

## LITIGATION BULLETIN

May 2006

### **BACK TO FUNDAMENTALS: TERMINATING DISTRIBUTORS FOR "FUNDAMENTAL BREACH" OF CONTRACT**

Your company wants to terminate its relationship with one of its distributors. Among other things, the distributor has developed a relationship with one of your competitors which you believe creates a conflict of interest. You also believe that the distributor has acted in bad faith and that its performance is less than satisfactory. You do not have a written contract with the distributor. Can you terminate the distributor immediately for cause in these circumstances?

The recent Ontario Court of Appeal decision in *1193430 Ontario Inc. v. Boa-Franc Inc.*<sup>1</sup> indicates that manufacturers in the above-noted circumstances must proceed with extreme caution. Boa-Franc confirms that, when there is no written distributorship agreement containing express termination provisions, the relationship can only be terminated immediately if the distributor has committed a "fundamental breach" of contract. This article explains the concept of "fundamental breach" and discusses the implications of the *Boa-Franc* decision.

#### **THE FACTS IN BOA-FRANC**

The plaintiff, Salem Hardwood Flooring, was an exclusive distributor of Boa-Franc's unfinished and pre-finished flooring products throughout most of Ontario. No formal distributorship contract existed - the terms of the relationship were partly oral and partly contained in an exchange of correspondence between the parties.

A few months after Salem became Boa-Franc's exclusive Ontario distributor, Salem's owner and president sold all of his shares in Salem to FloorCo, a competitor of Boa-Franc that manufactured unfinished hardwood flooring and operated a number of retail flooring stores. Previously, Salem was a small, closely held and very profitable company. FloorCo, by contrast, was a large, public company with substantial overhead and debt.

After FloorCo purchased Salem, Boa-Franc's president heard rumours of a relationship between the companies and specifically asked Salem's president what was going on. Salem's president did not tell Boa-Franc that FloorCo had purchased Salem or that he had become the Chief Operating Officer of FloorCo. Because he believed that telling the truth would negatively affect the relationship between Salem and Boa-Franc, Salem's president gave a vague answer that Salem had simply "aligned" itself with FloorCo's unfinished flooring side of the business.

About a month later, Boa-Franc's president discovered the true nature of the relationship between Salem and FloorCo and decided to terminate the relationship. Boa-Franc sent Salem a letter terminating the relationship effective immediately on the grounds that FloorCo's acquisition of Salem put Salem in an impossible conflict of interest with respect to the distribution of Boa-Franc products. The letter also alleged that retail dealers were dissatisfied with Salem's performance.

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<sup>1</sup> Leave to appeal to the Supreme Court of Canada refused on April 13, 2006

Salem sued Boa-Franc for wrongful termination of the distributorship, claiming that it was entitled to damages equivalent to two years' notice of termination. Boa-Franc argued that it chose Salem as its distributor because of Salem's independence from retailers and other manufacturers. The sale of Salem's shares to FloorCo fundamentally changed the nature of the entity with whom Boa-Franc made its distributorship arrangement. According to Boa-Franc, this fundamental change, along with Salem's failure to notify Boa-Franc of the sale, justified immediate termination.

The trial judge concluded that there was an implied term requiring good faith dealings between the parties. He also concluded that Salem had breached that duty by selling its shares to FloorCo without first informing Boa-Franc and by lying to Boa-Franc's President when he specifically asked about the subject. The trial judge then dismissed Salem's case on the basis that Salem's bad faith conduct gave Boa-Franc "just cause" to terminate the relationship. Salem appealed to the Ontario Court of Appeal.

### **THE COURT OF APPEAL DECISION IN BOA-FRANC**

The Court of Appeal allowed the appeal and found in favour of the distributor. The Court ordered Boa-Franc to pay damages approximating 6 months of lost profits.

The Court of Appeal was sympathetic to the argument that Salem owed a duty to be honest about the sale of its shares because that sale could affect Boa-Franc's legitimate business interests. Having said that, the Court noted that the agreement between the parties did not preclude Salem from dealing in its shares. The Court questioned whether the general duty of good faith could require Salem to disclose its change of ownership because this would create a new, unbargained for obligation independent from the terms of the parties' agreement.

The critical question for the Court of Appeal, however, was whether the breach of this obligation to disclose the change of ownership (even if it could be said to exist) gave the manufacturer the right to terminate the agreement for cause without notice. The Court of Appeal concluded that it did not.

### **FUNDAMENTAL BREACH OF CONTRACT - IMPLICATIONS OF THE BOA-FRANC CASE**

In finding in favour of Salem, the trial judge had relied on the employment law concept of "termination for just cause" as a basis to justify Boa-Franc's right to terminate the relationship without notice.

The Court of Appeal concluded that it was inappropriate to apply employment law concepts such as termination for just cause to commercial distributorship cases. Instead, the Court of Appeal held that a commercial distributorship agreement may be terminated without notice, only if the cause relied upon constitutes a "fundamental breach" of the agreement. A "fundamental breach" of contract is one that deprives the innocent party of "substantially the whole benefit of the contract". In this case, the Court of Appeal found that even if Salem had breached an obligation of good faith and honest communication, it was not a "fundamental breach".

Affirming earlier case law, the Court of Appeal held that five factors should be considered when determining whether a distributor's failure to perform constitutes a "fundamental breach" of contract:

- 1 the ratio between the obligations not performed by the distributor to its obligations as a whole;
- 2 the seriousness of the distributor's breach to the manufacturer;
- 3 the likelihood that the breach will be repeated;
- 4 the consequences of the breach; and
- 5 the relationship between the part of the obligation performed to the whole obligation.

Applying the above-noted factors, the Court of Appeal held that Salem's breach of any implied duty of good faith and honest communication did not constitute a "fundamental breach" of the distributorship agreement.

In reaching this conclusion the Court of Appeal made two significant observations. First, the Court noted that where an innocent party seeks to terminate a contract for fundamental breach, the innocent party's own conduct is an important barometer of the significance of the breach by the offending party. In this case, Boa-Franc had also lied to its distributor about the availability of product (Boa-Franc reduced the amount of product it was shipping to Salem just prior to termination, telling Salem that there had been a "fire" at the plant).

Second, the Court of Appeal noted that unwritten distributorship agreements may be terminated unilaterally on reasonable notice if there is a breakdown of mutual trust. In other words, situations like the one that occurred in this case are accommodated within the law of termination on notice.

### **SIGNIFICANCE OF THE DECISION**

The *Boa-Franc* case confirms that manufacturers may only terminate an unwritten distributorship agreement:

1. *immediately* where there has been:
  - (a) a "fundamental breach" of an express contractual obligation; or
  - (b) a fundamental breach of good faith in conjunction with the performance of a specific contractual obligation; or
2. *on "reasonable" notice* (the amount of notice depends on the facts of each case) to the distributor.

*Boa-Franc* also makes it clear that dishonesty on the part of your distributor alone may not constitute fundamental breach.

There must be a fundamental breach of an express contractual duty, or a fundamental breach of good faith in conjunction with a specific contractual duty, to terminate the distributor immediately. In *Boa-Franc*, Salem had no specific contractual obligation not to sell its shares or to notify Boa-Franc of, or obtain its consent to, such a transaction. Had these obligations existed, the Court of Appeal might have found that Salem committed a fundamental breach of good faith as a result of its actions.

*Boa-Franc* indicates that many breaches of unwritten, open-ended distributorship agreements by distributors, even egregious ones involving dishonesty, may leave the manufacturer unable to terminate except on reasonable notice.

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*The foregoing provides only an overview. Readers are cautioned against making any decisions based on this material alone. Rather, a qualified lawyer should be consulted.*

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