

Breach of the Duty of Honest Performance? Damages Still Need to Flow from the Breach

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June 8, 2023

On June 7, 2023, the Court of Appeal released its decision in *Bhatnagar v Cresco Labs Inc.*, 2023 ONCA 401, an appeal from the judgment of Justice Kimmel of the Superior Court of Justice (Commercial List), 2022 ONSC 1745. Cassels successfully represented Cresco on the application and appeal/cross-appeal.

Background

180 Smoke and its former principals (180 Smoke) sought \$6.16 million in damages representing amounts that they claimed were owing pursuant to a share purchase agreement (the SPA) upon a change of control where Cresco acquired Origin House (the Transaction).

180 Smoke was sold to Origin House for a purchase price of \$25 million. Since the parties disagreed about the value of 180 Smoke, the SPA allowed 180 Smoke to earn up to an additional \$15 million, if 180 Smoke met certain milestones. Up to \$12.5 million could be earned by 180 Smoke if it hit its revenue targets for 3 earn-out periods from 2019 to 2021 (the Revenue Milestones). The Revenue Milestone had a target payment of ~\$4.1 million per year. The remaining \$2.5 million would be earned by 180 Smoke if it obtained a cannabis processing license (the License Milestone).

Importantly, provisions were added to the SPA to address what would happen to the Revenue Milestones in the event of a change of control. The SPA provided for an “Unearned Milestone Payment Commitment” to be calculated and paid as of the date of closing on a change of control. The formula to calculate the Unearned Milestone Payment deducts payments for Revenue Milestones that 180 Smoke would have been eligible to receive as at the date of closing.

During the first earn-out period (2019), Origin House and Cresco entered into the Transaction. However, the Transaction did not close until 2020. 180 Smoke received over \$8.3 million on the close of the Transaction in unearned payments for the 2020 and 2021 earn out periods but did not receive the ~\$4.1 million for 2019 because it did not meet the revenue target.

The Application

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At the Application hearing, 180 Smoke argued that Origin House prevented it from earning the 2019 Revenue Milestone and License Milestone due to pre-closing restrictions placed on 180 Smoke. The Application Judge held that the pre-closing restrictions were objectively reasonable in commercial transaction.

180 Smoke next argued that Origin House breached its duty of good faith and honest performance by advising 180 Smoke that they “expect to close [*the Transaction*] in the coming weeks,” but not updating that advice when the closing date was delayed to 2020.

While the Application Judge found that there was no “hidden agenda” or “hidden motives” or any finding that Origin House intentionally misled 180 Smoke about the closing date, the Application Judge found that Origin House breached its duty of good faith and honest performance by failing to advise that the Transaction was delayed to the new year.

The Application Judge, however, did not award damages for this breach because 180 Smoke could not prove that damages flowed from the breach. Both of 180 Smoke’s principals admitted on cross-examination that 180 Smoke could not have hit the 2019 revenue target by the time the closing date was delayed to 2020. The Application Judge ultimately held that there needed to be some evidentiary foundation upon which the court can conclude that there was a credible opportunity that could have resulted in the closing date being changed, or some other outcome could have been achieved to make up for their loss of the Revenue Milestone payment for the first earn-out period.

The Appeal

On appeal, 180 Smoke argued that the Application Judge erred by:

- Failing to presume 180 Smoke’s loss after the finding that Origin House breached its duty of honest performance;
- Failing to award damages on a basis other than expectation damages;
- Misapprehending the evidence of lost opportunity; and by
- Failing to find that Origin House breached its contractual duty of good faith by preventing 180 Smoke from achieving the Milestones during the first earn-out period.

The Court of Appeal dismissed all grounds of appeal. Most important for the current analysis, was the Court of Appeal’s guidance on damages when there has been a breach of the duty of honest performance, as discussed below.

The “Wronged” Party Still Needs to Prove its Damages

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The appeal was largely premised on a single sentence from the Supreme Court's decision in *Callow*. 180 Smoke argued that *Callow* instructs the Court to *presume* damages for loss of opportunity where there has been a breach of the duty of honest performance based on this sentence of paragraph 116:

[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 Court of Appeal held that *Callow* does not direct the Court to presume that the aggrieved party is entitled to damages in the absence of an evidentiary foundation of a lost opportunity.

With respect to paragraph 116 of *Callow* in particular, the Court of Appeal held that 180 Smoke's submission that lost opportunity must be presumed first fails to take into account the permissive language "may", meaning that it *might* be presumed that Callow lost an opportunity. The submission also ignored the following two qualifiers: (1) since it was Baycrest's own dishonesty that precluded Callow from (2) *conclusively* proving what would have happened. Neither qualifier applied in the present case.

The Court of Appeal also confirmed that ordinary expectation damages remain the default remedy (i.e., there must be an evidentiary foundation to show that damages flowed from the breach of the duty of good faith and honest performance).

The Cross Appeal

Cresco cross-appealed the Application Judge's finding that Origin House breached its duty of good faith and honest performance by failing to update 180 Smoke that the closing of the Transaction was delayed to 2020.

The Court of Appeal held that the Application Judge made a palpable and overriding error by finding that 180 Smoke was unaware in 2019 that the Transaction's closing date was delayed to 2020 based on the following statements made in a letter from 180 Smoke's counsel:

The [Appellants] are nevertheless prepared to refrain from taking legal action to enforce their rights under the [SPA] upon receiving your confirmation that *in the event that the [Cresco Transaction] fails to close by January 30, 2020*, the [Appellants] will receive the Milestone Payments in the total amount of \$12,500,000 and the License Milestone payment in the amount of \$2,500,000 to be deposited into their account no later than the close of business on January 31, 2020. [Emphasis added.]

The cross-appeal was allowed, and the Application judgment was varied to state that Origin House did not

breach its duty of honest performance.

Implications

This case has helpfully clarified the ever-evolving duty of good faith and honest performance in contractual relationships.

The Court of Appeal confirmed that when there is a breach of the duty of good faith and contractual performance, the aggrieved party still needs to provide an evidentiary basis that the breach in fact caused damages. Without this helpful clarification, the law of contracts could have been turned on its head and breach of good faith claims could have become the fallback option for every breach of contract claim in Ontario for parties unable to prove damages.

There is still some uncertainty regarding the Application Judge's finding that Origin House breached its duty of honest performance by failing to update 180 Smoke of the delayed closing, even though Origin House did not lie, or knowingly mislead 180 Smoke. There was no evidence that Origin House intentionally left 180 Smoke in the dark to deprive it of the 2019 Revenue Milestone. In fact, the evidence demonstrated that Origin House wanted the Transaction to close earlier and always answered honestly when asked by 180 Smoke about the timing of the close of transaction. Origin House was not obligated to give any updates on the closing under the SPA.

At the hearing, Cresco raised arguments that the duty of good faith and honest performance ought not to extend so far as to place a positive obligation on a party like Origin House to provide regular updates on information which a party is not contractually obligated to provide in the first place (and which a capital market participant may not be at liberty to share due to securities regulations).

The foregoing submission was not addressed by the Court of Appeal in the decision. Cresco's cross-appeal was only allowed on the basis that evidence showed that 180 Smoke was aware that the closing date was delayed. This creates some uncertainty on when parties to commercial contracts are required to correct prior information they gave that no longer remains true.

Please reach out to the Cassels Litigation Team with any questions about the duty of good faith and honest performance in commercial agreements.