-123.

11 Appeal Decision at paras 10-18.

12 Ibid at para 32.

13 Ibid at para 34.

14 Ibid at para 34.

15 Ibid at para 36.

A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.

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