Cassels

Ontario Court of Appeal Provides Further Guidance on the Duty of Good Faith

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The contractual (and statutory) duty of good faith is a concept that informs the conduct of both franchisors and franchisees within the franchise relationship. As such, court decisions concerning the duty are helpful insight into the judicial expectations regarding what constitutes good faith behaviour. In *2161907 Alberta Ltd. v. 11180673 Canada Inc.*,[1] the Ontario Court of Appeal addressed a dispute involving the duty of good faith in a termination of a series of commercial agreements for the operation of a cannabis store. In this case, the Court of Appeal applied the principles set out in a trilogy of decisions by the Supreme Court of Canada on good faith contractual performance[2] and offered guidance on how a termination based on an error may not necessarily amount to bad faith.

2161907 Alberta Ltd. (216), the licensor, and 111180673 Canada Inc. (111), the retail operator, contracted to run a "Tokyo-smoke" branded cannabis store in Toronto. The contracts included a License Agreement to operate the store, a Sublease to rent the retail premises, and a Branding Fee to fund startup costs, including rent.

Two days before the store was scheduled to open, a dispute arose about 216's obligation to fund 111's first-month rent. 216 mistakenly believed that it was not obligated to advance the total funds needed to cover the rent's balance. When 216 refused to pay the rent in full, 111 advised that it would be laying off staff and no longer opening the store. 216 interpreted 111's response as a "threat to cease carrying on business," in breach of the License Agreement, and terminated its relationship with 111, including the Sublease and its obligation to pay the Branding Fee. 111 argued that 216 wrongfully terminated the agreements and breached its duty of good faith in the performance of its contractual relations.

The Court of Appeal ultimately determined that although 216 had no valid contractual reason to terminate the agreements, it had not acted in bad faith.

In respect of the former issue (the termination), the Court ruled that 111's statements regarding layoffs and not opening were not "a threat to cease to carry on business" for the purposes of triggering the right to terminate the License Agreement. Rather, 111's "threat" was not a credible threat and was reasonable given the unexpected shortfall in rent of $95,000 and the uncertainly as to whether it would be ready to open the store as planned. The Court agreed that 111's behaviour was "an emotional response to incorrect information at a critical time." Further, the Court of Appeal looked at the context of the "threat," namely that it was a response to a mistake by 216 concerning its funding obligations. In sum, the Court of Appeal upheld

the lower court's holding that the termination of the License Agreement was invalid.

However, in respect of the latter issue (good faith), the Court of Appeal overturned the lower court's finding that the termination was made in bad faith. The Court of Appeal held that despite 216's error, 216 did not act in bad faith, as it did not *knowingly* mislead 111 about the funding available for rent and then terminate the agreement to avoid paying the Branding Fee. The Court found that 216 did not lie or withhold information. Instead, it was mistaken when it informed 111 that 216 was not required to fund the rent. During its discussions with 111, 216 made reassurances that it would pay the Branding Fee and that it would assist in seeking rent deferral from the landlord. The Court held that these reassurances were based on 216's honest belief at the time, as 216 had not made a final decision to terminate the relationship until after it consulted with legal counsel to confirm its understanding of the termination.

The Court also concluded that 216's so-called "pouncing" on 111's refusal to open the store did not constitute bad faith. 216 was entitled to exercise its right of termination and was not prevented from ending the contractual relationship because 111 would be deprived of future Branding Fee payments. The Court held that, "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." Although 216's basis for terminating the agreement ultimately proved invalid, the decision was not unreasonable, malicious or so inconsiderate of 111's contractual interests to amount to bad faith.

The Court of Appeal concluded its findings on bad faith by stating the following:

"While 216's notice of termination was, by definition, an attempt to put an end to the agreement, the termination right in question formed part of the parties' bargain and reflected, among other things, the licensor's legitimate interest in protecting its brand in circumstances that the parties expressly stipulated would give rise to a right of termination. The fact that [216] erroneously believed those circumstances were present does not amount to bad faith."

We note that while this case falls within the context of a licensing arrangement, the discussion of the duty of good faith is generally applicable to contractual relationships as a whole, including franchising.

Key Takeaways

Franchisors are often concerned with the parameters of good faith in respect of terminating franchise relationships, and this decision is a helpful reminder that imperfections in the termination process may not rise to the level of bad faith. This case distinguishes an honest mistake from bad faith conduct and holds that courts are unlikely to find that a party breached its duty of good faith so long as the termination arose of the specific terms of the contact and was not made dishonestly, unreasonably, capriciously, or arbitrarily. This echoes the principles set out of in the Supreme Court's good faith trilogy. Further, if a party desires to

end a contractual relationship, and a valid reason occurs, the party is not prevented from “pouncing” or seizing the opportunity to do so.

A copy of the decision can be found here.

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[1] *2161907 Alberta Ltd. v. 11180673 Canada Inc.,* 2021 ONCA 590.

[2] See *Bhasin v. Hrynew,* 2014 SCC 71 (CanLII), *C.M. Callow Inc. v. Zollinger,* 2020 SCC 45 (CanLII), and *Wastech Services Ltd. v. Greater Vancouver Sewerage and Drainage District*, 2021 SCC 7 (CanLII).
