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There is No Presumption of Loss Flowing from a Breach of the Contractual Duty of Honest Performance

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Case commented on: *Bhatnagar v Cresco Labs Inc*, 2023 ONCA 401 (CanLII)

In *Bhatnagar v Cresco Labs Inc*, 2023 ONCA 401 ("*Cresco Labs*"), the Ontario Court of Appeal addressed whether the Supreme Court's decision in *CM Callow Inc v Zollinger*, 2020 SCC 45 (CanLII) ("*Callow*") created a legal presumption of loss once a court finds a breach of the contractual duty of good faith. The ONCA found that there is no presumption of loss and that a plaintiff claiming a loss of opportunity has the burden of providing evidence.

Facts

2360149 Ontario Inc ("180 Smoke") was a retailer, wholesaler, and manufacturer of vape products. It was founded by the appellants, former shareholders (the "Appellants").

The Appellants entered into a share purchase agreement ("the SPA") to sell 180 Smoke and its affiliates to an American cannabis company, CannaRoyalty Corp ("Origin House").

Under the SPA, Origin House would pay the Appellants $25 million on closing and an additional $15 million upon 180 Smoke meeting certain milestones in the subsequent years, including revenue milestones (the "Revenue Milestone Payments"). The SPA also addressed the possible acquisition of Origin House by including a term providing that the shareholders of 180 Smoke would be paid an "unearned Milestone Payment Commitment" which totaled the amount of all future entitlements to unearned milestone payments.

Prior to the closing of the SPA, Origin House entered into an acquisition agreement with the respondent, Cresco Labs Inc ("Cresco"). The parties expected the transaction to close before the end of 2019, which would have triggered the entire three years of 180 Smoke's shareholders' earn-out. However, the purchase ended up being delayed by several months. During this time, two of the key principals of 180 Smoke resigned, maintaining that it was largely impossible that 180 Smoke could achieve the revenue targets in 2019.

In October 2019, Cresco proposed a new target closing date of January 2020 for the Cresco transaction. Origin House did not share this information with the Appellants. The Cresco transaction ended up closing on January 8, 2020. The date fell within the second earn-out period, so Cresco paid the Appellants the Unearned Milestone Payment Commitment of 2020 and 2021. Cresco conceded that if the transaction had closed in 2019, the shareholders would have been entitled to receive the Revenue Milestone Payment for 2019.

Application Decision

The Appellants brought an application seeking an order for Cresco to pay the 2019 Revenue Milestone Payment. They argued that they were entitled to the payment, or alternatively, that their failure to achieve the 2019 revenue targets arose from Origin House's breach of contract.

The judge found that Origin House had breached its duty of honest performance of the SPA by not telling 180 Smoke that the closing date would be delayed to January 2020. However, the judge did not award damages for the breach. The judge maintained that there was no evidence that Origin House's failure to disclose had resulted in the shareholders' loss of opportunity, as even if the shareholders had been notified of the change to the closing date, they would nonetheless have failed to meet their 2019 revenue targets.

The Appellants appealed the decision to not award damages and the Respondents cross appealed the finding that they had breached their duty of honest performance. The ONCA dismissed the Appellants' appeal and allowed Cresco's cross-appeal.

Ontario Court of Appeal Reasons

Appeal

The Appellants argued that *Callow* "created a legal presumption of loss once a breach of the duty of honest performance had been found" (*Cresco Labs* at para 46). They maintained that the application judge was required to presume damages upon finding that Origin House had breached its duty of honest performance.

The ONCA disagreed. The Court said that *Callow* placed the burden on the claimant to show evidence that the breach caused the claimant to loss an opportunity or resulted in the claimant being unable to protect its interests (at para 55). It read the "may" as permissive, not mandatory, in that the court could, but was not required to, find a loss of opportunity upon finding a breach of honest performance of the contract (at para 62).

The ONCA found that the Appellants, unlike in *Callow*, "had no evidentiary foundation for their claim of loss of opportunity" (at para 65). Rather, the evidence showed that 180 Smoke could not have met its 2019 revenue targets, even if Origin House had informed the shareholders about the later closing date. In other words, there was no evidence to support the Appellants' claim that the breach of the duty of honest performance had resulted in the loss of the "opportunity to do something that might have led to a different outcome for [the Appellants]" (at para 75). For that reason, the Appellants were not entitled to expectation damages.

The Court also found that there were no exceptional circumstances to warrant granting the Appellants punitive or disgorgement damages.

Cross-Appeal

The Court of Appeal set aside the application judge's finding that Origin House breached its duty of honest performance. It found that the Appellants became aware in November 2019 that the Cresco transaction would close in January 2020 (at para 105). On that basis, the application judge's finding that Origin House had breached its duty of honest performance was no longer supported.

My Comments

Good Faith and the Duty of Honest Performance

In Canada, parties must perform their contractual duties honestly and in good faith. These principles were articulated and developed in the trilogy of cases: *Bhasin v Hrynew*, 2014 SCC 71 (CanLII) ("*Bhasin*"), *Wastech Services Ltd v Greater Vancouver Sewerage and Drainage District*, 2021 SCC 7 (CanLII) ("*Wastech"*), and *Callow*.

Prior to *Bhasin*, the principle of good faith applied sporadically and in certain discrete situations, such as the way in which an employment contract was terminated or the process by which an insurer investigated an insured's claim. In *Bhasin*, the SCC set out the standard (or umbrella) of good faith, as one that underlies three broad situations:

1. where the contractual parties are required to cooperate in order to achieve the objects of the contract (see *Dynamic Transport Ltd v OK Detailing Ltd*, 1978 CanLII 215 (SCC), [1978] 2 SCR 1072);
2. where one contracting party has discretionary powers under the contract (see *Mitsui & Co (Canada) Ltd v Royal Bank of Canada*, 1995 CanLII 87 (SCC), [1995] 2 SCR 187); and
3. where the contracting parties are engaging in behaviour designed to evade contractual obligations (see *Mason v Freedman*, 1958 CanLII 7 (SCC), [1958] SCR 483).

The Court said that in order to advance a claim for breach of the principle of good faith, a claimant must fit within one of these three situations. The Court also said, however, that the list of situations was not closed, and that the good faith principle can generate new rules. This is in fact what happened in *Bhasin*. The Court found that the respondent's conduct did not fit into any of the existing situations in which duties of good faith were found to exist, leading the Court to create a new common law duty under the umbrella of good faith: the duty of honest performance (*Bhasin* at paras 72-73).

The duty of honest performance is not an implied term, meaning it cannot be excluded by the parties, nor is it a duty of disclosure or a fiduciary duty. It simply "imposes a minimum standard of honest contractual performance" (*Bhasin* at para 74).

The second case in the trilogy, *Wastech*, is outside the scope of this post. It dealt with the second situation articulated in *Bhasin*, where one party has discretionary powers under the contract. The third case, *Callow*, refined the duty of honest performance.

Callow

In *Callow*, the SCC had to consider when non-disclosure qualifies as misleading conduct.

In *Callow*, the defendant, a group of condominium corporations, Baycrest, entered into two maintenance agreements with the plaintiff, Callow: a two-year winter contract and a separate one-year summer contract. Baycrest was allowed to terminate the winter contract upon 10 days' notice. Baycrest decided to terminate the winter agreement in the spring of 2013, but it did not inform Callow.

Throughout that spring and summer, Callow discussed renewing its winter agreement with Baycrest, and was left with the impression that Baycrest would renew its winter contract for another two years. This belief had a two-fold effect on Callow: 1) Callow did extra work under its summer contract, providing various "freebie-work", which it hoped would be incentive for Baycrest to renew the winter maintenance agreement and 2) it did not pursue other opportunities for maintenance contracts. Baycrest informed Callow that it would be terminating its winter contract in Sept 2013; it did so by providing 10 days' notice, as required under the agreement. However, Callow usually obtained winter work over the summer months, meaning it was too late for it to find replacement work when the contract was terminated (*Callow* at para 149).

Callow sued Baycrest, claiming:

1. Baycrest had acted in bad faith "by accepting the free services while knowing Callow was offering them in order to maintain their future contractual relationship" (*Callow* at para 15); and
2. Baycrest "knew or ought to have known that Callow would not seek other winter maintenance contracts in reliance on the representations that Callow was providing satisfactory service and the contract would not be prematurely terminated" (*Callow* at para 15).

A majority of the Supreme Court allowed the appeal on the basis of the duty of honest performance. It found that Baycrest had actively misled Callow to obtain free services, and that Baycrest had been required, under the duty of honest performance, to correct Callow's misapprehensions by disclosing its intentions.

The Supreme Court upheld the trial judge's award for expectation damages for breach of the duty of honest performance, putting it in the same position as if the breach had never occurred. The trial judge considered evidence that Callow had opportunities to bet on other winter maintenance contracts but did not, based on the "misapprehension as to the status of the contract with Baycrest" (*Callow* at para 116). The Supreme Court found that Callow would have had the opportunity to obtain another contract for the coming winter if Baycrest had been forthcoming about its decision (*Callow* at para 115).

Callow & Cresco Labs

In *Cresco Labs*, the Appellants relied on *Callow* to argue that once the application judge found a breach of the duty of honest performance, damages would be presumed even without explicit evidence of loss. Paragraph 116 of *Callow* reads in part as follows:

> [E]ven if I were to conclude that the trial judge did not make an explicit finding as to whether Callow lost an opportunity, *it may be presumed as a matter of law that it did*, since it was Baycrest's own dishonesty that now precludes Callow from conclusively proving what would have happened if Baycrest had been honest (emphasis added).

The Appellants' argument failed to consider two things. First, it failed to consider that the presumption is permissive not mandatory (*Cresco Labs* at para 61). The Appellants argued that once a breach of the duty of honest performance is found, the court must presume loss. However, the wording of the relevant paragraph in *Callow* was "may", not "shall", meaning a court does not have to presume a loss of opportunity.

Second, the Appellants' argument failed to consider that the *Callow* Court did in fact rely on evidence of loss of opportunity. The Supreme Court noted that the trial judge had "ample evidence" to show that Callow had opportunities to bid on winter contracts (*Callow* at para 116) and the Ontario Court of Appeal noted there was evidence before the trial judge showing Callow's typical approach to the bidding process, and the opportunities that existed to bid on contracts (at para 57).

There is one aspect about *Callow* that could be misconstrued, and which may partially account for the Appellants' argument about not needing evidence. In *Callow*, the Supreme Court said that to the extent that the trial judge did not make an explicit finding, it was because the breach precluded Callow from *conclusively* proving that loss. This sentence is curious in so far as the nature of damages for loss of opportunity. In *Folland v Reardon*, 2005 CanLII 1403 (ONCA), 74 OR (3d) 688 ("*Folland"*), which lays out the test for loss of opportunity, the court required, *inter alia*, that the plaintiff "show that the chance lost was sufficiently real and significant to rise above mere speculation". It also said that there is no bright line for distinguishing a real from speculative chance but that "chances assessed at less than 15 percent are seldom viewed as real chances" (*Folland* at paras 73-74).

While the nature of loss of opportunity means one cannot "conclusively prove what would have happened" (*Callow* at para 116), as there is no certainty involved, that type of evidence is not necessary, nor would evidence of a guarantee qualify as evidence of a lost opportunity; rather, a claim for lost opportunity only requires evidence of a "sufficiently real and significant" lost chance, which is likely what the Court in *Callow* meant. In other words, evidence is required to prove loss of opportunity, but it cannot conclusively prove what would have happened.

In *Cresco Labs*, the Appellants needed to provide evidence that there was an opportunity for them to meet the 2019 thresholds but for the alleged breach of contract. This would not be conclusive evidence that they would have reached the target, but it would be evidence of a "sufficiently real and significant" lost chance. But they could not prove that they would have met the revenue targets if they had known the actual date of the Cresco Transaction. At trial, the application judge found that it was "not open for the vendors to argue there was anything they could have done in October 2019 to enable 180 Smoke" to achieve the target revenue and that "despite their efforts made until then, there was little or no chance of those Revenue Thresholds being achieved in 2019" (*Bhatnagar v Cresco Labs Inc*, 2022 ONSC 1745 at para 85). The Ontario Court of Appeal found that the application judge had found "no evidence" to support the Appellants' claim (at para 75).

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