CONTRACT LAW UPDATE: DEVELOPMENTS OF NOTE (2022)

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Lisa A. Peters, K.C. | Lawson Lundell LLP
Vancouver | 604-631-9207
Kelowna | 778-738-2605
lpeters@lawsonlundell.com

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As those familiar with this annual update know, each fall I undertake a review of decisions from the previous 12 to 18 months, looking for cases relevant to commercial practice.[1] If there are cases bringing about significant changes to the law of contract or if the Supreme Court of Canada ("SCC") weighs in on a contract law issue, I will write about those cases. But typically, I will also highlight cases that remind us of longstanding contract law principles and that illustrate how those apply in practice.

At the end of this paper is a chart that tracks the topics I have covered over the past decade.

This is the latest I have published my annual update; all I can say is that Mr. COVID has no respect for deadlines. On the plus side, I am covering not one but two boilerplate clauses this year.

This year's topics are:

- Constitutions and bylaws of voluntary associations – when are they contractual in nature? The latest from the Supreme Court of Canada ("SCC");
- Interaction of arbitration agreements and bankruptcy or insolvency proceedings involving a party to an arbitration agreement;
- Rescission and rectification revisited at the SCC;
- Boilerplate and other commonplace clauses:
    - Best efforts clauses and their many variants
    - Ordinary course of business covenants
- Contracts with government and direct vs. indirect fettering of legislative discretion; and
- Update on the doctrine of good faith in contract law.

[1] I would like to acknowledge the work of Nicole Welsh, a law student at the University of Victoria, who did her summer articles at Lawson Lundell in 2022, and who diligently reviewed cases and articles to assist me in mapping out this year's topics. I would also like to thank my colleagues Catherine Whitehead and Codie Chisholm for reviewing and proofreading this year's paper.

Bylaws of Voluntary Associations – When Are They Contractual in Nature?

The topic that the SCC addressed in *Ethiopian Orthodox Tewahedo Church of Canada St. Mary Cathedral v. Aga*, 2021 SCC 22, was when, and on what basis, there will be a contractual relationship among members of a voluntary association.

This question arose when members of the appellant church sued the church, and certain church leaders, when they were expelled from the church's membership after a dispute arose about a movement within the church that some members considered heretical.

The existence or non-existence of a contract among the members was critical because of longstanding jurisprudence[2] holding that courts only have jurisdiction to intervene in decisions of voluntary associations where a legal right (*e.g.*, a contractual right) is at issue.

The appellant church was incorporated under the Ontario *Corporations Act*,[3] was the owner of the church building and land, and was a local branch of the global Ethiopian Tewahedo Orthodox Church. Church members were not members of the corporate entity but rather of an unincorporated association (the "Congregation").

The expelled members brought an action against the church and members of its senior leadership, alleging, *inter alia*, that the church failed to follow its own internal procedures in deciding to expel them from the Congregation. The relief sought included a declaration that their expulsion was null and void, as it violated the principles of natural justice. The expelled members relied, particularly in the Ontario Court of Appeal ("ONCA"), on a 1977 Constitution and Bylaw (which appear to have been promulgated by the parent global church), asserting that those documents were contractually binding and enforceable, giving rise to a justiciable issue to be tried and providing a basis for the Court's jurisdiction.

While the SCC noted that the categories of legal rights that could ground the jurisdiction of courts to intervene in decisions of voluntary associations included private rights in property, contract, tort or unjust enrichment, as well as statutory causes of action, the only possible category of legal rights applicable on the facts was contract rights.

The motion judge granted the appellants' motion for summary judgment on the basis that the Court had no jurisdiction to review or set aside the expulsion decision in that

[2] Including an 1877 decision of the Ontario Court of Chancery cited by the SCC and *Highwood Congregation of Jehovah's Witnesses (Judicial Committee) v. Wall*, 2018 SCC 26.
[3] R.S.O. 1990, c. C.38.

the expelled members failed to allege or provide evidence of an underlying legal right.

The ONCA allowed the appeal, effectively holding that membership itself (in a voluntary association with a constitution and bylaws) constitutes a legal right grounding jurisdiction, stating in part (at para. 40):

> Voluntary associations do not always have written constitutions and by-laws. But when they do exist, they constitute a contract setting out the rights and obligations of members and the organization.

The SCC disagreed, holding that membership in a voluntary association does not automatically give rise to a contractual relationship. Rather, said Justice Rowe (in a unanimous judgment), a contract exists only if the conditions of contract formation, including an intention to create legal relations, are met. There was no evidence of an objective intention to enter into legal relations. The motion judge found that the respondents were not even aware of the Bylaw or its terms when they became members. And, said the SCC, becoming a member of a religious voluntary organization, paying dues, and even agreeing to be bound to certain rules of that organization does not, without more, evince an objective intention to enter into a legal contract enforceable by the courts.

Justice Rowe commented on the so-called "web of contracts" cases, situating them historically, and explaining how they did not stand for the proposition that membership in a voluntary association that has a written constitution and bylaws invariably gives rise to a contract.

The concept of a web of contracts among members of an association, such as a union, arose historically because voluntary associations lack legal personality, except where the legislature has expressly or by implication conferred that status on them. A member who has been wronged by such an association cannot sue it directly, absent a statutory provision. To fill this legal void, the common law developed the theory that some voluntary associations are constituted by a web of contracts between each member and every other member. But as Justice Rowe explains, the existence of a web of contracts in those cases can be understood as founded on an objective interpretation of what the parties intended. While the elements of a valid contract are required, where it is shown that the members of the association objectively intended to form contractual relations, offer, acceptance and consideration can often be implied from the circumstances. In other words, the ONCA erred in interpreting such cases as mandating a conclusion that the relationship among members of a voluntary association is invariably contractual.

As the law has evolved, statutory reforms conferring significant rights and obligations on categories of voluntary associations (such as trade unions) have resulted in a conclusion that they have legal personality, making the theory of a web of contracts among members of such an association unnecessary.[4]

But when a web of contracts among members of a voluntary association is alleged, the claimant must establish an intention to create legal relations. The test for an intention to create legal relations is objective: was their conduct such that a reasonable person would conclude that they intended to be contractually bound?

Bottom line: Membership in a voluntary association is not automatically contractual (regardless of whether there is a constitution or bylaws in place or not).

Courts only have jurisdiction over decisions of such associations where a legal right is at issue.

When the legal right said to found jurisdiction of the court over decisions of a voluntary association is an alleged contractual right, the relationship must meet the conditions for contract formation, including an objective intention to create legal relations. Where property or employment are at stake, such an intention is more likely to exist. Conversely, in religious contexts, where individuals may intend for their mutual obligations to be spiritually but not legally binding, an intention to create legal relations is less likely to be established.

Purely theological issues are not justiciable; however, where a legal right is at issue, courts may need to consider questions that have religious aspect in vindicating the legal right.

If members of a voluntary association want their relationship to be contractual, the bylaws and constitution of the association should be drafted (or amended) to make that intention plain.

Risk of an Arbitration Clause being Found "Inoperative" Where There are Parallel Insolvency Proceedings

The lengthy decision of the SCC in *Peace River Hydro Partners v. Petrowest Corp.*, 2022 SCC 41, is of particular interest to practitioners in the areas of insolvency law and arbitration law. Many specialists in those areas have chosen to comment on the case;

[4] See, for example, *Berry v. Pulley*, 2002 SCC 40.

for that reason, I will not delve into its facts or summarize the majority and concurring reasons.

Instead, I will briefly report on why the decision is important to those who draft contracts and to those who deconstruct them (*i.e.*, litigators).

The Peace River Hydro Partners (the "Partnership") that had been formed to build a hydroelectric dam in northeastern B.C. (the Site C project) subcontracted certain construction work to the respondent Petrowest Corporation and its affiliates ("Petrowest"). There was more than one contract between the parties: some of the work was governed by individual purchase orders and some was governed by a subcontract. Most, if not all, of these documents contained a mandatory arbitration clause. However, the wording of the four types of arbitration clauses in question differed. Further, each applied to a different set of disputes and each established a different arbitration process (the "Arbitration Agreements").

When Petrowest ran into financial difficulties, Ernst & Young was appointed receiver (the "Receiver") of the Petrowest group of companies pursuant to s. 243 of the *Bankruptcy and Insolvency Act* ("BIA").[5] The Receiver brought a civil claim in the Supreme Court of British Columbia seeking to collect accounts receivable allegedly owing to Petrowest by the Partnership. The Partnership applied under s. 15 of B.C.'s *Arbitration Act*[6] for a stay of the court proceedings on the ground that the Arbitration Agreements governed the dispute.

Subsection 15(2) provided that on an application for a stay of this nature, the court must make an order staying the legal proceeding unless it determines that the arbitration agreement is void, inoperative or incapable of being performed.[7] The Receiver opposed the stay application, arguing that the BIA authorized the Court to assert centralized judicial control over the matter rather than sending the Receiver to multiple arbitral forums and that such an outcome was called for in this case. The chambers judge dismissed the stay application and the B.C. Court of Appeal ("BCCA") dismissed the appeal from that ruling.

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[5] R.S.C. 1985, c. 55.
[6] R.S.B.C. 1996, c. 55, now repealed and replaced by *Arbitration Act,* S.B.C. 2020, c. 2. Section 7 of that latter Act is equivalent to the former s. 15.
[7] The wording of the stay provision in B.C.'s *Arbitration Act* (which mirrors the UNCITRAL Model Law on International Commercial Arbitration and the *Convention on the Recognition and Enforcement of Arbitral Awards*, 330 UNTS 38) is effectively the same as in its *International Commercial Arbitration Act*, R.S.B.C. 1996, c. 233, and therefore includes the agreement being "inoperative" as a basis for a court refusing a stay. This is not the case in all provinces; contrast, for example, the *International Commercial Arbitration Act*, R.S.A. 2000, c. I-5 (which does contain this wording) and the *Arbitration Act*, R.S.A. 2000, c. A-43 (which does not).

The majority and minority opinions in the SCC both agreed that the appeal should be dismissed, but applied slightly different reasoning. I will focus on the majority judgment authored by Justice Côté.

Justice Côté began the majority judgment by stating that the appeal called upon the Court to clarify whether and in what circumstances a contractual agreement to arbitrate governed by the *Arbitration Act* should give way to the public interest in the orderly and efficient resolution of a court-ordered receivership under s. 243 of the BIA.

One of the issues at each level of court was whether s. 15 was engaged in circumstances where the receiver was not a party to the Arbitration Agreements. I will not deal with that issue except to say that the SCC held that s. 15 was engaged and that permitting a court-appointed receiver to avoid arbitration on the basis that it is not a party to the debtor's pre-existing agreement to arbitrate would be inconsistent with s. 15, principles of contract law, party autonomy, and the SCC jurisprudence on arbitration. Nor will I deal with the Court's discussion of the doctrine of separability.

I will focus on the Court's interpretation of the stay provision (s. 15), since the question of when an arbitration agreement will or will not be enforceable by way of a court-ordered stay is as much a contract law question as it is an arbitration question.

Subsection 15(2) provided that the court must order a stay unless it determined that the arbitration was "void, inoperative or incapable of being performed."

After confirming that each of the exceptions listed in s. 15(2) is to be construed narrowly, Justice Côté reviewed the meaning of each of the terms in s. 15(2) (at paras. 135-145), a summary that is bound to be referred to repeatedly in stay applications under provincial and territorial arbitration statutes containing this terminology going forward.

She summarized the meaning of two of the terms as described in the commentary as follows:

- "Void": where the arbitration agreement is "intrinsically defective," and therefore void *ab initio*, according to the rules of contract law, including when it is undermined by fraud, undue influence, unconscionability, duress, mistake, or misrepresentation.

- "Incapable of being performed": when the arbitral process cannot effectively be set in motion because of a physical[8] or legal impediment[9] beyond the parties' control.

It was the term "inoperative" that was most relevant to the application before the Court. Côté J. noted that in arbitration law, the term has been used to describe an arbitration agreement which, although not void *ab initio*, had ceased for some reason to have future effect or had become inapplicable to the parties and their dispute. Possible reasons for finding an arbitration agreement inoperative that she lists include frustration, discharge by breach, waiver or a subsequent agreement between the parties.

In the view of the majority, the application of the "inoperative" exception is straightforward where a party to the arbitration agreement is subject to bankruptcy or insolvency protection and is the defendant in litigation commenced in the Court. Justice Côté sets out the following propositions:

- Where the proceedings subject to the arbitration agreement are ***against*** the debtor, those proceedings are typically stayed under the applicable bankruptcy or insolvency legislation, with the result that the arbitration agreement is inoperative. However, it is up to the bankruptcy judge whether to stay the proceeding against the debtor or refer it to arbitration (on the basis that this would be the most expeditious way to prove the debtor's claim).

- Where a court-appointed creditor representative, like a receiver, initiates court proceedings on ***behalf of a debtor***, insolvency law typically allows such claims to proceed on policy grounds,[10] but again the court must assess whether to permit the receiver to proceed with the claim in court rather than through the arbitral process bargained for by the parties.

The majority held that ss. 183(1) and 243(1)(c) of the BIA give the courts statutory authority to hold that an arbitration agreement is inoperative in the receivership context and noted that parties may also resort to inherent jurisdiction in some cases, but that it was not necessary to consider that jurisdiction on these facts.

[8] Examples given include where the arbitrator specified in the agreement is not available or the chosen arbitration institution has been dissolved or has ceased to exist.
[9] An example given is where the dispute is covered by an express legislative override of the parties' right to arbitrate.
[10] Including maximizing creditor recovery and salvaging the debtor's business as a going concern.

Justice Côté provided a list of factors for a court to consider when an assertion that an arbitration agreement is "inoperative" under s. 15(2) is made due to parallel insolvency proceedings:

- The effect of arbitration on the integrity of the insolvency proceedings;
- The relative prejudice to the parties from the referral of the dispute to arbitration;
- The urgency of resolving the dispute;
- The applicability of a stay of proceedings under bankruptcy or insolvency law; and
- Any other factor the court considers material in the circumstances.

After considering these factors on the facts, the majority concluded that the receiver had established that the Arbitration Agreements were inoperative.

That conclusion, in my view, was driven primarily by the existence of multiple agreements, each with different arbitral processes, which the Court found would compromise the orderly and efficient resolution of the receivership, contrary to the objectives of the BIA.

The SCC majority made it clear that when arbitration would compromise the orderly and efficient conduct of a court-ordered receivership, a court may assert control over the proceedings, both to ensure the timely resolution of the parties' dispute and to protect the public interest in the orderly restructuring or dissolution of the debtor and the equal treatment of its creditors.

A key paragraph in the majority judgment is the following:

> [10] I stress that this result is context-specific. The unique facts of this case, which pit the public policy objectives underlying the *BIA* against freedom of contract and party autonomy, justify departing from the legislative and judicial preference for holding parties to their arbitration agreements. Contrary to conventional wisdom, however, arbitration law and insolvency law need not always exist at "polar extremes". They have much in common, including an emphasis on efficiency and expediency, procedural flexibility, and expert decision-making. These shared interests often converge through arbitration, such that granting a stay in favour of arbitration will promote the objectives of both provincial

> arbitration legislation *and* federal insolvency legislation. It is for this reason that courts should generally hold parties to their agreements to arbitrate, even if one of them has become insolvent. To do otherwise would not only threaten the important public policy served by enforcing arbitration agreements and thus Canada's position as a leader in commercial arbitration, but also jeopardize the public interest in the expeditious, efficient, and economical clean-up of the aftermath of a financial collapse.

Bottom line: While the general rule in B.C. (and elsewhere) is that court proceedings are stayed whenever the applicant for a stay makes out an arguable case that the dispute is one that the parties have previously agreed will be resolved by way of arbitration, a stay is not inevitable. The competence-competence principle is not absolute. The party seeking to avoid arbitration can prevail (in jurisdictions with provisions in arbitration statutes based on the UNCITRAL Model Law and the New York Convention) by showing on a balance of probabilities that one or more of the statutory exceptions applies (*i.e.*, that the arbitration agreement is void, inoperative or incapable of being performed).

In a dispute governed by an arbitration agreement where a party to that agreement becomes insolvent or bankrupt, there is a tension between arbitration law and insolvency law as regards the forum in which the dispute is to be resolved. While valid arbitration agreements are generally to be respected, it may be necessary in certain insolvency matters to preclude arbitration in favour of a centralized judicial process, when arbitration would compromise the orderly and efficient conduct of the insolvency proceedings. The court may have statutory jurisdiction to hold that an arbitration agreement is inoperative in a particular insolvency context (as was the case in *Peace River Hydro Partners*) or may, in other cases, resort to its inherent jurisdiction.

Other commentators have noted that this decision is fact specific; while the Court did provide the five factors listed above as a template for considering the interaction of other insolvency proceedings with an arbitration clause or clauses, given the nature of the factors, one cannot predict with any certainty when an arbitration agreement will be found inoperative in the context of parallel insolvency proceedings.

But at minimum, those who are drafting arbitration clauses, particularly where there are multiple related agreements, can mitigate the risk of the arbitration agreements in those agreements being found to be inoperative by adopting the same arbitral procedure and arbitral rules for each agreement so that the arbitration option cannot be described as inefficient or chaotic as it was in this case.

There may be other circumstances outside the insolvency context in which an arbitration agreement could be found inoperative due to the existence of a parallel, statutory form of court proceeding underpinned by policy imperatives. I will not speculate on what they might be, but will track subsequent cases to see what counsel come up with.

The Remedy of Equitable Rescission

While *Canada (Attorney General) v. Collins Family Trust*, 2022 SCC 26, is a case about tax planning mistakes, I discussed the lower court decisions in previous updates because the case is also about the equitable remedies of rescission and rectification, which are remedies that may be pursued by a contracting party outside the tax planning context.

I delved into the facts and the decision of the BCCA in a prior update.[11]

As I noted in 2020, the uncertainty that remained following the judgment in the BCCA was when equitable rescission (as opposed to rectification) would be available as a remedy for mistake and, in particular, in relation to a tax planning mistake. The BCCA held that the SCC decision in *Canada (Attorney General) v. Fairmont Hotels Inc.*[12] ("*Fairmont*") (the leading case on the remedy of rectification) did not apply where the remedy sought was equitable rescission, and followed its earlier decision in *Re Pallen Trust*[13] and the English decision in *Pitt v. Holt*.[14]

The SCC allowed the appeal. The majority held that:

- the principles that the SCC stated in *Fairmont* are irreconcilable with the conclusion in *Pitt v. Holt* (and implicitly therefore with the conclusions in *Re Pallen Trust*) that equity can relieve a tax mistake;

- there was no room for distinguishing *Fairmont* based on the remedy sought (rectification as opposed to equitable rescission); and

[11] See my 2020 update: https://www.lawsonlundell.com/assets/htmldocuments/Contract%20Law%20Update%20-%20Developments%20to%20Note%202020.pdf
[12] 2016 SCC 56. Along with the companion case out of Quebec, *Jean Coutu Group PJC) Inc. v. Canada (Attorney General),* 2016 SCC 55.
[13] 2015 BCCA 222.
[14] [2013] UKSC 26.

- the conclusion of the BCCA that equitable rescission was available to relieve a party from a tax planning mistake was contrary to principles of tax law and the prohibition against retroactive tax planning.

Ultimately, then, the SCC majority decision is specific to the context of tax planning mistakes and does not discuss the remedy of equitable rescission in other contexts (as I had hoped it might).

But the judgment of Justice Côté, in dissent,[15] does contain discussion of the differences between the remedies of rectification and rescission, and where each remedy may be appropriate, that could be useful outside the tax context.

As I discussed in my 2020 update, equitable rescission of contracts is typically granted with the limiting principles of equity in mind, *i.e.*, it may be granted in circumstances where there is fraud, undue influence or other unconscionable conduct underlying the contract and it would be unconscionable or unfair to allow the common law to operate in favour of the party who seeks to enforce the contract.

I have my eye out for instructive appellate cases on equitable rescission as a remedy in a contract case.[16]

Bottom line: Equitable rescission is no longer a potential fix for tax planning "mistakes" of the type considered in this body of law, as the SCC has held that there is nothing unconscionable or unfair in the ordinary operation of tax statutes to transactions freely agreed upon. A taxpayer is barred from resorting to equity in order to undo or alter or in any way modify a concluded transaction or its documentation to avoid a tax liability arising from the ordinary operation of a tax statute.

The interaction of the remedies of rectification and rescission in a non-tax context, and the availability of those remedies outside that context, are arguably not affected by this decision and its tax-specific context.

Contracts with Government and Fettering of Legislative Discretion

When I reviewed the SCC decision in *Resolute FP Canada Inc. v. Ontario,* 2019 SCC 60 ("*Resolute FP*") in my 2020 paper, I did not cover the discussion by the dissenting

[15] In her view, *Fairmont* did not preclude rescission in the tax planning mistake context.
[16] I will flag for you the decision of ONCA in *Urban Mechanical Contracting Ltd. v. Zurich Insurance Company Ltd.*, 2022 ONCA 589, in which the Court upheld the decision of the application judge to refer the case to trial. Two issues that will be determined at trial in that case are whether rescission can ever be granted of a surety bond where there are third parties who would be affected by such an order and in what circumstances a statutory code (in this case the *Construction Lien Act,* R.S.O. 1990, c. C. 30) extinguishes equitable remedies.

justices of why, in their view, the indemnity granted by Ontario to former owners of a pulp and paper mill did not impermissibly fetter the legislature's law-making powers, rendering it unenforceable. The majority did not address this issue.

Levy v. British Columbia (Ministry of Public Safety and Solicitor General), 2022 BCSC 356 ("*Levy v. BC*"), a recent decision authored by the Chief Justice of the B.C. Supreme Court, considers the issue of when public policy dictates that a contract with government will be unenforceable because its terms fetter law-making powers of the legislature.

This decision has prompted me to revisit the dissent in *Resolute FP* and the principles articulated therein, which are important to those acting for government and those whose clients contract with government.

As a reminder, in *Resolute FP*, the core issue was the interpretation of an indemnity clause (the "1985 Indemnity"), forming part of the settlement of litigation in which two First Nations sued owners of a pulp and paper mill (the "Dryden Mill") in relation to the mercury waste contamination of two rivers caused by the operation of that Mill. Ontario granted the 1985 Indemnity, which was a schedule to the settlement agreement. The other parties to the 1985 Indemnity were Reed Ltd. ("Reed") and Great Lakes Forest Products Limited ("Great Lakes").

The live question in the subsequent litigation was whether a successor owner of the Dryden Mill and a corporate successor to Great Lakes were entitled to recover compensation from Ontario under the 1985 Indemnity for the cost of complying with a Director's Order issued by the Ministry of the Environment in 2011 (under environmental legislation enacted subsequent to the execution of the 1985 Indemnity).

The majority of the SCC, in a short judgment, found that the motions judge made palpable and overriding errors in interpreting the scope of the 1985 Indemnity in context, which I summarized in my 2020 paper. The majority did not deal with the fettering doctrine, but it was considered in the courts below.

The motions judge held that the fettering doctrine did not apply to the 1985 Indemnity for three reasons:

- The fettering doctrine only applies to agreements that restrict legislative functions, not to business agreements. The 1985 Indemnity was a business agreement that did not restrict the Province's legislative functions;

- The Supreme Court of Ontario approved the 1985 Indemnity in an earlier related judgment approving the settlement agreement that the Province did not challenge. The Province could not engage in a collateral attack on the earlier judgment by arguing that it could not enter into the court-approved 1985 Indemnity; and

- When the Province enters into contracts it is governed by the private law of contract and should be bound by its contracts in the same way as a private person. The Province is presumed to have acted in good faith when it granted the 1985 Indemnity. Accordingly, it must have believed that it was fully enforceable and not restricted by the fettering doctrine. The Province should be held to the business agreement it entered into.

This conclusion was upheld by the ONCA, which held that there was no language in the 1985 Indemnity that purported to fetter Ontario's legislative powers and emphasized that absent legislation by which the Province relieved itself from the financial obligations it voluntarily assumed in the 1985 Indemnity, Ontario remained bound by the deal that it struck.

As outlined in my 2020 paper, the majority decision in the SCC allowed the appeal, but did so based on the application of interpretative principles and a finding that the motion judge made palpable and overriding errors of fact.

The dissenting justices in the SCC, in reasons co-authored by Côté and Brown JJ., endorsed the motion judge's interpretation, taking the opportunity to review the jurisprudence and theory underpinning what the two justices describe as the "fettering doctrine".

The portion of the dissenting judgment dealing with the fettering doctrine and its application to the 1985 Indemnity is found at paras. 111 to 131.

The key takeaways are:[17]

[17] The minority also dealt with the statement by commentators and some lower court judges that to the extent the SCC's decision in *Pacific National Investments Ltd. v. Victoria (City),* 2000 SCC 64, is irreconcilable with the Court's decision in *Wells v. Newfoundland*, [1999] 3 S.C.R. 199, the former is wrongly decided. First, Justices Côté and Brown pointed to the subsequent decision in *Pacific National Investments Ltd. v. Victoria (City),* 2004 SCC 75, where the Court unanimously rejected the argument that a finding that the City had an obligation to make restitution in the circumstances would constitute an indirect fetter on the City's legislative power. They then concluded:

> [129] Bearing all of this in mind, and to the extent that *Pacific National No. 1* can be taken as holding that the Crown will not be liable in damages for the breach of a governmental contract where that breach was caused by legislative action (or inaction), we are of the respectful view

- As a matter of constitutional law, the executive of the Canadian state cannot bind or restrict the legislature's sovereign law-making power, whether by contract or otherwise.

- Accordingly, a contract entered into by the executive that purports to require that a certain law be enacted, amended or repealed cannot be enforced by way of injunction or specific performance. This is sometimes referred to as the rule against direct fettering.

- There is an important difference between a contract that impermissibly fetters the legislature's power to enact, amend and repeal legislation, and a contract whose breach by the Crown exposes it to liability. Where the legislature exercises its law-making power in a manner inconsistent with the terms of a contact, the Crown may be subject to liability for damages for breach of contract. That obligation is an indirect fetter on legislative power but is not forbidden by the rule against fettering, but rather is required by the rule of law.

- A legislature must be free (unfettered) to exercise its law-making powers as it sees fit, within constitutional bounds. But where the legislature exercises its powers in such a way as to breach a government contract (a contract between the executive and a counterparty), the Crown is, as a general rule, liable, unless the legislature also expressly and unambiguously extinguished the counterparty's rights of action or excluded Crown liability.

These principles were reviewed and applied by Chief Justice Hinkson in *Levy v. BC*.[18]

In that case, the plaintiff was rendered quadriplegic as a result of an assault. He was granted benefits for his injuries under the *Crime Victim Assistance Act,* S.B.C. 2001, c. 38 (and related Regulations) through the Crime Victims Assistant Plan ("CVAP"), which was administered by the Ministry of Public Safety and Solicitor General. CVAP benefits included money for personal care, income support, caregivers and medical supplies and aids.

The plaintiff retained counsel and commenced a civil action against his assailants and others to recover damages. CVAP was kept informed of steps in the litigation (given

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that it does not state the law as it relates to the fettering doctrine. On this point, we consider ourselves bound by *Wells*, and not *Pacific National No. 1*.

[18] Note that the Province first applied to strike Mr. Levy's claim as disclosing no reasonable cause of action and as an abuse of process. The BCCA upheld the dismissal of the Province's application and in doing so discussed the anti-fettering doctrine, agreeing with the chambers judge that the authorities on this issue were not sufficiently settled: 2018 BCCA 36.

its rights to an assignment of amounts payable under a judgment or settlement under the legislation) and the director of CVAP was present at the mediation that ensued and resulted in a settlement. Under the settlement, CVAP was repaid its funding of the plaintiff's expenses to date and the plaintiff received a lump sum payment of $2.1 million. A clause in the settlement provided that CVAP would continue funding the plaintiff's care without seeking repayment. The release executed specifically set out that the Province was releasing and waiving "any and all interest that [CVAP] has, or may have, in excess of $312,000…Michael Levy is to receive or has received in accordance with the terms of the Settlement."

When CVAP refused to pay certain types of costs for his care needs (including the amounts for services he required to live independently from his mother), the plaintiff commenced a suit against the Province, alleging that as result of the mediation, the Province entered into a contract with him for continuing CVAP benefits, without recourse to any settlement funds, and that the Province was in breach of that contract.[19]

One of the arguments made by the Province was that the contract asserted by the plaintiff was unenforceable because its terms fettered the Director's powers under the Act. It submitted that the interpretation advanced by the plaintiff required the CVAP to fund benefits without applying the legislation, which contains provisions requiring the director to take into account amounts received by a victim of crime by way of, *inter alia*, judgment or settlement, and that it would improperly require the CVAP to contract out of the legislation contrary to the public interest. The Province alleged that an agreement precluding the Director from considering the plaintiff's receipt of settlement funds would be an impermissible fetter on the Director's discretion in relation to an award of benefits under the Act.

Chief Justice Hinkson cited with favour a passage in *Government Liability: Law and Practice*,[20] in which the authors summarize the interpretative approach that courts take to potential conflicts between the contractual and public powers of the Crown in the following propositions:

> On the basis of these cases, it is possible to see how the courts attempt to avoid a conflict between contractual and public powers of the Crown. At the first stage, there is a presumption that the contract does not promise anything interfering with public power. If, notwithstanding that presumption, it is found that there is a genuine contractual right to a

[19] The plaintiff also pleaded unjust enrichment and negligent misrepresentation in the alternative.
[20] Karen Horsman and Gareth Morley, *Government Liability: Law and Practice*, looseleaf ed. (Aurora: Canada Law Book, 2007--) at §3.22 (the decision in *Levy v. BC* cites to 2.30.10(10), but this exact quote is now at§3.22).

> certain public result, then the public power will be interpreted, to the extent possible, as consistent with the contractual right. Only if there is no way of reconciling the two will a conflict be recognized: if it is, then the contractual right gives way, subject to a right of compensation if that can be reconciled with the statute.

After reviewing the jurisprudence and commentary, including the dissent in *Resolute FP*, Chief Justice Hinkson concluded as follows:

> 95 Guided by the reasoning of Côté, Brown, and Rowe JJ. in *Resolute*, I have concluded that there is an important difference between a contract that impermissibly *fetters* the legislature's power to enact, amend, and repeal legislation, and a contract, such as that alleged by the plaintiff in this case, whose breach by the Crown exposes it to *liability*. This is the so-called "indirect fetter" discussed in *Resolute* above, whereby the Province is not thereby truly fettered.
>
> 96 […] I find that here, the defendant entered into an agreement with the plaintiff, and its obligations were therefore no longer governed only by statute.

Bottom line: It is uncontroversial that a contractual promise by the Crown that legislation will or will not be passed in the future or that executive action will or will not be taken is unenforceable as contravening the fettering doctrine.

But whether or not the Crown will be liable in damages when legislation or executive action is inconsistent with a contractual promise made by the Crown is a different question.

In light of the dissent in *Resolute FP* and the adoption of the reasoning of the dissenting judges by Chief Justice Hinkson in *Levy v. BC*, it is arguable that there is no bar (at least in B.C.) to the Crown agreeing to so-called indirect fetters by agreeing to pay damages in the event of future legislative or other public law actions (such as by way of an indemnity). The authors of *Government Liability: Law and Practice*[21] suggest that there should an interpretative rule to the effect that the Crown does not intend to promise to pay compensation absent clear language to that effect (in part as a means of reconciling *dicta* from some lower courts), but do not reject the proposition that liability could be imposed by such clear language.

[21] *Ibid,* at §3.6.

Outside of a context where the Crown agrees to payment of compensation (such as by way of an indemnity or settlement agreement), will it be liable for damages when legislative or executive actions are inconsistent with a contractual obligation of the Crown? Can we extrapolate from the 1999 SCC decision in *Wells v. Newfoundland*[22] (despite its specific context of the contractual relationship between the Crown and senior civil servants)? Such a consequence could be contrary to any presumption that only by clear contractual language can the Crown bind itself to pay compensation (if indeed such a presumption exists).

In the views of some commentators[23] (and apparently the minority in *Resolute FP*), the answer to the questions posed in the preceding paragraph is "yes" (subject to the Crown's ability to expressly bar recovery of damages by way of subsequent legislation). It would be helpful to have an SCC majority decision on point; in the meantime, I will track lower court decisions like *Levy v. BC* and how appellate courts in other provinces and territories deal with the issue.

Boilerplate and Other Commonplace Clauses

In an ideal world, at least from the perspective of contracting parties and those who draft contracts, boilerplate or commonly used clauses would have a definitive, ascertainable meaning.

However, all contractual provisions, including boilerplate, are subject to the principles of contract interpretation enunciated by the SCC. Therefore, they must be interpreted in the context of the given contract (or suite of related contracts) and in the context of the underlying factual matrix. This reality can make it difficult to give clients advice on how a particular clause will be interpreted by a court, particularly in the abstract.

But there are principles set out in the case law that inform the potential range of meanings of a given boilerplate or commonly used clause; these principles provide some degree of certainty in terms of how a court will interpret the clause. Knowledge of those principles in relation to a particular type of clause allows solicitors to modify or expand upon standard language to make it more likely that the clause will serve their client's objectives.

In addressing this year's categories of clauses, I will focus on the specific interpretative principles applied to those clauses in cases considering them.

[22] [1999] 3 S.C.R. 199.
[23] See, for example, Peter W. Hogg, *et al.*, *Liability of the Crown*, 4th ed. (Scarborough: Carswell, 2011) at 331.

Best Efforts Clauses and Their Many Variants

Parties to commercial agreements frequently include clauses that require a party to use "best efforts" or some other described degree of effort to fulfill a condition or other obligation. Part of the challenge for commentators seeking to rationalize the case law interpreting these clauses is the variation in the language chosen to impose the obligation to make "efforts".

I last wrote about this topic in 2011.

Given the litigation that such clauses have spawned in the intervening decade, the BCCA decision in *Sutter Hill Management Corporation v. Mpire Capital Corporation*, 2022 BCCA 13, ("*Sutter Hill*")[24] has prompted me to finally revisit this topic.

Some commentators focus on the case law considering two versions of such a clause: one requiring best efforts and one requiring commercially reasonable efforts.[25]

Atmospheric Diving Systems Inc. v. International Hard Suits Inc. (1994), 89 B.C.L.R. (2d) 356 (S.C.) is still the most cited case on clauses requiring "best efforts." Madam Justice Dorgan distilled the following principles from prior cases:

1. "Best efforts" imposes a higher obligation than a "reasonable effort".

2. "Best efforts" means taking, in good faith, all reasonable steps to achieve the objective, carrying the process to its logical conclusion and leaving no stone unturned.

3. "Best efforts" includes doing everything known to be usual, necessary and proper for ensuring the success of the endeavour.

4. The meaning of "best efforts" is, however, not boundless. It must be approached in the light of the particular contract, the parties to it and the contract's overall purpose as reflected in its language.

5. While "best efforts" of the defendant must be subject to such overriding obligations as honesty and fair dealing, it is not necessary for the plaintiff to prove that the defendant acted in bad faith.

6. Evidence of "inevitable failure" is relevant to the issue of causation of damage but not to the issue of liability. The onus to show that failure was

[24] Leave to appeal ref'd 2022 CanLII 78993 (S.C.C.).
[25] For example, Geoff R. Hall, *Canadian Contractual Interpretation Law*, 4th ed. (Toronto: LexisNexis Canada, 2020) at §§9.3 and 9.5.

inevitable regardless of whether the defendant made "best efforts" rests on the defendant.

7. Evidence that the defendant, had it acted diligently, could have satisfied the "best efforts"" test is relevant evidence that the defendant did not use its best efforts.

Geoff Hall, in the most recent edition of his text,[26] adds two further principles:

1. A "best efforts" clause is to be measured by an objective rather than a subjective standard.

2. Where a government actor is subject to a "best efforts" obligation, the public interest can serve to limit the obligation: the governmental entity must place the public interest first even if doing so impairs the "best efforts" it can use to fulfill its contractual obligation.

The case most often cited for its discussion of what constitute "commercially reasonable efforts", is still *364511 Ontario Ltd. v. Darena Holdings Ltd*.,1999 CanLII 2422 (Ont. C.A.).

This decision and subsequent cases applying it confirm the following:

1. "Commercially reasonable efforts"[27] is a lower standard than "best efforts".

2. This standard allows the party with the performance obligation to take into account its economic position and viability when deciding where to draw the line in terms of efforts to satisfy the underlying obligation.

3. The more relaxed standard does not mean that the obligated party can elect whether to perform or not. That party also may not, through its own actions, create a situation where it is impossible for it to perform.

Of course, principles of contract interpretation that require the interpreter to consider the clause in the context of the particular agreement as a whole and the surrounding circumstances mean that decision on what any version of such a clause means is not

[26] *Ibid* at §9.3.1.
[27] Sometimes framed as "reasonable commercial efforts". It is also sometimes framed as "all reasonable commercial efforts." In *Nelson v. 53945 British Columbia Ltd*., 2007 BCSC 1544, Mr. Justice Ehrcke rejected the proposition that the word "all" elevated the standard. *Quaere* whether that ruling has been put in doubt by the analysis of the BCCA in *Sutter Hill.* In *0997723 B.C. Ltd. v Lee*, 2022 BCSC 2066, Mr. Justice Skolrood did not appear to view that to be the case.

truly precedential but at least can provide guidance, a point emphasized by the BCCA in *Sutter Hill*.

Sutter Hill addressed a chimera brought into being by contract drafters: a clause requiring "commercially reasonable best efforts" to satisfy a condition precedent "as soon as possible".[28]

The contract in question in this case was an agreement for the purchase and sale of a care home in Abbotsford, BC. The agreement was made subject to a condition precedent of the Purchaser applying for and obtaining from the Fraser Health Authority ("FHA") approval for the transfer to the Purchaser of all relevant licences and related funding agreements.

Under Article 2.5, the Purchaser was obligated to "use commercially reasonable best efforts to satisfy the condition precedent set out in this Section 2.5 as soon as possible".

The trial judge found that the phrase "commercially reasonable best efforts" appeared to be a "victim of overdrafting". He stated that he was unable to construct an interpretation of the "commercially reasonable best efforts" standard that incorporated the meanings of both "best" and "reasonable". He concluded that the word "reasonable" had to be given more significance than the word "best" and that, ultimately, the word "best" did not add anything to the phrase "commercially reasonable efforts". He then applied the law that explained that standard.

The trial judge did two things that were found to be in error by the Court of Appeal:

1. He divided up the parts of the clause ("commercially reasonable best efforts" and "as soon as possible") and interpreted them separately, rather than looking at the clause as a whole in light of the surrounding circumstances; and

2. He focussed on what was said about similar wording in case law and dictionary definitions rather than focussing on what the parties must have intended by the wording chosen (including their merger of "commercially reasonable" and "best efforts", which the trial judge put down to overdrafting).

BCCA situates the wording in *Sutter Hill* on a continuum between "best efforts" and "commercially reasonable efforts" and states:

[28] Other variants include commercial best efforts, all reasonable commercial efforts, and reasonable best efforts.

> [34] With respect, the judge was required to consider what the parties intended by taking into account *all* of the words ("best" as well as "commercially reasonable", and including "as soon as possible". […]
>
> [37] If, as the judge appears to have concluded, the parties intended the requirement in the condition precedent to mean the same as "commercially reasonable efforts", why would they not have said so? Why would they add the word "best", and the term "as soon as possible"? With respect, putting that down to "overdrafting" sidesteps the process of determining the intent of the parties and the scope of their understanding by looking at the contract as a whole, and giving all of the words their ordinary grammatical meaning consistent with the surrounding circumstances.

After listing the relevant surrounding circumstances, the Court concludes:

> [39] These surrounding circumstances support the conclusion that the parties were concerned that FHA approval be obtained *as soon as possible*, always bearing in mind that neither party could control how fast the FHA moved. What they could control was how fast *they* moved, and accordingly they set a standard for the degree of effort that included not only "commercially reasonable", but also "best", and "as soon as possible".
>
> [40] As the judge observed at para 56, "commercial effort is usually about making choices based on sound judgment". But given the surrounding circumstances, and the addition of the words "as soon as possible", the judge's conclusion that "best" does not add anything significant to the phrase, with respect, misses what the parties intended by the words they chose to use. That, in my view, would be something between "commercially reasonable efforts", meaning those efforts that would appear to be reasonable from a commercial perspective, and "best efforts" which, as the judge noted, would generally be taken to mean leaving no stone unturned (see, for instance, *Atmospheric Diving Systems Inc v International Hard Suits Inc* (1994), 89 B.C.L.R. (2d) 356 at para 71), always bearing in mind the parties' clear intention that the approval be obtained "as soon as possible".
>
> [41] Looking at the contract as a whole, and considering the surrounding circumstances, I conclude that by the condition precedent, the parties intended that the purchaser would do everything it reasonably could to

> obtain the necessary approvals as soon as possible, excepting only such steps as would be commercially unreasonable. If there was delay on the part of FHA, so be it. But there should be no delay on the part of either party.

Thus, there remains a notion of a hierarchy of standards that parties can impose by their choice of wording in Canadian law, and also a recognition, at least under B.C. law, that there can be variations that exist within the hierarchy between a "best efforts" standard and a "commercially reasonable efforts" standard.

Based on my selected reading of U.K. decisions, courts in that jurisdiction recognize a hierarchy of standards but do not necessarily agree as to the list of standards and where they fit on the hierarchy. Some decisions take the view that the wording "best endeavours" imposes the same standard as "all reasonable endeavours" (with "reasonable endeavours" being a lower standard), others have expressed doubt that those first two standards are equivalent. Whether a "best endeavours" standard requires a party to subordinate, if necessary, its own commercial and financial interests (and leave no stone unturned) also appears to be unsettled, or at least dependent on the facts of the particular case.

According to recent articles by U.S. commentators,[29] while U.S. practitioners widely believe that there is a hierarchy of standards (with "best efforts" at its apex), U.S. courts have found that there is no meaningful distinction among the various efforts standards used in commercial agreements.

Bottom line: If the agreement is governed by Canadian common law, you and your client will have some certainty as to the standard of conduct being imposed by a "best efforts" clause or "commercially reasonable efforts" clause. You now also have some guidance on the standard imposed by the phrase "commercially reasonable best efforts" (at least when modified by "as soon as possible").

To achieve more certainty, especially given that the interpretation of efforts clauses will still be contextual, elaborate on the effort required in terms of specific tasks or achievements, including time frames where appropriate.

[29] I commend to you the following two articles, which review the U.S. law and contrast it with some Canadian and U.K. law: Charles Thau, "Is This Really the Best We Can Do? American Courts' Irrational Efforts Clause Jurisprudence and How We Can Start to Fix It" (2021) 109:3 Geo. L.J. 665; Kenneth A. Adams, "Interpreting and Drafting Efforts Provisions: From Unreason to Reason" (2019) 74:3 Bus. Law. 677.

Avoid the temptation of crafting a new standard that has not been judicially considered unless commercial uncertainty is your aim (or unless you include indicia in the agreement that make it indisputable what the standard requires).

Do not assume that the versions of efforts clauses commonly used have the same meanings in jurisdictions outside common law Canada and do not assume that other jurisdictions accept the idea of a hierarchy of standards.

Interim Operating/Ordinary Course Covenants

In the context of merger and acquisition ("M&A") transactions, it is commonplace for the contract of purchase and sale (or arrangement agreement) to include a covenant requiring the seller to operate the business in the "ordinary course" in the time frame between execution of the agreement and closing.

I will refer to these covenants as "ordinary course covenants" (they are also referred to as interim operating covenants in the case law).

It is arguable that ordinary course covenants are not true boilerplate in that they are drafted to take into account the nature of the business underlying the relevant transaction, may (or may not) include definitions of "ordinary course," and may expressly deem particular conduct or operations as not being in the ordinary course.

But on the other hand, such covenants may be copied from a precedent without significant or any transaction-specific redrafting and as such can have the characteristics (including flaws) of boilerplate.

Three cases recently decided by trial courts shed some light on the interpretative approach to such clauses:

- *Fairstone Financial Holdings Inc. v. Duo Bank of Canada*, 2020 ONSC 7397 ("*Fairstone*")
- *Cineplex Inc. v. Cineworld Group PLC*, 2021 ONSC 8016 ("*Cineplex*")
- *Chemtrade Electrochem Inc. v. Superior Plus Corporation*, 2022 ABKB 858 ("*Chemtrade*")

I am not going to review the facts in each of these cases in detail. Each involved an M&A transaction and an agreement containing an ordinary course covenant.

In what follows, I will use the term "acquirer" and "target" generically (rather than buyer and seller).

In *Fairstone* and *Cineplex*, the alleged breach of the ordinary course covenant arose from the target's actions in response to the COVID-19 pandemic. In both those cases, the acquirer relied on a material adverse effects clause ("MAE clause"), in addition to the ordinary course covenant, as the basis for terminating the agreement. I will not address that aspect of the decisions; the MAE clause in both cases was found inapplicable due to an express carve-out.[30] I will address the extent to which the MAE clause informed interpretation of the ordinary course covenant.

In *Chemtrade,* the alleged breach of the ordinary course covenant was the issuance by the target of what the Court describes as the "March Grant", in which it granted Deferred Share Units and Performance Share Units to its employees and executives pursuant to its established long-term incentive plan ("LTIP") in March 2016.

I have included, in an appendix, the text of the ordinary course covenant (and the definition of Ordinary Course) from the agreements in each of the three cases.

The purpose of ordinary course covenants in the M&A context has been described as serving two fundamental purposes:[31]

- To ensure that the business the acquirer bargained for at closing is essentially the same as the one it decided to buy when signing the agreement of purchase and sale; and

- To eliminate or mitigate the "moral hazard" of targets acting in their own interest to the detriment of the acquirer during the interim period.

Each of the decisions confirms that ordinary principles of contract interpretation apply to ordinary course covenants: most importantly, such covenants must be interpreted in the context of the agreement as a whole and with regard to the surrounding circumstances underlying the ultimate execution of the agreement.

In each of the cases, the conduct of the target was found to have been carried out "in the ordinary course," with the result that the covenant was not breached.

Fairstone

In *Fairstone*, the acquirer alleged breach of four covenants by the target that allowed it to avoid closing, including an MAE covenant and an ordinary course covenant.

[30] See Paul Blyschak, "Material Adverse Effect (MAE) Clauses in Canada: What U.S. Counsel Needs to Know" (2022) 16:2 Va. L. & Bus. Rev. 327 for a recent discussion of these clauses.
[31] *Cineplex* at para. 109; *Fairstone* at para. 167.

The target was Canada's largest consumer finance company that served near-prime borrowers. The acquirer was a privately owned Schedule I Canadian bank.

Justice Koehnen held that the adverse effect on the target's business arose from the pandemic and that the pandemic fell within the phrase "worldwide, national, provincial or local emergencies," which was an express carve-out from the definition of "material adverse effect," such that the MAE covenant did not apply.

On moving to the ordinary course covenant, he noted that the expression "ordinary course" arises in different legal contexts, including insolvency legislation, improper preferences and business agreements and that the context may influence the meaning of the phrase.

His reasons contain a helpful review of the use of the term "ordinary course" in multiple legal contexts, including in insolvency legislation, the law of preferences and M&A agreements. He concluded that whether a transaction is in the ordinary course of business is to be determined from the acquirer's perspective.

While acknowledging that there are variations in ordinary course covenants and that they must be interpreted in context, Justice Koehen laid out some general principles:

- The acquirer of a business accepts systemic economic risks associated with the ownership of a business, such as economic contractions and the detrimental effect they have on a business (subject to the overlay of MAE clauses).

- In the absence of specific language that protects an acquirer against economic slowdowns, the acquirer would generally be seen as accepting the risk of such slowdowns between contract execution and closing.

- When economic changes such as recessions occur, the concept of ordinary course is interpreted by comparing what the business has done in similar economic circumstances to what it is doing in the present or by comparing what the business is doing in response to what other businesses are doing. The magnitude and duration of the changes are relevant since they will inform the appropriateness of the response.

- If the business takes prudent steps in response to an economic contraction, and the steps have no long-lasting effects and impose no obligations on the acquirer, it should not be seen as operating outside the ordinary course.

- But where the target is responding to economic circumstances that are not broadly systemic, but rather are more specific to it, it is less likely that the conduct will be held to fall within the ordinary course.

He then listed 13 factors gleaned from the case law, noting that not all will be relevant in a given case and that their relative importance will also be contextual:[32]

1. Does the conduct render the nature of the business different at closing than it was at the time of signing?
2. Does the conduct give rise to moral hazard concerns?
3. Was the conduct arm's length in nature?
4. Is the conduct part of the usual, habitual flow of the business or was it unusual?
5. If the conduct was unusual, was it ordinary in light of the circumstances the business was facing?
6. Were those circumstances systemic or specific to the company?
7. How does the conduct compare to standards in the industry?
8. What was the intent behind or reason for the conduct?
9. Was the conduct pursued in good faith for the purpose of continuing the business?
10. Does the conduct defeat the legitimate interests of a creditor or other interested party?
11. Would the conduct surprise a reasonable businessperson?
12. What was the magnitude and duration of the conduct? Does it have a long-term impact?
13. Are there equities that should weigh in favour of the purchaser?

Justice Koehnen rejected the acquirer's position that nothing done in response to the pandemic could be in the ordinary course because the pandemic was an extraordinary event. This interpretation, said Koehnen J., would effectively make the

[32] At para. 182.

pandemic a reason for not closing, even though emergencies in the nature of the pandemic were excluded from the definition of MAE.

The operating covenant required not only that the target's conduct be in the ordinary course in the sense of being taken in the course of day-to-day operations, but also had to be "consistent with past practices".

The Court held that by taking steps to reduce expenditures and tighten lending requirements, the target's response to the pandemic was consistent with past practices.

The changes to the target's business model that the acquirer complained of included temporary branch closures, implementation of a time-limited loan deferment program, staffing decreases, decreases in expenditures, and a changes to accounting practices.

The Court held that the nature of the target's business remained the same at closing as it did at the time of signing. None of the changes complained about led to any fundamental modification of the business and none involved the assumption of longer-term obligations with which the acquirer would be saddled.

While some of the measures taken involved the target doing business differently than it did before the pandemic, there was no evidence that it was acting differently from other participants in the industry. The conduct was pursued in good faith for the purpose of continuing the business and to respond to systemic challenges that the pandemic posed for the entire economy.[33]

Finally, the Court considered the wording of the operating covenant that permitted the target to operate outside the ordinary course if it had the prior written consent of the acquirer (not to be unreasonably withheld). The target did not seek consent because it took the position that it was operating within the ordinary course. The Court held that to the extent any steps the target took were outside the ordinary course of business, the acquirer would have been unreasonable to withhold consent. The steps at issue were not particularly complex, were often mandated by government regulation, were common to those that businesses around the world had taken, were of short to midterm duration and were likely similar to steps the acquirer itself had taken in the face of the pandemic.

[33] The operating covenant was made a closing condition, and another provision required that such covenants be performed by the target "in all material respects." Justice Koehnen stated that if he was wrong, and the target did operate outside the ordinary course, none of its conduct breached the ordinary course covenant in a material respect.

Cineplex

In *Cineplex*, the ordinary course covenant[34] had two components. The first required the target to "conduct its business in the Ordinary Course and in accordance with Laws." The second required the target to "use commercially reasonable efforts to maintain and preserve its and its Subsidiaries' business organization, assets, properties, employees, goodwill and business relationships with customers, suppliers, partners and other Persons with which the Company".

The conduct that the acquirer complained of was:

- Deferral of payments to suppliers, film studios and landlords; and
- Reduced capital expenditures during the period between signature and closing.

Extensive evidence was led (the trial was conducted over twenty days) by the target as to the steps it took in response to the pandemic and its rationales for taking the steps and by the acquirer as to the steps it took towards closing, including seeking the required regulatory approvals and its motivations and reasoning in ultimately delivering a notice to terminate based on alleged breaches of covenants by the target.

Justice Conway rejected the acquirer's argument as to how the MAE clause and ordinary course covenant interacted. Having already found that the MAE excluded a pandemic from the definition of what constituted a MAE, he rejected the position of the acquirer that the target had to operate during the pandemic exactly as it did in non-pandemic times. The parties had allocated the systemic risk of a pandemic to the acquirer by way of the exclusion from the MAE clause; it would not be a harmonious reading of the agreement as a whole if the ordinary course covenant was read as effectively reallocating that risk to the target.

He then held:

- That the target could not be held in default of the first component of the ordinary course covenant when it was prevented from conducting its normal day-to-day operations by government mandate (referring to the closure of theatres for a period of time).

[34] Note that the acquirer alleged breaches of other covenants; the trial judge also found against it on those argument.

- That the deferral and spending reductions undertaken by the target to conserve its liquidity were commercially reasonable efforts to maintain and preserve the business once the theatres were closed, consistent with the second component of the ordinary course covenant.

The outcome (that the target did not breach the ordinary course covenant) is clearly dependent both on the wording of the ordinary course covenant in question and the facts. Nevertheless, Justice Conway outlined some general principles as follows:

> [110] The concept of what is in the ordinary course of business for a particular business is a flexible and contextual one and is a question of mixed fact and law [citations omitted]. In the mergers and acquisitions context, the cases have considered whether a buyer can be relieved from completing a transaction where the seller operated outside of the ordinary course. The court's analysis tends to be fact specific.
>
> [111] In general terms, buyers have been excused from closing a transaction where the seller's actions significantly change the nature of the business or have a long-lasting impact that would affect the buyer in operating the business after closing [citation omitted].

Chemtrade

In *Chemtrade*, both parties purported to terminate the agreement, with the target then suing the acquirer and the acquirer making a counterclaim within that action. One of the arguments of the acquirer was that the target's issuance of the March Grant was not in the ordinary course because, had the transaction closed as expected in June 2016, the target's management and employees would have received three year's worth of LTIP compensation for just over three months of work, which the acquirer described as an unjustified windfall.

The Court considered each of the key phrases in the definition of "Ordinary Course" in the agreement: consistent with past practice; commercially reasonable in the circumstances; and taken in the ordinary course of day-to-day operations of the business.

There was evidence, including expert evidence, that the March Grant was consistent with the target's past practices (and this element was conceded by the acquirer).

On the second element, the target led evidence that the March Grant was issued after much thought and effort of the human resources committee of its Board and following careful consideration and unanimous approval by the Board. Justice Price

stated that "as with the business judgment rule, an assessment of commercial reasonableness does not demand perfection, but provides for latitude."[35] In her view, courts are ill-suited to second-guess the application of business expertise to corporate decision making, should be reluctant to do so and should afford deference to the decisions of directors.

On the third element, she found that the March Grant formed a routine part of the target's employees' compensation and that compensating employees clearly fell within the target's obligation to maintain its day-to-day operations.

Bottom line: Where an M&A agreement contains both an MAE clause and an operating covenant, courts will not interpret their interaction so that the acquirer can reallocate risk it assumed by way of a carve-out from the MAE clause to the target by way of the operating covenant.

Ordinary course covenants (and the definition of "ordinary course") will vary from deal to deal[36] and their interpretation is necessarily contextual. But in general terms, acquirers have been excused from closing a transaction where the target's actions significantly change the nature of the business or have a long-lasting impact that would affect the acquirer in operating the business after closing.

Parties litigating an alleged breach of an ordinary course covenant should have regard to the 13 factors listed in Justice Koehnen's decision in *Fairstone.*

Inter alia, should the matter proceed to litigation, target companies will be well served by leading evidence that the conduct that the acquirer is complaining of is consistent with past practices (even if the definition of "ordinary course" does not explicitly refer to consistency with past practices) and consistent with what other industry members have done in response to a particular event, such as a recession.

Conversely, it will be to the advantage of an acquirer who is seeking to rely on an ordinary course covenant as the basis for not closing to lead evidence (to the extent that it is available) to establish that the event (such as a economic downturn) that the target was responding to was specific to it, rather than the industry as a whole.

A target's responses to an extraordinary event, like the COVID-19 pandemic, are not automatically outside of the ordinary course just because the event itself is.

[35] At para. 104.
[36] As evidenced by the examples from the three cases I discuss, which are set out in Appendix A.

Update on the Doctrine of Good Faith in Contract Law

Since the SCC decision in *Bhasin v. Hrynew*,[37] I have tracked the developing common law on duties of good faith in contract in these annual updates.

This year I have little to report. While there are numerous cases in which such a duty was raised by a party in 2022, the cases all involved application of (or arguments based on) the principles already articulated in the trilogy of SCC decisions (*Bhasin v. Hrynew*; C.*M Callow Inc. v. Zollinger*;[38] and *Wastech Services Ltd. v. Greater Vancouver Sewerage and Drainage District.*[39]

It is worth noting one appellate decision, *Potash Corporation of Saskatchewan Inc. v. HB Construction Company Ltd.*, 2022 NBCA 39, which dealt with two related actions arising from a construction dispute.

In the non-lien action brought by the general contractor ("Comstock"), the trial judge found that the contract administrator ("AMEC")[40] breached its "duty of good faith as contract administrator" by failing to conduct an independent evaluation of Comstock's compliance with its contract prior to issuing a Notice of Default. The trial judge ultimately dismissed Comstock's claim against AMEC on causation and evidentiary grounds, but awarded damages against Potash Corporation of Saskatchewan Inc. ("PCS").

Comstock appealed and revisited the basis of its claims against AMEC, including an alleged basis in the doctrine of good faith. There was no contractual relationship between Comstock and AMEC, both of whom had contracts with PCS. Accordingly, the claim had to sound in tort or be based on an extension of duties of good faith in contract to extra-contractual parties.

The New Brunswick Court of Appeal ("NBCA") found that any duties owed by AMEC in contract were due to the owner, PCS, alone. While the engineer could create liability for its client for a failure to act fairly and impartially when exercising its decision-making function under construction contracts, in the typical construction project framework, it would have no contractual liability to the general contractor.

Justice LeBlond stated at paragraph 163 that "[t]here is no juristic reason to extend the contractual duty of good faith" to extra-contractual parties, noting that the duty's

[37] 2014 SCC 71.
[38] 2020 SCC 45.
[39] 2021 SCC 7.
[40] The entity retained to provide engineering, procurement, design and construction management for the project.

animating principle is focused on good faith performance of contracts, not the creation of a generalized duty of good behaviour. He says that Comstock was effectively asking the Court to recognize a new duty of good faith that ignored privity of contract.

The only way that Comstock, then, could establish a "bad faith claim" against AMEC was via tort. But while the pleadings alleged professional negligence, no evidence had been led at trial as to the standard of care of engineers in the relevant factual context. Other torts, including inducing breach of contract, were rejected on the facts.

Bottom line: Allegations of a breaches of duties of good faith in contract law are often made by litigants. To date, the vast majority of these allegations have been analyzed by lower courts pursuant to the guidance given in the SCC trilogy and involve either an allegation of the breach of the duty of honesty in contractual performance or a breach of the duty to exercise contractual discretion in good faith.

However, counsel do try, from time to time, to expand on the existing duties, given that the SCC did articulate an organizing principle in *Bhasin v. Hrynew* under which duties consistent with the existing law might be developed.

As the NBCA made plain in *Potash Corporation of Saskatchewan Inc. v. HB Construction Company Ltd*., any such duty has to be rooted in a contractual relationship as the SCC trilogy of cases is about duties of good faith in contract law. If there is no contractual relationship, a plaintiff will have to root a claim based on bad faith behaviour in a known tort or some other cause of action. The contractual duty of good faith is not an independently actionable tort and there is no tort of "bad faith".

APPENDIX A – RELEVANT PROVISIONS IN CASES DEALING WITH OPERATING COVENANTS

Fairstone

Section 5.1 of the Share Purchase Agreement required the target to operate the business in the ordinary course between the date the Agreement was signed and the date of closing. More specifically, it provided:

> Except as expressly provided in this Agreement or the Disclosure Letter (including in Schedule 5.1 of the Disclosure Letter) or with the prior written consent of Purchaser, which consent shall not be unreasonably withheld, and to the extent lawfully able to do so, the Principal Sellers shall cause the Acquired Companies to, and the Acquired Companies shall, during the Interim Period, conduct their respective Businesses (as applicable) in the Ordinary Course and, without limiting the generality of the foregoing, the Principal Sellers shall cause each Acquired Company not to:

This provision was followed by a list of 23 specific prohibitions describing steps that the target could not take without the acquirer's consent.

"Ordinary Course" was defined in section 1.1 (mmm) as:

> (mmm) "Ordinary Course" means with respect to an action taken by a Person, that such action is consistent with the past practices of the Person and is taken in the ordinary course of the normal day-to-day operations of the Person.

Cineplex

Section 4 of the Arrangement Agreement contained various covenants restricting the manner in which Cineplex could operate the business during the period between the date of the agreement and closing (the "**Interim Period**").

The Operating Covenant in s. 4.1(1) read as follows:

> The Company covenants and agrees that, during the period from the date of this Agreement until the earlier of the Effective Time and the time that this Agreement is terminated in accordance with its terms, except:

> (i) with the prior written consent of the Purchaser, such consent not to be unreasonably withheld, delayed or conditioned; (ii) as required or contemplated by this Agreement or as expressly set out in the Company Disclosure Letter; or (iii) as required by Law, the Company shall, and shall cause each of its Subsidiaries to, conduct its business in the Ordinary Course and in accordance with Laws, and the Company shall, in good faith, use commercially reasonable efforts to maintain and preserve its and its Subsidiaries business organization, assets, properties, employees, goodwill and business relationships with customers, suppliers, partners and other Persons with which the Company or any of its Subsidiaries has material business relations.

"Ordinary Course" was defined in s. 1.1 to mean actions "taken in the ordinary course of the normal day-to-day operations of the business of the Company…consistent with past practice."

Section 4.1(2) listed, without limiting the generality of the Operating Covenant, 30 specific actions that the target agreed not to take in the Interim Period.

Chemtrade

Section 4.1(1) of the Agreement stated:

> The Company covenants and agrees that, during the period from the date of this Agreement until the earlier of the Effective Time and the time that this Agreement is terminated in accordance with its terms, unless otherwise agreed to in writing by the Purchaser, in its sole and absolute discretion, the Company shall, and shall cause each of its Subsidiaries to, conduct its business in the Ordinary Course, in a proper and prudent manner and in accordance with good chemical industry practice and Laws, and the Company shall use commercially reasonable efforts to maintain and preserve its and its Subsidiaries' business organization, assets (including, for greater certainty, the Company Assets), properties, employees, goodwill and business relationships with customers, suppliers, distributors, licensors, partners and other Persons with which the Company or any of its Subsidiaries has business relations and to perform and comply with all of its obligations under the Material Contracts.

"Ordinary Course", was defined as follows in the Agreement:

[w]ith respect to an action taken by the Company or the Purchaser, as applicable, that such action is consistent with the past practices of the Company or the Purchaser, as applicable, is commercially reasonable in the circumstances and is taken in the ordinary course of the normal day-to-day operations of the business of the Company or the Purchaser, as applicable.

APPENDIX B – CHART OF TOPICS COVERED IN PRIOR YEARS

HEADINGS	2021	202	2019	2018	2017	2016	2015	2014	2013
Links to Contract Law Paper by Year	https://www.lawsonlundell.com/assets/htmldocuments/2021%20Contract%20Law%20Update%20Updated%20to%20March%2012%202022.pdf	https://www.lawsonlundell.com/assets/htmldocuments/Contract%20Law%20Update%20-%20Developments%20to%20Note%202020.pdf	https://www.lawsonlundell.com/assets/htmldocuments/Contract%20Law%20Update%20-%20Developments%20of%20Note%202019.pdf	https://www.lawsonlundell.com/assets/htmldocuments/Contract%20Law%20Update%20May%2024%202019.pdf	https://www.lawsonlundell.com/assets/htmldocuments/2017%20Contract%20Law%20Update.pdf	http://www.lawsonlundell.com/media/news/550_Lisa%20Peters%20Contract%20Law%20Update%20November%2015%202016%20Final.pdf	http://www.lawsonlundell.com/media/news/502_Contract%20Law%20Update%202015%20_final_.pdf	https://www.lawsonlundell.com/assets/htmldocuments/461_Contract%20Law%20Update%202014%20_LP_.pdf https://www.lawsonlundell.com/assets/htmldocuments/464_Formatted_Tell%20Me%20No%20Lies%20_The%20New%20Duty%20of%20Honesty%20in%20Contractual%20Performance-final2.pdf	http://www.lawsonlundell.com/media/news/396_2013%20developments%20in%20contract%20law%20paper%20_in%20house%20and%20website%20version%20as%20at%20October%2031_.pdf
Acceptance by Conduct									
Anti-oral Amendment Clauses						X			
Arbitration Clauses				X	X			X	X
Automatic Renew Clauses							X		
Best Efforts Clauses									
Binding Effect and Enurement Clauses									X
Buy/Sell Clauses									
Conditions Precedent									X
Confidentiality Clauses							X		
Consideration in the Context of Contract Variations				X					
Continuing Breach of Contract						X	X		
Contract Interpretation			X			X		X	
Contract Termination									

HEADINGS	2021	202	2019	2018	2017	2016	2015	2014	2013
Links to Contract Law Paper by Year	https://www.lawsonlundell.com/assets/htmldocuments/2021%20Contract%20Law%20Update%20Updated%20to%20March%201%202022.pdf	https://www.lawsonlundell.com/assets/htmldocuments/Contract%20Law%20Update%20-%20Developments%20to%20Note%202020.pdf	https://www.lawsonlundell.com/assets/htmldocuments/Contract%20Law%20Update%20-%20Developments%20of%20Note%202019.pdf	https://www.lawsonlundell.com/assets/htmldocuments/Contract%20Law%20Update%20May%202024%202019.pdf	https://www.lawsonlundell.com/assets/htmldocuments/2017%20Contract%20Law%20Update.pdf	http://www.lawsonlundell.com/media/news/550_Lisa%20Peters%20Contract%20Law%20Update%20November%2015%202016%20Final.pdf	http://www.lawsonlundell.com/media/news/502_Contract%20Law%20Update%202015%20_final_.pdf	https://www.lawsonlundell.com/assets/htmldocuments/461_Contract%20Law%20Update%202014%20_LP_.pdf https://www.lawsonlundell.com/assets/htmldocuments/464_Formatted_Tell%20Me%20No%20Lies%20_The%20New%20Duty%20of%20Honesty%20in%20Contractual%20Performance-final2.pdf	http://www.lawsonlundell.com/media/news/396_2013%20developments%20in%20contract%20law%20paper%20_in%20house%20and%20website%20version%20as%20at%20October%2031_.pdf
Contracting with First Nations under the *Indian Act*									X
Contractual References to Legislative Provisions				X					
Discretionary Powers						X			
Duties of Good Faith (see supplements)	X	X				X	X	X	X
Duty of Honesty in Contractual							X	X	
Efficient breach								X	
Economic Duress									
Electronic Transactions									
Entire Agreement Clauses			X					X	
Equitable Mistake									
Exculpatory Clauses and Limitation of				X			X	X	X
Forum Selection Clauses		X		X	X			X	

HEADINGS	2021	202	2019	2018	2017	2016	2015	2014	2013
Links to Contract Law Paper by Year	https://www.lawsonlundell.com/assets/htmldocuments/2021%20Contract%20Law%20Update%20Updated%20to%20March%201%202022.pdf	https://www.lawsonlundell.com/assets/htmldocuments/Contract%20Law%20Update%20-%20Developments%20to%20Note%202020.pdf	https://www.lawsonlundell.com/assets/htmldocuments/Contract%20Law%20Update%20-%20Developments%20of%20Note%202019.pdf	https://www.lawsonlundell.com/assets/htmldocuments/Contract%20Law%20Update%20May%2024%202019.pdf	https://www.lawsonlundell.com/assets/htmldocuments/2017%20Contract%20Law%20Update.pdf	http://www.lawsonlundell.com/media/news/550_Lisa%20Peters%20Contract%20Law%20Update%20November%2015%202016%20Final.pdf	http://www.lawsonlundell.com/media/news/502_Contract%20Law%20Update%202015%20_final_.pdf	https://www.lawsonlundell.com/assets/htmldocuments/461_Contract%20Law%20Update%202014%20_LP_.pdf https://www.lawsonlundell.com/assets/htmldocuments/464_Formatted_Tell%20Me%20No%20Lies%20_The%20New%20Duty%20of%20Honesty%20in%20Contractual%20Performance-final2.pdf	http://www.lawsonlundell.com/media/news/396_2013%20developments%20in%20contract%20law%20paper%20_in%20house%20and%20website%20version%20as%20at%20October%2031_.pdf
Frustration and *Force*				X					
Fundamental Breach									
Illegal Contracts									
Implied Terms and Implied Contracts			X				X		
Inconsistent Terms		X							
Indemnity Clauses			X						
Liquidated Damages									
Mistake		X							
Mitigation									X
No Suit Clauses					X				
"No Waiver" Clauses	X								
Nominal Consideration			X						
Non est Factum	X								
Options						X			
Penalty Clauses						X			
Perpetual	X								
Pre-Incorporation Contracts	X								

HEADINGS	2021	202	2019	2018	2017	2016	2015	2014	2013
Links to Contract Law Paper by Year	https://www.lawsonlundell.com/assets/htmldocuments/2021%20Contract%20Law%20Update%20Updated%20to%20March%201%202022.pdf	https://www.lawsonlundell.com/assets/htmldocuments/Contract%20Law%20Update%20-%20Developments%20to%20Note%202020.pdf	https://www.lawsonlundell.com/assets/htmldocuments/Contract%20Law%20Update%20-%20Developments%20of%20Note%202019.pdf	https://www.lawsonlundell.com/assets/htmldocuments/Contract%20Law%20Update%20May%2024%202019.pdf	https://www.lawsonlundell.com/assets/htmldocuments/2017%20Contract%20Law%20Update.pdf	http://www.lawsonlundell.com/media/news/550_Lisa%20Peters%20Contract%20Law%20Update%20November%2015%202016%20Final.pdf	http://www.lawsonlundell.com/media/news/502_Contract%20Law%20Update%202015%20_final_.pdf	https://www.lawsonlundell.com/assets/htmldocuments/461_Contract%20Law%20Update%202014%20_LP_.pdf https://www.lawsonlundell.com/assets/htmldocuments/464_Formatted_Tell%20Me%20No%20Lies%20_The%20New%20Duty%20of%20Honesty%20in%20Contractual%20Performance-final2.pdf	http://www.lawsonlundell.com/media/news/396_2013%20developments%20in%20contract%20law%20paper%20_in%20house%20and%20website%20version%20as%20at%20October%2031_.pdf
Privity of Contract									
Rectification		X			X				
Releases	X				X				
Rights of First Refusal						X			
Restrictive covenants								X	
Severability			X						
Smart Contracts				X	X		X	X	
Specific Performance									X
Standard of Review on Contract Interpretation Issues						X		X	
Statutory									
Statutory Warranties Under the International Sale of Goods			X						
Stipulated-Consequence-on-Insolvency Clauses		X							
Time of the Essence Clauses									
Unconscionability	X	X	X				X	X	X

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VANCOUVER
Suite 1600, Cathedral Place
925 West Georgia Street
Vancouver, British Columbia
V6C 3L2
t 604.685.3456

CALGARY
Suite 1100, Brookfield
Place 225-6th Avenue S.W.
Calgary, Alberta
T2P 1N2
t 403.269.6900

KELOWNA - DOWNTOWN
Suite 403, Innovation Centre
460 Doyle Avenue
Kelowna, British Columbia
V1Y 0C2
t 778.738.2610

KELOWNA - LANDMARK
Suite 1800, Landmark 6
1631 Dickenson Avenue
Kelowna, British Columbia
V1Y 0B5
t 250.861.5332

YELLOWKNIFE
Suite 200 - 4915 - 48th Street
Yellowknife, Northwest Territories
X1A 2N6
t 867.669.5500

LAWSON LUNDELL LLP

Leading full service business law firm in Western and Northern Canada

lawsonlundell.com

@LawsonLundell