

GOOD FAITH IN BUSINESS TRANSACTIONS - FIVE CONSIDERATIONS FOR BUSINESSES

Posted on October 3, 2022

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The law of contractual good faith in Canada and its application has significantly evolved with the Supreme Court of Canada's trilogy in *Bhasin*,^[1] *C.M. Callow*,^[2] and *Wastech*.^[3]

The Ontario Superior Court of Justice in *Bhatnagar v Cresco Labs Inc.*^[4] applies the trilogy's jurisprudence on good faith to a dispute over a complex transactional business agreement.

In turn, this article outlines five key lessons for businesses from *Bhatnagar*, and summarizes the Court's take on the pertinent aspects of the contractual duty of good faith as distilled from the Supreme Court of Canada's trilogy.

THE FIVE TAKEAWAYS FOR BUSINESSES

Five lessons arise from the Court's decision in *Bhatnagar* which businesses should keep in mind when negotiating, drafting, and performing their transactional agreement:

1. A party cannot circumvent the requirements of a tortious misrepresentation claim through a breach of good faith argument;
2. Whether there is a breach of good faith will heavily factor in what the parties contemplated in a contract – if a party agrees to a provision, it cannot later turn its back on it and use a good faith argument to escape the consequences;
3. The law of good faith does not step in to fill the gap left by an absent term in a contract. If a party has an expectation, it should include it in the contract – a breach of good faith argument is not a catch-all for overlooked terms;
4. There exists a duty to make disclosure to correct a misapprehension that is held by a counter-party – it is a breach of good faith to leave the counter-party in the dark on a material issue; and
5. Even if a party succeeds in a breach of good faith argument, it still must prove causation and damages with an evidentiary foundation – otherwise, the victory is merely symbolic and there will be no damages award.

FACTS OF BHATNAGAR

The applicant vendors sold their interests in a vape products company named 180 Smoke to Origin House Corp. ("**Origin House**") via a share purchase agreement ("**SPA**").

The SPA was executed on February 19, 2020. One day later on February 20, 2020, Origin House was acquired by the respondent, Cresco Labs Inc. ("**Cresco**"). Accordingly, it was not fully transparent to the vendors what the intentions were of the ultimate purchaser, Cresco.

It was agreed upon that Cresco stepped into the shoes of the purchaser under the SPA after it acquired Origin House, and that Cresco was liable to the vendors for any breaches of the SPA.

The SPA contained provisions that the applicant vendors were to be paid "revenue milestone payments" and a "license milestone payment" (together, "**Milestone Payments**"), but only if 180 Smoke sufficiently expanded its business to meet certain thresholds. These expansion plans were to be financially supported by the purchasers of 180 Smoke through a "Milestone Budget", totaling \$5.15 million.

THE APPLICANT VENDORS' BREACH OF GOOD FAITH ARGUMENT

The applicant vendors brought the application on the basis that they were still owed payments under the Milestone Payments, amongst other allegedly owed funds. They did so despite the fact that 180 Smoke did not meet the required thresholds to trigger the payment of the Milestone Payments under the SPA.

The vendors argued that they were entitled to the payments on the basis of expectation damages for a breach of the duty to act honestly and in good faith in the performance of contractual obligations, and in the exercise of contractual discretion, amongst other unsuccessful arguments.

The argument centered on the allegation that the purchaser hindered 180 Smoke in its efforts to implement the expansion plan for its business; had the purchaser not done so, 180 Smoke would have met the thresholds required to trigger the Milestone Payments, and receive other payments. The vendors alleged:

- Misrepresentations were made outside of the SPA about the level of discretion and autonomy the vendors would have over the operations of 180 Smoke;
- Misrepresentations were made outside of the SPA about the timing of the financial support 180 Smoke would receive – the funds to support the expansion were not released in a timely manner;
- Origin House failed to approve leases and new hires for 180 Smoke, and in some cases failed to approve them at all; and
- Origin House failed to advise the vendors that its amalgamation with Cresco was to be delayed into 2020, after telling the vendor numerous times that the amalgamation was expected to occur in 2019.

THE COURT SUMMARIZES THE KEY ASPECTS OF CONTRACTUAL GOOD FAITH

The Court in *Bhatnagar* began its analysis with a summary of the Supreme Court of Canada's trilogy on good faith.

In relation to the measure of damages the applicant vendors would be entitled to, the Court stated that proof of loss or proof the business would have expanded are not necessary. The vendors only need proof that 180 Smoke was deprived of the opportunity to attempt to generate the revenue required to meet the thresholds for the Milestone Payments as a result of the purchaser's failure to act in good faith, and/or the purchaser's failure to exercise contractual discretion in good faith.^[5]

The Court also applied *Bhasin* to hold that the purchaser here must perform its contractual duties "honestly and reasonably, and not capriciously or arbitrarily", and that the purchaser must have appropriate regard to the legitimate contractual interests of 180 Smoke.^[6]

Further, the Court looked to the trilogy to affirm the following:

- Parties have a duty 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;^[7]
- The duty to exercise contractual discretion in good faith is breached when discretion is exercised unreasonably, which means in a manner unconnected to the purposes underlying the discretion;^[8] and
- Parties have a duty to co-operate in good faith to achieve the objects of the contract.^[9]

With the trilogy guiding the analysis of the Court in *Bhatnagar*, five lessons arise from the decision.

1. Lesson One: a Breach of Good Faith is not a Substitute for a Tortious Misrepresentation Claim

The Court noted that while the alleged misrepresentations may add some colour to the claim of the vendors, a misrepresentation claim should not be brought as a breach of good faith. The vendors' attempt to circumvent the more stringent requirements for proving a tortious misrepresentation did not sit well with the Court. In consequence, the Court refused to consider the alleged misrepresentations altogether since a claim in misrepresentation was not advanced by the vendors.

Since the application was predicated as a breach of contractual good faith case focused on contractual interpretation issues, and as the impugned SPA contained a valid "entire agreement" clause, misrepresentations made outside of the SPA had no place in the vendors application.

2. Lesson Two: Whether there is a Breach of Good Faith can depend on what the Parties Contemplated in their Contract

In relation to the willingness and general reluctance of the purchaser to support 180 Smoke in its expansion, the Court found that there was no breach of good faith.

The SPA contemplated a change of control transaction where Origin House would be amalgamated with Cresco. In anticipation of such, Origin House issued a “pre-closing restrictions memo” which imposed restrictions on 180 Smoke entering into certain transactions, including entering into new leases, material contracts, or employment agreements, and making certain capital expenditures without approval.

Further, a provision of the SPA also provided alternative payment methods for 180 Smoke to attain a payment in lieu of a Milestone Payment should a change of control transaction occur which causes 180 Smoke to not meet the thresholds required for the Milestone Payment.

The Court took the position that the vendors likely understood the consequences of a change of control transaction upon entering into the SPA, considering how the consequences of such are expressly outlined in the SPA and were negotiated by the parties.

Accordingly, as Origin House and 180 Smoke turned their minds to a change of control transaction hindering expansion efforts in the SPA, the Court held that the purchaser did not breach good faith in relation to alleged reluctance of the purchaser to support 180 Smoke’s expansion plans.

3. Lesson Three: The Law of Good Faith Does Not Step in to fill the Gap Left by the Absence of a Term in a Contract

The Court also found it “difficult” to conclude that there was a breach of good faith in relation to the duty to cooperate and the timing of the release of funds, which the purchaser agreed to provide to 180 Smoke to support its expansion plans.

This was because the SPA contained no specific timelines of how 180 Smoke’s expansion plans would be funded, and the vendors failed to provide a notice of any complaint regarding the timing of the advance of funds, which the SPA permitted the vendors to do.

Accordingly, it was not open to the vendors to argue that the release of funds was delayed such that there was a breach of good faith, as the SPA did not stipulate required timelines. If a party has a concern over how and when funds are to be advanced, that should be worked into the contract – the law of good faith does not fill that gap.

Factoring in the ample discretion the SPA gave Origin House for new leases, new hires, new license applications, and the timing of the release of funds to support 180 Smoke’s expansion plans, the Court relied on *Wastech* to support its conclusion. It held that Origin House exercised its discretion in a manner consonant

with the purpose for which the discretion was given in the SPA, which was to allow Origin House to pursue a change of control transaction with Cresco.

4. Lesson Four: The Failure to Disclose Information that Materially Impacts a Party under the Contract is a Breach of Good Faith

Origin House continuously assured the vendors that any change of control transaction would close in 2019. However, it ended up closing in 2020. This caused the vendors to receive a lower lump sum payment for the lost opportunity of no longer being able to attain the Milestone Payments after a change of control transaction which the SPA provided for.

Here, the Court found that Origin House breached its duty of good faith and honest performance under the SPA when it failed to advise the vendors that the closing date had changed. The closing delay materially impacted the payout the vendors received, and the vendors were left in the dark on this.

Applying *Callow*, the Court stated that Origin House had a duty to speak up to correct any misapprehension that the closing would not happen in 2019.^[10] The Court highlighted that even though Origin House did not intentionally mislead the vendors about the closing date, its failure to update the vendors after it found out that the closing date had changed amounted to a breach.

Interestingly, the Court added that the duty here was only a duty to disclose the delay in closing, and *not* a duty to inform the vendors that their contractual payout would be materially impacted for the worse. The Court stated that this would be for the vendors to figure out on their own.

5. Lesson Five: There is No Automatic Entitlement to Damages if a Breach of Good Faith is Found – You Still Need to Prove Causation and Damages

In the words of the Court, “[c]ausation and damages are an integral part of a breach of contract claim. That does not change just because the alleged breach is of the duty of good faith and honest performance of the contract.”

The vendors relied on *Callow* to argue that as their expansion plan efforts were hindered by the change of control transaction, there was a theoretical opportunity lost which might have led to an outcome where 180 Smoke made profits sufficient to attain the Milestone Payments and a greater payout under the SPA.

To succeed in this argument, the Court stated that the vendors had to meet a minimum evidentiary threshold to show that there were opportunities that they might have pursued if they were told that the closing date would be changed.^[11] There must be an “evidentiary premise”.

The Court did not look favourably on the vendors’ failure to put forward evidence of any concrete rights or

recourses they could have taken to attain the contractual payouts they say they could have possibly attained:

“The court does not need to know precisely what the vendors would have done and whether they would have succeeded, but there needs to be some evidentiary foundation upon which the court can conclude that there was a credible opportunity...”

The Court noted that it may make reasonable inferences from facts that support them that a credible opportunity was lost. However, the vendors presented insufficient facts to support any inference.

Ultimately, the Court opined that the vendors' success in establishing a breach of good faith was merely a symbolic victory that came at a great cost; indeed, there was a breach, but since no loss could be established, no damages were awarded.

CONCLUSION

The decision in *Bhatnagar* applies the good faith jurisprudence of the trilogy to a set of complex facts in the business amalgamation context. The pitfalls of the vendors in *Bhatnagar* illustrate the contextual ways a court will apply the general organizing principle of good faith in contractual relations, and this provides valuable lessons for businesses to keep in mind when entering into agreements.

[1] *Bhasin v Hrynew*, [2014 SCC 71](#) [*Bhasin*].

[2] *C.M. Callow Inc. v Zollinger*, [2020 SCC 45](#) [*Callow*].

[3] *Wastech Services Ltd. v Greater Vancouver Sewerage and Drainage District*, [2021 SCC 7](#) [*Wastech*].

[4] [2022 ONSC 1745](#) [*Bhatnagar*].

[5] *Callow* at para 116.

[6] *Bhasin* at paras 60, 63, 65.

[7] *Callow* at paras 80, 81, 83.

[8] *Wastech* at para 70.

[9] *Bhasin* at para 49.

[10] *Callow* at paras 81, 83.

[11] *Callow* at para 116.

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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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