Where there's smoke: No presumption of loss in breach of honest performance

July 21, 2023

In *Bhatnagar v. Cresco Labs Inc*., the Ontario Court of Appeal held that a party claiming for a breach of the contractual duty of honest performance must prove any loss that breach caused on evidence and that the court will not automatically presume that a breach caused any loss.

What you need to know

- This decision further develops the contractual duty of honest performance following the Supreme Court's recent decision in *M. Callow Inc. v. Zollinger*.
- This duty requires that parties to a contract not lie or intentionally mislead their co-contracting party. Where a party breaches this duty, the injured party can claim damages based on what the injured party could have expected had the breaching party not acted dishonestly.
- The Court of Appeal held that a finding that a party breached this duty of honest performance does not automatically lead to a presumption that the injured party suffered any loss as a result of the breach.
- The injured party must lead evidence of actual loss to be awarded damages, such as evidence demonstrating loss of opportunity caused by the breaching party's dishonesty. If the breaching party's dishonesty precluded the injured party from conclusively proving its losses, the court could presume that the injured party suffered a loss.

Background

On Feb. 19, 2019, the applicant shareholders of 180 Smoke (the shareholders), a vape retailer, wholesaler and manufacturer, sold their shares in 180 Smoke to Origin House by way of a Share Purchase Agreement (SPA). In addition to a purchase price of $25 million, the SPA provided for an additional payment of up to $15 million if 180 Smoke met certain milestones in the subsequent three years, including revenue milestones.

The SPA also addressed the event of a possible change in control of Origin House, providing that the shareholders would be paid an "Unearned Milestone Payment Commitment", totalling the amount of all future entitlements to unearned milestone payments. On April 1, 2019, Origin House entered into an acquisition agreement with the defendant Cresco Labs Inc (Cresco). The transaction was expected to close by the end of 2019, which would have triggered all three years of the shareholders' earn-out.

Initially, Origin House was confident that the transaction would close before the end of 2019. However, in June 2019, it became clear that there would be at least a several month delay in closing. Notably, around this time, key principals of 180 Smoke resigned. By September 2019, it was acknowledged that 180 Smoke had little chance of reaching its revenue targets for 2019.

On Oct. 20, 2019, Origin House learned that Cresco was proposing a new target closing date of January 2020. Origin House did not share the new closing date with the shareholders.

Ultimately, the transaction closed on Jan. 8, 2020. Given that this date fell within the second earn-out period, the shareholders were paid for the unearned milestones of 2020 and 2021. Cresco conceded that if the Cresco Transaction had closed in 2019, the shareholders would have been entitled to an additional payment for the 2019 unearned milestone.

Application decision

The shareholders brought an application seeking, among other things, an order directing Cresco to pay the 2019 milestone payment, maintaining that they were entitled to it pursuant to the terms of the SPA and that, alternatively, any failure on their part to reach the 2019 revenue targets was a result of breaches of contract by Origin House.

The application judge found that the shareholders were not entitled to the claimed payments but that Origin House had breached its duty of honest performance of the SPA by failing to advise the shareholders of the new proposed closing date of January 2020. However, there was no evidence that Origin House's dishonesty caused the shareholders to lose any specific opportunities or any other damages. The application judge rejected the shareholders' claim that finding of Origin House's breach of its duty of honest performance led to a presumption that the shareholders suffered damages, and as a result did not award any damages.

The shareholders appealed and Cresco cross-appealed the finding that Origin House breached its duty of honest performance.

The Court of Appeal dismissed the shareholders' appeal on damages and allowed Cresco's cross-appeal on the duty of honest performance.

Reasons

On appeal, the shareholders argued that the application judge was required to presume damages if she found that Origin House had breached its duty of honest performance, basing this submission on the Supreme Court's decision in *Callow*.

The Court of Appeal rejected the applicants' interpretation of *Callow*, finding that the Supreme Court only held that it "may" be possible to presume a breach of the duty of honest performance caused damages and that the result in *Callow* was based on actual evidence of damages. The language is therefore permissive, not mandatory.

The Court of Appeal held that this presumption could be available if the shareholders had evidence that Origin House's dishonesty had precluded the shareholders from proving they lost opportunities, but that there was no such evidence. It was clear from the evidence that 180 Smoke could not have met the 2019 revenue targets even if the shareholders had been informed by Origin House of the new closing date. Further, the shareholders had *no* evidentiary foundation for proving their claim for lost opportunity, rather than no ability to *conclusively* prove the lost opportunity.

The Court of Appeal likewise clarified that the ordinary approach in cases involving breach of honest performance is to award expectation damages that put the aggrieved party "in the position that it would have been had the duty been performed", rather than exceptional remedies, such as punitive damages or disgorgement. Again, there was no evidence in this case that the shareholders were entitled to ordinary damages or that there were exceptional circumstances for which ordinary damages would be inadequate.

Finally, the Court of Appeal allowed Cresco's cross-appeal and overturned the application judge's finding that Origin House had breached its duty of honest performance because the evidence showed that the shareholders were in fact aware, in November 2019, that the transaction could close in January 2020.

Conclusion

This decision highlights that the burden of proof rests on the applicant to show evidence of actual loss, as a finding of breach will not automatically lead to a loss.

For further questions about this decision or the contractual duty of honest performance, reach out to any of the authors or key contacts listed below.

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