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Contract Law Update: Developments of Note (2016)

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The target audience for this paper is comprised of commercial litigators and commercial solicitors. For that reason, the cases I selected from those decided over the last year (post-September 2015) are primarily those in which contract law principles are discussed in a commercial context.

I have attached as an appendix a list of topics covered in prior updates. Those updates are all available on Lawson Lundell LLP's website under my profile (www.lawsonlundell.com/team-Lisa-Peters.html).

This year's topics are:[1]

- Tracing the trajectory of the two key rulings in *Sattva Capital Corp. v. Creston Moly Corp.*: the nature and role of the factual matrix and the standard of review on appeal from a decision interpreting a contract;
- Are anti-oral amendment clauses efficacious?
- Options as unilateral or bilateral contracts (and why it matters);
- Limitations law as applied to continuing breaches of contract;
- What's new with penalty clauses?
- The duty of good faith performance and rights of first refusal; and
- Contract clauses vesting a party with discretion – are they void for uncertainty?

Sattva, the Factual Matrix and Standard of Review

The decision of the Supreme Court of Canada in *Sattva Capital Corp. v. Creston Moly Corp.*, 2014 SCC 53, is significant for three reasons:[2]

[1] I would like to acknowledge the assistance of Erica Zacharias, summer articled student and Allard School of Law student, for her help in reviewing this year's crop of cases and choosing likely topics.

1. Its ruling on the characterization of contract interpretation questions, namely that contract interpretation issues are questions of mixed fact and law;[3]

2. The impact of that characterization both on the standard of review and on the ability of parties to successfully appeal a trial judge's ruling on contract interpretation and of parties to commercial arbitrations to seek leave to appeal jthe arbitrator's decision, particularly in B.C.; and

3. Its discussion of the nature and role of "surrounding circumstances" (also referred to as the factual matrix) in the contract interpretation exercise and confirmation that evidence of surrounding circumstances is admissible in all contract interpretation cases, not only where there is an ambiguity.

Post-*Sattva*, litigation counsel have sought ways out from the standard of review ruling, which limited the unsuccessful party's ability to appeal a lower court ruling on a contract interpretation issue and constrained even more the ability to obtain leave to appeal an arbitral award on a contract interpretation issue (and to succeed on appeal in either case).

Subsequent cases also delved into the specifics of what constituted admissible and relevant surrounding circumstances or factual matrix in a given case.

In 2016, in *Ledcor Construction Limited v. Northbridge Indemnity Insurance Co.*, 2016 SCC 37 ("*Ledcor*"), the Supreme Court of Canada ("SCC") took the opportunity to add a gloss to its earlier ruling on the standard of review issue in *Sattva*.

Where the contract being interpreted is a standard form contract, said the SCC, the standard of review is correctness (at least in the context of appeals from court rulings). The SCC provided several rationales for this exception to what was thought to be the blanket rule from *Sattva:*

- The factual matrix carries less weight when the contract being interpreted is a standard form contract because the parties do not negotiate the terms.

- The interpretation of a standard form contract itself has precedential value and can therefore fit under the definition of a pure question of law.

- The mandate of appellate courts, namely ensuring consistency in the law, is advanced by permitting them to review the interpretation of standard form contracts for correctness.

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[2] For a more detailed discussion of the case, see my 2014 update.

[3] Leaving aside extricable questions of pure law, which will be rare.

This ruling was likely inevitable. Appellate courts from various provinces did not all agree on whether the ruling in *Sattva* on standard of review applied to standard form contracts. As outlined by the SCC at paragraphs 22 and 23 of *Ledcor*, the Courts of Appeal in any given province were not even internally consistent. So, for example, the Ontario Court of Appeal applied a standard of correctness in some cases involving standard form contracts and deferred to trial court's interpretations and applied a reasonableness standard in others.

There were two Ontario Court of Appeal cases and two B.C. Court of Appeal cases that predated, but perhaps foreshadowed, the SCC ruling in *Ledcor*. In each of *Sankar v. Bell Mobility Inc*., 2016 ONCA 242,[4] *MacDonald v. Chicago Title Insurance Company of Canada*, 2015 ONCA 842,[5] *True Construction Ltd. v. Kamloops*, 2016 BCCA 173 and *Precision Plating Ltd. v. Axa Pacific Insurance Company*, 2015 BCCA 277,[6] the appellate court held that the standard of review on a question of contract interpretation where the contract was a standard form contract was correctness.

Two of these cases, like *Ledcor*, dealt with insurance policies. However, *Sankar* involved terms of service for prepaid phone cards (*i.e.*, not an insurance contract) and *True Construction* involved standard form documents developed by the British Columbia Documents Committee[7] widely used in the tendering process throughout B.C. Perhaps the next stage in the debate will be about what other classes of contracts are properly characterized as standard form contracts to which the standard of review ruling in *Ledcor* applies.[8]

It is worth keeping in mind the comments of the SCC on the relevance of the factual matrix in *Ledcor* as well. The SCC held that the factual matrix was less relevant for standard form contracts. However, it conceded that certain factors should nonetheless be considered when interpreting such a contract, including: the purpose of the contract; the nature of the relationship it creates; and the market or industry in which it operates.

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[4] Leave to appeal to the S.C.C. was sought, but the case was remanded to the Ontario Court of Appeal pursuant to s. 43(1.1) of the *Supreme Court Act* for disposition in accordance with the ruling in *Ledcor*: 2016 CanLII 70291 (S.C.C.).

[5] Leave to appeal dismissed, 2016 CanLII 70285 (S.C.C.).

[6] Leave to appeal dismissed, 2016 CanlII 943 (S.C.C.).

[7] A committee of the Public Construction Council of British Columbia.

[8] The BCCA cited *True Construction* with favour in *Sherry v. CIBC Mortgages Inc*., 2016 BCCA 240, when considering standard form mortgage documents. That case is discussed in more detail under a later topic.

The message from *Sattva* that the factual matrix is always relevant has apparently not worked its way into the collective consciousness of all trial judges. There have been a number of cases decided post-*Sattva* where the trial judge was found to have insisted, improperly, on reading only the words of a contract in context, without regard to the factual matrix, in the absence of an ambiguity.

For example, in *British Columbia (Minister of Technology Innovation and Citizens' Services) v. Columbus Real Estate Inc*., 2016 BCCA 283, the dispute was over the interpretation of an option agreement. The B.C. Court of Appeal held that the trial judge erred in failing to consider the surrounding circumstances, including:

> …the law of mortgages; the prevailing custom and practice regarding purchase and sale agreements involving the transfer of encumbered property; s. 21 of the *Property Law Act*; the objective evidence of the parties' intent in setting the purchase price at $11 million and the maximum value of permitted encumbrances at $11 million; the object of the Option; and the scope of the adjustments clause.

In *Starrcoll Inc. v. 2281927 Ontario Ltd*., 2016 ONCA 275, the application judge was held to have erred in requiring there to be an ambiguity before he could consider the factual matrix.

There are other cases from the past year applying *Sattva* that are worth noting because they help refine what types of circumstances and documents form part of the relevant factual matrix in which a contract is to be interpreted.

- *Deslaurier Custom Cabinets Inc. v. 1728106 Ontario Inc*., 2016 ONCA 246[9] – In a dispute about insurance obligations in a commercial lease, the motions judge admitted evidence tendered by the tenant as to terms of the landlord's leases with other tenants. The Court of Appeal revisited the passage in *Sattva* warning that only knowledge that was or reasonably ought to have been within the knowledge of both parties at or before the date of contracting was admissible as "surrounding circumstances." The Court went on to note that the record did not establish, and the motions judge made no finding, that the leases with other parties were within the knowledge or ought to have been within the knowledge of both parties prior to entering into the lease.

- *Alsip v. Top Rollshutters Inc. dba Talius*, 2016 BCCA 252 – The appellant alleged that while the trial judge recognized his obligation to have regard to the surrounding circumstances in ascertaining the intention of the parties, he erred in failing to consider all of the circumstances forming part of the factual matrix when the contract was entered into. The Court of Appeal disagreed noting that: 1) a

[9] Leave to appeal was sought in this case. Pursuant to s. 43(1.1) of the *Supreme Court Act*, the case was remanded to the Ontario Court of Appeal for disposition in accordance with *Ledcor*.

judge is not obliged to make express reference to every single piece of evidence that could conceivably form part of the factual matrix; 2) much of the evidence that the appellant was referring to involved one party's subjective understanding of the contract, not shared with the other party; and 3) the evidence in question was not material to the interpretative question before the court (whether the contract in question was a fixed term contract or a contract of indefinite duration).

- *Parsons v. Canadian Red Cross Society*, 2016 ONSC 4809 - In this case, Justice Perell gives detailed consideration to what constitutes the factual matrix for a settlement agreement entered into in relation to two national class actions.

- *Jones Collombin Investment Counsel Inc. v. Fickel,* 2016 ONSC 6536: Justice Penny confirms that generally speaking, evidence of the subjective intentions of parties is not admissible as part of the factual matrix. Accordingly, prior drafts of the agreement and of negotiations, because they involve an element of subjectivity, are usually excluded. Justice Penny noted that another reason for treating evidence of negotiations as suspect is that a position deemed by a party to be acceptable at one stage of the negotiations might well be viewed by the same party as unacceptable at a different stage. However, he went on to say that in some circumstances, the fact of an offer or counter-offer being made could constitute objective evidence within the knowledge of both parties before the final contract is made.

- *Sankar v. Bell Mobility Inc., supra*: The Court underscored the difference between considering the factual matrix and considering the documents that make up the contract itself. In this case, customers purchased prepaid wireless phone cards. The initial agreement contemplated that customers could top up their accounts through Bell's websites, through the purchase of phone cards and the purchase of PIN receipts, provided they "topped up" before expiry of their plan's active period. The documents related to the "top up" were not part of the factual matrix, but rather contained contractual terms themselves. The distinction between the factual matrix and the documents making up the contract itself mattered because of the need to determine whether the contractual terms were sufficiently similar to give rise to a common issue. Communications made by Bell to its customers prior to the expiry of their top-ups to notify them that their funds were about to expire were not part of the factual matrix, since they took place after the contract was made.

Bottom line: When a trial judge interprets a standard form contract, the standard of review from that decision will be correctness. Parties unhappy with the decision at first instance will no doubt seek to characterize the contract in question as a standard form contract whenever such an argument is plausible. Obvious examples of standard form contracts include most insurance policies and contracts of adhesion used by on-line vendors.

Ledcor may have no impact on the standard of review for arbitration decisions interpreting standard form contracts.

The factual matrix will have less significance in the interpretative exercise when the contract is a standard form, but you should consider leading evidence on the purpose of the contract, the relationship between the parties it creates and the particular market or industry in which it operates.

Consider whether the documents you say form part of the relevant factual matrix contain contractual terms and are, in fact, part of the contract itself and are admissible on that basis.

The factual matrix is always admissible, provided the evidence in question is relevant and was known or reasonably ought to have been known by the parties at the date of contracting.

Anti-Oral Amendment Clauses

A clause stipulating that no amendment to the agreement is valid unless it is in writing and signed by each party will invariably be included in the boilerplate section of a commercial contract. Such clauses are referred to in the commentary as "anti-oral amendment clauses" or "no oral amendment clauses".

Examples might read as follows:

> No change or modification of this agreement is valid unless it is in writing and signed by each party.
>
> -or-
>
> This Agreement shall not be deemed or construed as having been amended as a result of any oral communication between the parties or as a result of any practice of the parties, but all amendments to this Agreement are to be in writing and signed by both parties.

Language of this sort is often buried in an entire agreement clause, which, as I will explain below, may complicate the analysis of a purported oral amendment in the face of such a clause.

The question addressed in two U.K. cases and one Nova Scotia case this year was whether the court can, in the face of such a clause, enforce an oral amendment.

The two recent English cases on point support the proposition that party autonomy should prevail: provided that there is consideration to support an oral agreement

amending an existing agreement containing an anti-oral amendment clause, such an oral amendment will be effective.

In *Globe Motors Inc. v. TRW Lucas Varity Electric Steering Ltd*., [2016] EWCA 396, the English Court of Appeal, in *obiter*, took it upon itself to resolve an apparent inconsistency in prior decisions of the Court on the issue. The Court rejected arguments based on commercial certainty and policy. A general principle of English law, it said, is that absent statutory or common law restrictions, parties have freedom to agree to whatever terms they wish, and can do so in a document, orally or by conduct. Applying that principle, an anti-oral amendment clause does not prevent parties from later making a new contract varying the original contract by an oral agreement or by conduct.

In *MWB Business Exchange Centres Ltd. v. Rock Advertising Ltd*., [2016] EWCA Civ 553, the Court revisited this issue. It held that the most powerful consideration was that of party autonomy, citing a decision of Justice Cardozo in the New York Court of Appeals from 1919:[10]

> Those who make a contract, may unmake it. The clause which forbids a change, may be changed like any other. The prohibition of oral waiver, may itself be waived … What is excluded by one act, is restored by another. You may put it out by the door, it is back through the window. Whenever two men contract, no limitation self-imposed can destroy their power to contract again…

The Nova Scotia Court of Appeal considered the issue in the past year. In *Archibald v. Action Management Services Inc*., 2015 NSCA 103 ("*Archibald*"), the clause in question required any waiver of provisions of a lease to be in writing, signed by the parties.

The tenants were experiencing financial difficulties and met with the landlord to ask for a rent reduction. The trial judge accepted the tenants' evidence that this meeting resulted in an oral agreement that the lease would be terminated and the tenants would be released from their obligations thereunder on condition they paid the landlord $11,200. One of the issues on appeal was whether the clause in the lease requiring waivers to be in writing precluded the parties from orally agreeing that the tenants would be released from their obligation to pay further rent.

According to the Nova Scotia Court of Appeal, the leading case in Canada on "no oral amendment clauses" is the decision of the Ontario Court of Appeal in *Shelanu Inc. v. Print Three Franchising Corporation* (2003), 64 O.R. (3d) 533 ("*Shelanu*"). The aspect of *Shelanu* that the Nova Scotia Court followed was its articulation of a test that foreshadowed the *Tercon* test later enunciated by the SCC, treating the anti-oral

[10] *Beatty v. Guggenheim Exploration Company*, 225 N.Y. 380 at 387-8 (C.A.1919).

amendment clause as a type of exclusion clause. In *Archibald*, as in *Shelanu*, the Court held that the first step in the test is to determine if the no waiver or no oral amendment clause applies to the circumstances. In both cases, the Courts concluded that the clause in question did not apply because what the parties did was not an amendment or waiver, but rather a surrender and revocation of the agreement in question.

With the benefit of hindsight, the decision in *Shelanu* seems internally inconsistent. On the one hand, it purports to analyze the anti-oral amendment clause under what is now the *Tercon* test. But then, in *dicta*, the Court goes on to address whether, on the facts before it, the Court should exercise its discretion not to enforce the clause, an exercise separate and apart from the *Tercon* test (had the anti-oral amendment clause been found to apply). It concludes that where the parties have, by their subsequent course of conduct, amended the earlier written agreement so that it no longer represents the intention of the parties, the court will refuse to enforce the written agreement, even in the face of an anti-oral amendment clause. The Court upheld the ruling below that there was consideration for the oral "amendment".

If such a clause was properly analyzed under the *Tercon* test, then providing the clause applied on the facts, it should be enforced unless it was unconscionable when entered into or unless enforcing it would violate public policy. Yet the Ontario Court of Appeal in *Shelanu* seemed to view its discretion to refuse to enforce the clause as unbounded.

There are a few cases on this issue decided prior to *Shelanu* and one B.C. case decided in 2012.

In *Scheckter v. Polonuk*, 1992 CarswellAlta 787 (C.A.), the parties to a joint venture agreement agreed to pay to a trustee amounts necessary to pay premiums on a life insurance policy used to fund a buy-sell agreement. But instead, the premiums were paid out of the earnings of the property that the trustee company held. One member of the joint venture sued to enforce the original scheme because he felt unfairly treated by the inequality of the premiums. He argued that an anti-oral amendment clause in the agreement precluded the change in practice as to the payment source. The Court of Appeal held that this argument, and a secondary argument that there was no consideration for the change, could not prevail in the fact of a clear agreement by the parties to amend, especially where the oral amendment is being raised as a defence, rather than as a cause of action.

In *Premier Marketing Solutions Inc. v. NII Northern International Inc*., 2012 BCSC 1478, the parties entered into a written agreement covering the terms under which the plaintiff would act as commission sales representatives for the defendant. The commission amount was 2% of net sales. The agreement contained an anti-oral amendment clause within an entire agreement clause. The defendants alleged that the parties orally agreed to reduce the commission to 1% and conducted themselves accordingly thereafter.

The plaintiffs brought a claim for commission they said was owing. They denied the existence of any oral agreement, but relied primarily on a submission that no oral agreement to amend was enforceable in light of the anti-oral agreement clause. On an application for summary trial, Chief Justice Bauman cited *Shelanu*, and took the view that the defendant was making an improper attempt to apply the parol evidence rule in a circumstance where it does not apply. He referred the case to trial for adjudication on the question of whether there was an oral agreement reducing the commission amount.[11]

Conversely, in *West Edmonton Mall Ltd. v. Clock Gallery Limited* (1993), 7 Alta. L.R. (3d) 327 (Q.B.), Master Funduk refused to enforce an oral agreement alleged by a tenant whereby the rent amount under a lease was reduced where the lease contained an anti-oral amendment clause within an entire agreement clause. In his view, it was important to give legal efficacy to such terms to prevent uncertainty.

I took a cursory look at U.S. case law and commentary. That review revealed that the U.S. state law is not consistent on this topic.

In some states, an oral agreement will be enforceable notwithstanding an anti-oral amendment clause, provided there is new consideration, mutual assent and clear and convincing evidence of the parties' intent to act inconsistently with the no oral amendment clause.[12] Yet in other states, contractual provisions requiring amendments to be in writing will trump any oral modifications or past practice by the parties.[13]

Which is the correct approach? Should the *Tercon* test apply to the enforceability of anti-oral amendment clauses, with the result that purported oral amendments will rarely be effective? Are such clauses akin to exclusion clauses (because they are included in entire agreement clauses of otherwise)? Are other policy imperatives more important in this particular context, including party autonomy such that the parties can be found to have orally amended a contract in the face of such a clause?

We will have to wait and see what the appellate courts have to say in the future. The weight of authority at present appears to favour party autonomy.

Bottom line: Based on the recent English cases and the appellate authority that exists in Canada, a party who can prove an oral amendment may overcome an anti-oral

[11] The Ontario Court of Appeal in *Shelanu* took the same view: the parol evidence rule does not apply to bar evidence of any subsequent oral agreement to rescind or modify a written contract, provided that the oral agreement in question is not invalid under the *Statute of Frauds* or equivalent legislation.

[12] See, for example, *Quality Products & Concepts Co. v. Nagel Precision, Inc*., 469 Mich 362, 382, 666 NW2d 251 (S.C. 2003).

[13] See, for example, *Nassau Beckman, LLC v. Ann/Nassau Realty*, LLC, 105 A.D.3d 33, 960 N.Y.S. 2d 70 (App. Div., First Department, 2013).

amendment clause, provided there is consideration for the amendment and clear and convincing evidence of the parties' intention to amend.

However, there is still some inconsistency in the case law, leaving open the argument that the enforceability of such clauses should be addressed under the *Tercon* test, meaning that they will be enforceable in most instances. Clarification from the appellate courts on this issue would be welcome.

Is there any point, then, in including an anti-oral amendment clause in the boilerplate of a commercial agreement? Commentators from the U.K. and U.S. suggest that while these clauses are unlikely to prevent non-written variations, they reduce the risk that the contract will be inadvertently amended verbally or by conduct and may cause courts to require a higher standard of proof of any alleged amendment. And if these clauses are properly assessed under the *Tercon* test, then they will be enforceable in a commercial context where unconscionability is unlikely to be present.

Is Your Option Agreement a Unilateral or Bilateral Contract?

Ever since the Supreme Court of Canada issued reasons for judgment in *Sail Labrador Ltd. v. The Challenge One*, [1999] 1 S.C.R. 265, we have known that an option may be a unilateral contract or an element of a bilateral contract in which it is contained.

Why does it matter? It matters because deficient performance of a unilateral option contract will be assessed differently from deficient performance of a bilateral contract.

In the context of a bilateral contract, only substantial non-performance permits the non-breaching party to rescind the contract on the basis that the failure in performance substantially deprived them of what was bargained for.

Conversely, where an option is found to be a unilateral contract, courts have historically required that conditions precedent to the exercise of such an option be strictly performed in order to give rise to liability on the part of the optionor.

A recent commercial case involving a “put-right” option, *Flintoff v. Crown William Mining Corporation*, 2015 ONSC 2027, aff’d 2016 ONCA 86, illustrates these principles.

In that case, twelve individuals (the plaintiffs) sued in relation to an option contained in an asset purchase agreement (“APA”). The plaintiffs had obtained judgments against a certain Emilia von Anhalt. Crown William Mining Corporation (“Crown William”) agreed to facilitate their collection of these judgments. The controlling shareholders of Crown William were Sablo Management Inc. (“Sablo”) and Shamrock Group S.A. (“Shamrock”).

Under the APA, Crown William purchased the judgments in favour of the plaintiffs against von Anhalt for $982,841.50. That amount was to be satisfied by way of two

promissory notes and the issue and allotment to the plaintiffs of 20,000 shares in Crown William. Included in the APA was a put-right option. It provided that following a two-year holding period, the plaintiffs could require Shamrock and Sablo to purchase the issued Crown William shares at $3.00 per share.

The put-right option provision required that the plaintiffs give written notice that they were exercising the option and requiring the defendants to buy their shares. The APA also provided that if the defendants failed to purchase the shares, the plaintiffs were entitled to exercise any remedies available to them five business days after providing written notice specifying the default and informing the defendants that they intended to exercise their remedies.

The issue of whether or not the put-right option was a unilateral contract or part of a bilateral contract mattered because the defendants alleged that the plaintiffs had failed to strictly comply with the notice provision. Sablo and Shamrock took the position that the notices were not delivered to their current place of business, relying on s. 263(1) of the Ontario *Business Corporation Act.*[14]

The APA did not stipulate an address for delivery and the trial judge held that notice was effectively given to the defendants at the address of their registered trustee. But in the alternative, he went on to find that the option formed part of bilateral contract, such that the plaintiffs only had to show substantial performance of the notice requirement, a conclusion with which the Court of Appeal agreed.

Both Courts noted that the shares in question were essentially security for part of the purchase price for the von Anhalt judgments due to the plaintiffs. Exercising the put-right option was the mechanism that would allow the respondents to receive that part of the purchase price. Therefore, the option was part and parcel of the consideration received by the plaintiffs and not an isolated agreement separate from the rest of the APA.

A recent B.C. case illustrates this concept in the context of an option to renew in a lease and explains the effect of a time of the essence clause on performance obligations in a bilateral contract.

In *Excel Autobody Ltd. v. Tsang & Sons Holdings Ltd*., 2015 BCSC 553, the plaintiff leased premises for an autobody business. The lease contained an option to renew for a further five-year term. The tenant sent a registered notice to renew within the time

[14] R.S.O. 1990, c. B.16. Section 263(1) provides as follows: "Except where otherwise provided in this Act, a notice or document required to be sent to a corporation may be sent to the corporation by prepaid mail at its registered office as shown on the records of the Director or may be delivered personally to the corporation at such office and shall be deemed to be received by the corporation on the fifth day after mailing".

frame stipulated in the lease. The tenant followed up with an email. The landlord took the position that the notice was invalid for several reasons.

Madam Justice Ross rejected all the alleged grounds for the notice being invalid put forward by the landlord, and concluded it had received the notice by registered mail. But she went on to conclude that the option was part of a single bilateral contract, *i.e.,* the lease, in any event. If time was not of the essence under the lease, she held, the later notice to the landlord by email constituted substantial performance.

Her Ladyship rejected the proposition that time is always of the essence in the exercise of an option. There was no express time of the essence clause in the lease, and she concluded that there were no circumstances to support a conclusion that the parties intended to make time of the essence in relation to the exercise of the option.

There are recent examples in B.C. jurisprudence of options that were found to be unilateral contracts, in relation to which strict or complete performance of conditions to option exercise was required: see *American Creek Resources Ltd. v. Teuton Resources Corp*., 2014 BCSC 636[15] (earn-in agreement in mining context) and *Gadhri v. 0760815 B.C. Ltd*., 2016 BCSC 521 (option to purchase real property).

Bottom line: If you want to insist on strict compliance with conditions to option exercise, you will want a stand-alone option agreement. Conversely, if you are the party bargaining for an option right, it will better for you if the option is embedded in a larger bilateral agreement, in case your performance of conditions precedent to option exercise are less than perfect. Even in the context of a bilateral contract, the party granting the option can dictate strict timely performance of particular obligations by including a time of the essence clause.

Limitations Law as Applied to Continuing Breaches of Contract

Last year, I reported on a B.C. Court of Appeal decision that dealt with the concept of continuing breach of contract and the possibility of the innocent party re-electing to accept the other party's repudiation after initially affirming the contract.[16]

This year, the Ontario Court of Appeal weighed in on how limitations law principles apply to a continuing breach.

In *Pickering Square Inc. v. Trillium College Inc*., 2016 ONCA 179, Trillium was the tenant under a lease with Pickering of commercial space in a shopping mall for a term running from June 1, 2006 to May 31, 2011. The lease contained covenants requiring Trillium to pay monthly rent; operate its vocational college business continuously;

[15] Aff'd 2015 BCCA 170.
[16] *Dosanjh v. Liang*, 2015 BCCA 18.

maintain the premises throughout the lease term; and to restore the premises following expiry of the lease.

When Trillium vacated the premises in December 2007, Pickering sued for rent arrears and claimed specific contractual remedies for breach of the covenant to continuously operate under s. 16.08(b) of the lease.[17] That action was settled in August 2008. Under the settlement, Trillium was obligated to resume occupation of the leased premises by October 1, 2008, with all the terms of the lease remaining in force. Although Trillium paid rent for the balance of the lease term (subject to two minor deficiencies), Trillium never resumed occupation. Pickering therefore started a second action in February 2012, seeking to recover: (i) arrears of rent; (ii) damages under s. 16.08(b) of the lease; and (iii) damages for failure to restore the premises at the end of the lease term. It is important to the outcome that Pickering did not cancel the lease; but rather elected to affirm the lease in the face of Trillium's breaches.

One of the live issues at trial was how the Ontario *Limitations Act, 2002*, S.O. 2002, c. 24, Sched. B, applied to the damages claim under s. 16.08 of the lease. Under that Act, the basic limitation period is two years from the date the claim was discovered.

Did the limitation period run from October 1, 2008, when the defendant failed to resume occupation and operations (which would mean it had expired) or was the damages claim founded on a continuing breach, such that a new cause of action accrued each day the defendant failed to resume occupation?

Trillium argued for the former, alleging that the breach of the covenant to operate its business continuously was complete on October 1, 2008 and that each subsequent day it failed to resume occupation of the premises was not a separate breach but simply an instance of additional damages.

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[17] The remedy clause read as follows:

> (b) If the Tenant fails to take possession of and to open or to reopen the Leased Premises for business, fully fixtured, stocked and staffed within the times and in the manner required pursuant to this Lease or to carry on business at all times during the Term duly and strictly in accordance with the terms, covenants and conditions contained in this Lease, the Landlord shall be entitled (i) to collect (in addition to the Minimum Rent, Additional Rent and all other charges payable hereunder), an additional charge at a daily rate of Ten Cents ($0.10) per square foot ($1.08 per square metre) of the Rentable Area of the Leased Premises or One Hundred Dollars ($100.00), whichever is the greater, for each and every day that the Tenant fails to commence to do or to carry on business as herein provided, the additional charge being a liquidated sum representing the minimum damages which the Landlord is deemed to have suffered as a result of the Tenant's default, and is without prejudice to the Landlord's right to claim a greater sum of damages; and (ii) to avail itself of any other remedies for the Tenant's breach hereunder, including obtaining an injunction or an order for specific performance in a court of competent jurisdiction to restrain the Tenant from breaching any of the provisions of this Section 16.08 and to compel the Tenant to comply with its obligations under this Section 16.08…

In dealing with this position, the Ontario Court of Appeal explained that there were three types of breaches of contract:

> [23] Breaches of contract commonly involve a failure to perform a single obligation due at a specific time. This sort of breach is sometimes called a "once-and-for-all" breach: it occurs once and ordinarily gives rise to a claim from the date of the breach – the date performance of the obligation was due. Trillium's breach of s. 16.08 does not fall into this category because its obligation to operate its business was ongoing rather than single and time-specific.
>
> [24] A second form of breach of contract involves a failure to perform an obligation scheduled to be performed periodically – for example, a requirement to make quarterly deliveries or payments. A failure to perform any such obligation ordinarily gives rise to a breach and a claim as from the date of each individual breach: [citations omitted]. That is not this case.
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> [25] As the motion judge found, this case falls into a third category of breach: breach of a continuing obligation under a contract. Trillium breached its covenant to operate its business continuously – "at all times" – for the duration of the lease.

Pickering's election to affirm the contract played a critical role in the outcome. The Court found that the election to affirm rather than cancel did not postpone the date of discovery until expiry of the lease. Rather, the limitation period applied on a "rolling basis" -- it commenced each day a fresh cause of action accrued and ran two years from that date. Pickering was held entitled to claim damages for breach of the covenant to occupy for the period going back two years from the commencement of its action.

Implicitly the Court was saying that if you elect to accept the repudiation, your limitation period will crystallize at that point for what was a continuing breach, *i.e.,* you must sue within two years of that date.

Pickering's claim for breach of the covenant to restore was treated as a once-and-for-all breach. It began to run at the end of the lease term, when the obligation to restore was triggered. The claim was accordingly brought within time (less than two years after the lease term expired).

This case is significant outside Ontario, particularly in other provinces that have a modern limitation statute containing analogous provisions, such as B.C. and Alberta.

Bottom line: To carry out a limitations analysis in a breach of contract case, you need to characterize the breach: is it a "once-and-for-all" breach, breach of a periodic

obligation or a breach of a continuing obligation? With the third category (and probably also the second), your election to accept the repudiation or to affirm the contract will affect the limitations outcome. Different claims against a contracting party may be subject to different limitation periods because of the characterization of the various actionable breaches.[18]

What's New in the Treatment of Alleged Penalty Clauses?

I last wrote about liquidated damages clauses and their potential characterization as unenforceable penalty clauses in my 2012 Update.

A recent decision of the B.C. Court of Appeal reminds us that the doctrine of penalty is not designed to grant relief from a commercially imprudent bargain and only can apply in the context of a remedy stipulated upon breach of the contract.

In *Do v. Nichols*, 2016 BCCA 128, Mr. and Mrs. Nichols defended a foreclosure proceeding brought against them as mortgagors. The Nichols had entered into a contract of purchase and sale of property to Do, who intended to develop it. The purchase price was $1.7 million. The Nichols agreed to grant to Do, as of the completion date, an *inter alia* mortgage in the amount of $500,000. The Nichols covenanted to take all necessary steps to subdivide the property by a set date. If the Nichols failed to subdivide, or the appraised value of the lots was not at least $1.9 million, then the Nichols agreed to pay to Do the sum of $500,000, failing which he was entitled to enforce his security interest under the *inter alia* mortgage.

The Nichols argued that the clause providing for the *inter alia* mortgage was an unenforceable penalty, an argument on which they succeeded at trial, with the trial judge granting relief from forfeiture under s. 24 of the *Law and Equity Act*, R.S.B.C. 1996, c. 253.

The Court of Appeal held that the trial judge erred in finding the mortgage provision was a penalty, holding that the question of penalty or liquidated damages only arises in the context of the breach of an agreement. Mr. Justice Goepel stated in part:

> [23] The June Agreement contemplated that the Development Property might not be subdivided, in which case the vendor was obliged to pay the buyer $500,000, secured by a mortgage. It was not a breach of the contract to fail to subdivide, but rather a term specifically contemplated by the parties. There was, accordingly, no breach of contract. Accordingly and with respect, the question of whether the $500,000 obligation was a penalty, or a genuine pre-estimate of liquidated damages, does not arise in the circumstances of this case.

[18] On this point, see also *Pedersen v. Soyka*, 2014 ABCA 179.

The Court also rejected the proposition that the agreement was unconscionable.

The other development worth noting is the trend in Ontario to allow the law of unconscionability to govern the enforceability of penalty clauses. Rather than setting aside too readily clauses negotiated by the parties having penal consequences (*i.e.*, exceeding a genuine pre-estimate of damages) as unenforceable, Ontario courts have required that the party seeking relief establish unconscionability. The leading Ontario case reflecting this approach is *Peachtree II Associates – Dallas, L.P. v. 857486 Ontario Limited* (2005), 76 O.R. (3d) 362 (C.A.).[19] In that case, Justice Sharpe explained that the common law's approach to penalty clauses is based on finding that at the time of contracting the penalty clause was not a genuine pre-estimate of the innocent party's anticipated damages from a breach of contract whereas equity's approach to forfeiture or penalty clauses is based on a finding of unconscionability at the time of enforcement of the forfeiture or penalty clause.

Of course, unconscionability requires proof of both substantive unfairness and inequality of bargaining power. The latter will rarely be proven in a commercial context.

Since the decision of the B.C. Court of Appeal in *Liu v. Coal Harbour Properties Partnership*,[20] this would appear to be the approach in that province as well. In that case, the Court adopted a five- part test from a 1987 B.C. Supreme Court decision:[21]

> 1. The question "penalty" or "liquidated damages" is to be answered as at the date of the making of the agreement [and at the time set for performance];
>
> 2. If the answer is "liquidated damages", that is the end of the matter, but, if the answer is "penalty"; then,
>
> 3. There arises the next question should relief be granted against the penalty?
>
> 4. The answer to that question depends upon whether to enforce the penalty would be unconscionable, and that unconscionability has to be determined at the date of the invocation of the clause.
>
> 5. Section 24 of the *Law and Equity Act* only applies if and when stage 3 has been reached.

[19] Leave to appeal refused, 2006 CarswellOnt 316 (S.C.C.).

[20] 2006 BCCA 385.

[21] See also *Maxam Opportunities Fund v. Greenscape Capital Group Inc.*, 2013 BCCA 460 at para. 53.

However, the Court of Appeal's subsequent decision in *Tang v. Zhang*,[22] a case about deposits in real estate transactions, raised some doubt as it appeared to bless the older approach of characterizing the clause as a liquidated damages or penalty clause.

Recent decisions of B.C. Supreme Court judges suggest that B.C. has shifted the focus of the analysis to unconscionability in the same fashion as Ontario. See *Webster v. Robbins Parking Service Ltd*., 2016 BCSC 1863 and *Habitat for Humanity Canada v. Hearts and Hands for Home Society*, 2015 BCSC 1182, aff'd 2016 BCCA 217.

Bottom line:

Given recent jurisprudence in Ontario and B.C., courts in those jurisdictions are unlikely to be persuaded that a clause with penal consequences (*i.e.,* not representing a genuine pre-estimate of damages at the time the contract was entered into) will be automatically unenforceable. Rather, the focus of the courts will be on whether it would be unconscionable for the innocent party to retain the amount in question. Commercial parties will have difficulty establishing unconscionability. The consumer cases involving parking violation fees illustrate that a consumer will not automatically be found to have been vulnerable to a commercial counterparty and that equity will not intervene merely because a party, acting foolishly or immoderately, has made a very bad bargain.

Good Faith Performance and Rights of First Refusal

Long before the decision in *Bhasin v. Hyrnew*, 2014 SCC 71, Canadian courts held that the grantor of a right of first refusal ("ROFR") must act reasonably and in good faith in relation to that right and must not act in a fashion designed to eviscerate the very right that has been given. The case most often cited for this proposition is the decision of the Ontario Court of Justice (General Division) in *GATX Corp. v. Hawker Siddeley Canada Inc*. (1996), 27 B.L.R. (2d) 251.

This year, the Saskatchewan Court of Queen's Bench addressed good faith in the context of ROFRs post-*Bhasin* in *Northrock Resources v. Exxon Mobil Canada Energy*, 2016 SKQB 188 ("*Northrock Resources*").

As you know, the SCC in *Bhasin v. Hrynew* articulated a new duty of honesty in contractual performance, *i.e*., parties must not lie or otherwise knowingly mislead each other about matters directly linked to the performance of the contract. At the same time, the SCC described an organizing principle of good faith that parties generally must perform their contractual duties honestly and reasonably and not capriciously or arbitrarily, which principle the SCC said manifests itself through the existing doctrines about the types of situations and relationships in which the law requires honest, candid, forthright or reasonable contractual performance.

[22] 2013 BCCA 52.

Where does the duty articulated in *GATX* in the context of ROFRs fit?

While Court does not expressly say so, it is my view that the Saskatchewan Court in *Northrock Resources* was treating that duty as one of the pre-existing situations in which the organizing principle of good faith applies. In particular, after reviewing the jurisprudence, Justice Currie states:

> [66] I conclude that a breach of a duty of good faith may be established where a party is shown to have lied or misled, thereby breaching the duty of honest performance. Further, such a breach may be established where a party is shown to have structured a transaction for the purpose of avoiding a ROFR.

The case is a helpful illustration of how a grantor motivated by tax objectives can demonstrate that they were not motivated by a desire to eviscerate the ROFR.

ExxonMobil Canada Energy ("Exxon") and Northrock Resources ("Northrock") were parties to certain agreements containing a ROFR in the event that Exxon sold specific interests other than to an affiliate. Exxon engaged in a two-stage transaction to dispose of its interest in relevant assets: first, it transferred the interest to its wholly owned affiliate ("NSULC"), then the shares in NSULC were sold to Crescent Point General Partner Corp. This structure is apparently referred to in tax parlance as a "busted butterfly". The offering memorandum and related documents advised bidders that the contemplated transaction had flexible structuring, and that two transaction structures were possible: the busted butterfly or an asset sale. The offer Exxon ultimately accepted from Crescent Point was a non-discounted offer under a busted butterfly structure.

Northrock alleged that the transaction breached the ROFR and brought an action, alleging breach of contract, breach of a duty of good faith and the torts of inducing breach of contract and conspiracy.

Justice Currie held that neither the sale of the interest to NSULC nor the subsequent sale of the NSULC shares triggered the ROFR. He went on to consider whether Exxon breached any duty of good faith.

Justice Currie accepted the evidence of Exxon witnesses that the company proceeded with the busted butterfly structure for tax reasons (a tax benefit of $29 million). He declined the invitation from Northrock to draw negative inferences from the fact that the Exxon employee handling the transaction sought a series of legal opinions on whether a busted butterfly transaction might trigger a ROFR, which opinions indicated some uncertainty and risk on that issue. He concluded as follows:

> [80]…A decision can be a *bona fide* business decision, even in the face of some risk or uncertainty. Many business decisions involve risk and uncertainty. They involve weighing the risk and uncertainties. That is the nature of business. The element of uncertainty about the legal opinions does not affect my acceptance of Mr. Graham's testimony that ROFRs were a detail that did not affect the decision, because the decision was driven by the concern for the tax pools.
>
> [81] In this case, the essence of the decision was that the busted butterfly structure could result in a benefit to ExxonMobil of $29 million, with a negligible related cost.
>
> [82] As to Northrock's argument that the legal opinions were outright wrong, I am not concerned with whether Mr. Graham was correct in his understanding and in his recommendation to ExxonMobil. I am concerned with whether he was motivated by the ROFR concerns.
>
> [83] Further, I am not persuaded of the validity of the proposition that a client may *bona fide* follow legal advice only if that advice ultimately proves correct. Such a proposition is entirely impractical, given the complexities of the law and of the wide range of circumstances to which it applies. Similarly, it strikes me that following legal advice is an indication of, if anything, *bona fide* conduct rather than the opposite.

Justice Currie went on to reject the tort causes of action and to dismiss the claim.

Bottom line: The good faith duty of a grantor of a ROFR to not act in a fashion designed to eviscerate the very right that has been given, *i.e.*, by structuring a transaction for the purpose of avoiding the ROFR, is part of the pre-existing good faith law recognized in *Bhasin v. Hrynew*. A transaction that avoids triggering a ROFR will necessarily be scrutinized under this body of law. It will behoove grantors of ROFRs to be able to point to a rationale for the transaction other than avoiding the ROFR and to paper that rationale leading up to the transaction. On the other hand, it will behoove grantees to bargain for watertight ROFRs that preclude assignments to affiliates and other related parties if they wish to prohibit a two-stage process whereby the grantor assigns to an affiliate and the affiliate is then acquired by a third party.

Discretionary Clauses –Are They Void for Uncertainty?

I have not previously written about cases discussing when uncertainty as to a contract term may result in a court concluding that there is no enforceable contract between the parties. My primary reason for not doing so is that the cases are very fact dependent and generally do not contain a detailed analysis of the law adding to what the leading contract law textbooks already tell us.

But in *Sherry v. CIBC Mortgage Inc*., 2016 BCCA 240 (“Sherry”), the B.C. Court of Appeal took the opportunity to address at some length the law on uncertainty of terms in a commercial context, prompting me to include the topic in this year’s paper.

The question addressed by the court in *Sherry* was when, due to the degree and nature of discretion built into an express promise or obligation of a contracting party, the promise or obligation is illusory and the contract therefore too uncertain to be enforced.

The contracts at issue in this proposed class action were CIBC residential mortgages under which the bank retained discretion in the calculation of prepayment charges. Borrowers had some rights to prepay the mortgage, either partially or in full, but would incur what the pleadings referred to as a "Prepayment Penalty" if they prepaid more than a penalty-free proportion provided for in the contract.

Prepayment Penalties were stated to equal the greater of:

- three months' interest on the principal amount that was subject to the Prepayment Penalty; and

- an amount referred to as an interest rate differential (“IRD" or “IRD amount") based on the principal amount that is subject to a Prepayment Penalty, qualified by reference to

    - a contract rate specified or described in the mortgage contract (the “Contract Rate”); and

    - another rate (the “Comparison Rate”).

In some of the mortgages, the CIBC retained discretion to determine the method by which the IRD would be calculated. An example clause set out in the pleadings described the Prepayment Penalty as above, and then stated, in reference to the three month’s interest and IRD amount:

> “... each of which will be calculated by us [CIBC] using a method determined by us from time to time in our discretion”

In other mortgages, CIBC retained discretion as to how the Comparison Rate would be calculated, *i.e*., to determine what mortgage was comparable to the borrower’s mortgage. In some mortgages, CIBC retained discretion on both these fronts.

The judge hearing the certification application held that there was an arguable case that the mortgage contracts lacked sufficient certainty to be enforceable. She also held that the other causes of action pleaded, including unconscionability, were not doomed to failure.

The Court of Appeal's ruling on the contract law issue, overturning the certification of that cause of action, is the aspect of the case I will discuss.

The Court of Appeal accepted the proposition that it is open to contracting parties to agree that one of them may exercise a discretion, as long as that discretion does not relate to an "essential aspect" of the contract (plaintiff's counsel conceded that the terms at issue here were not essential). The Court cited its earlier decision in *First City Investments Ltd. v. Fraser Arms Hotel Ltd.*, [1979] B.C.J. No. 2097, for its articulation of what constitutes an essential term (also referred to as a fundamental or vital term):

> It is only the lack of a term that is so essential to the contract that without it the Court cannot collect the real intentions of the parties from the language within the four corners of the instrument and so cannot give effect to such intentions by supplying anything necessarily to be inferred that will render the contract unenforceable.

There is nothing new or startling about this principle.

The plaintiff, however, sought to rely on a line of Australian cases that broke down uncertainty into three categories:

(a) No agreement on a fundamental term;

(b) One party has a choice as to whether or not to perform; and

(c) A vital matter has been left to the discretion of one of the parties.

It was the second of these components, which was not linked in the Australian cases to the character of the clause as “essential” or “vital”, upon which the plaintiff relied and the chambers judge appeared to base her ruling. In a subset of Australian cases, a term which reserved the fixing of a substantial obligation to the discretion of the bank was held to render the contract "illusory" and unenforceable.

The Court of Appeal held that this was not the law in B.C., where instead the courts have a duty to attempt to give meaning to the terms chosen by the parties and to their intentions. Accordingly, Canadian courts will not treat discretionary clauses as "illusory" and therefore invalid. The issue canvassed in the Canadian cases, noted the Court of Appeal, is the categorization of discretionary clauses, *i.e.,* whether the discretion given one party under the contract is controlled by objective or subjective standards. The Court acknowledged that the 1985 decision of the Ontario Court of Appeal in *Greenberg v. Meffert*[23] was the leading authority on construing discretionary clauses and

[23] (1975), 18 D.L.R. (4th) 548 (Ont. C.A.), leave to appeal dismissed, [1985] 2 S.C.R. ix.

characterizing them as imposing an objective standard of reasonableness or a subjective standard.

There are earlier examples in the jurisprudence of Canadian courts refusing to avoid contracts containing a clause granting one party discretion, some of which are listed in the decision in *Sherry* (at para. 64). I will summarize two examples.

Canadian Bedding Company Ltd. v. Western Sleep Products Ltd.:[24] The defendant Western held the licence to manufacture and sell Serta mattresses in Western Canada. The parties entered into an oral agreement that led to Canadian Bedding opening retail stores selling Serta mattresses. The terms of the agreement were contested at trial. One term that was uncontroversial was that Western agreed to contribute to the cost of advertising, but that the amount of contribution was at the discretion of Western. The parties understood that Western would indicate each year the co-operative advertising it would provide. Western argued that this term of the Agreement was void for uncertainty, which argument was rejected by the trial judge.

447022 B.C. Ltd. v. McDonald's Restaurants of Canada Ltd.:[25] The contract at issue was for the purchase and sale of five parcels of land in Whistler. The contract was subject to a condition that the plaintiff be able to obtain a satisfactory rezoning for development of the lands. When the municipality granted preliminary approval for the proposed rezoning but refused final approval, the parties amended the agreement, reducing the purchase price by $450,000, removing the subjects, and providing for a payment of $450,000 if subdivision was ultimately approved.

The agreement, as amended, contained the following term:

> If a minor sub-division appears possible whereby the benefit is not sufficient (as determined by the Vendor in his discretion) to justify payment of the full $450,000 a lesser amount may be paid if agreed to in advance by the Vendor.

The plaintiff purchaser (who was seeking return of the deposit after failing to close) argued that this clause rendered the purchase price uncertain and unascertainable and as the clause did not limit the margins of the defendant's subjective discretion, it was unenforceable.

Mr. Justice Davies took the view that he had an obligation to strive to determine the parties' intentions and enforce the contract. He held that the purchase price was ascertainable, and that the agreement as to the $450,000 was a proviso for possible additional funds flowing to the vendor. He held that the discretion granted to the Vendor

[24] 2009 BCSC 1499.

[25] (1996), 50 R.P.R. (2d) 297 (B.C.S.C.).

did not render the proviso unenforceable since the discretion did not arise as part of the formative stages of the contract.

Bottom line: Commercial contracts between sophisticated parties are unlikely to be susceptible to attack as being void for uncertainty unless they lack an essential term (highly unlikely where sophisticated, legally represented parties are involved). The inclusion of a provision or provisions giving significant discretion to one of the parties does not, under Canadian law, trigger an "uncertainty" analysis unless that grant of discretion results in the agreement lacking an essential term. The usual issue in Canadian law is whether the standard against which the exercise of discretion is to be assessed is subjective or objective.

CONTRACT LAW – DEVELOPMENTS OF NOTE
SUMMARY OF TOPICS

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