After the handshake: Good faith obligations in pre-contractual M&A agreements

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Canadian courts remain reluctant to recognize pre-contractual duties of good faith but will still carefully scrutinize parties' conduct.

What you need to know

- There is currently no free-standing legal duty to negotiate in good faith in Canada, outside of Québec.
- Recent Supreme Court of Canada (SCC) jurisprudence has injected new perspectives into good faith obligations, which will impact early-stage agreements in M&A transactions.
- Courts will analyze the parties' conduct based on an objective standard to determine if pre-contractual agreements may be somewhat or wholly binding.
- Careful drafting can mitigate the risk of unintended good faith obligations being imposed on parties.

Pre-contractual agreements relevant to M&A

Most commonly, M&A transactions commence with a Letter of Intent, Memorandum of Understanding, Term Sheet, Offer to Purchase or Heads of Agreement (collectively, each an LOI). The general purpose of these documents is to summarize the key terms and conditions of a prospective agreement. It sets the tone for the negotiations and provides the framework for the subsequent formal agreement. These typically do not carry the same level of legal enforceability as a formal contract but may nevertheless contain provisions that are intended to be binding, such as an obligation to negotiate in good faith or a confidentiality clause. In addition, parties may decide to enter into early-stage agreements such as confidentiality, exclusivity, and/or standstill agreements which can help promote positive negotiation between parties.

The duty (or lack of) to negotiate in good faith

Outside of Québec, Canadian courts have not recognized a duty to negotiate in good faith. The leading case on this is *Martel Building Ltd. v. Canada*, which was decided at the SCC in 2000. *Martel* remains unaffected by the recent developments in good faith

jurisprudence seen in *Bhasin v. Hrynew*, *C.M. Callow Inc. v Zollinger, and Wastech Services Ltd. v. Greater Vancouver Sewerage and Drainage District*, as these cases were primarily concerned with good faith obligations in the context of performing an existing contract. More recently, *Martel* has been affirmed in various contexts:

- *Concord Pacific Acquisitions Inc. v. Oei*, a decision from the British Columbia Court of Appeal in the context of a dispute between a real estate development company and a landowner regarding a Heads of Agreement and eventual Share Purchase Agreement. This case cited *Martel* for the proposition that there is no duty to negotiate in good faith.[1]
- *Christine Elliott v. Saverio Montemarano,* a decision from the Ontario Superior Court of Justice in the context of a dispute between a purchaser of land and a real estate developer regarding an Agreement of Purchase and Sale. This case affirmed *Martel* in holding that there is no duty to negotiate in good faith. The Court refused to consider any alleged misleading conduct of the plaintiff because it would have occurred prior to when the Agreement of Purchase and Sale was entered into.
- *Joseph's Holdings Ltd. v. Windsor (City),* a decision from the Ontario Superior Court of Justicein the context of a dispute between a land developer, an abutting landowner, and the municipality. This case also cited *Martel* for the proposition that there is no duty of care owed between commercial parties in the conduct of contractual negotiations. The Court went even further, stating, "the primary goal of commercial negotiations is to achieve the most advantageous financial bargain, which would be undermined if a duty of care was owed between the parties."[2]

The impact of recent SCC jurisprudence

As mentioned above, the decisions in *Bhasin*, *Callow*, and *Wastech* did not overturn the holding from *Martel* that there is no duty to negotiate in good faith. However, a closer read of these cases suggests that the central holdings, namely, (i) the organizing principle of good faith and, (ii) the duty of honest performance; will certainly have implications on the way M&A transactions are negotiated. Now, in situations where parties have decided to enter into an early-stage contract, *Bhasin*, *Callow* and *Wastec*h contend that parties will have a legal duty to perform obligations under such agreements honestly.[3]

In light of these developments, prospective parties to M&A deals should direct more attention towards understanding how good faith obligations will apply to early-stage agreements.[4] For example, consider the case of *Certicom Corp. v. Research in Motion Ltd*, a dispute decided by the Ontario Superior Court of Justice prior to *Bhasin*. In *Certicom*, the parties entered into a non-disclosure agreement (NDA) to assess the desirability or viability of establishing a business or contractual relationship.[5] Eventually, talks broke down and Research in Motion Ltd. (RIM) launched a hostile take-over bid, to which Certicom Corp. argued violated a negative covenant concerning the use of confidential information contemplated in the NDA.[6] The Court, siding with Certicom Corp., granted a permanent injunction impeding RIM's take-over bid.[7] However, importantly, the Court's decision did not expressly consider what we know today as the organizing principle of good faith.[8] Perhaps if this case was decided post-*Bhasin*, the Court may have undergone a separate analysis to consider if RIM violated good faith duties and obligations. This would have included an analysis of, among other factors, if

RIM showed “appropriate regard” for the interests of Certicom Corp. in performing the NDA.[9]

This example raises an important point for M&A advisors and their clients. In the past, *Certicom* could be relied upon as bedrock guidance for negotiating confidentiality agreements in connection with prospective M&A deals.[10] Now, considering the new perspectives brought to the table in *Bhasin*, *Callow*, and *Wastech*, existing case law relating to pre-contractual agreements should be treated with increased caution. This will, in turn, put pressure on parties to be genuinely committed to the negotiation process for early-stage contracts.[11]In addition, it is notable that the Court has shown an increased willingness to develop the law and principles of good faith in Canada. After all, the SCC in *Martel* did not shut the door to the possibility that it could one day find that there is a common law duty to negotiate in good faith.[12] Further, some experts suggest that decision in *Bhasin* offered some prospect for the recognition of such duties, and that some forms of bad faith bargaining might already be captured by an unrecognized duty to bargain in good faith.[13] Irrespective of possible interpretations of the case law, what is certain is that advisors should continue to monitor the jurisprudence and prepare for any subsequent developments.

How a “non-binding” LOI can become binding

LOIs may contain non-binding provisions that generally preclude the existence of any binding obligations. However, there are some circumstances where a preliminary agreement such as an LOI could be deemed somewhat or wholly binding due to the actions of parties. Any binding element could create a contractual dimension which imposes good faith duties concerning the performance of the LOI. This includes situations where the parties objectively behave in a manner that suggests they intend that the LOI or certain provisions thereof should be binding. Consider the following examples:

- In *Advantage Tool & Machine Ltd. v. Cross Industries Ltd.,* the defendant was found to have repudiated the contract through a manifest intention not to comply with the continuing obligations under the LOI. The defendant had already started making installment payments for the purchase of the company, and the keys to the shop were handed over with the defendant taking occupancy. Interestingly, the Court considered the text messages exchanged between parties in which they expressed gratitude that the deal worked out for both. In consideration of the evidence, the Court deemed the Offer to Purchase to be a binding contract, and the exercise of drafting an Asset Purchase Agreement was a mere formality and was not required.[14]
- In *Wallace v. Allen,* the LOI at issue contained a term stating that the document must be reduced into a binding agreement of purchase and sale by the parties within the next 40 days.[15] Despite this, the Court found the parties had an intention to create legal relations such that the LOI was a binding contract. All the terms they considered necessary or essential to the transaction were agreed upon and included in the LOI. In addition, the parties “used the language of contract” in the letter of intent, such that the language in the document reflected “an intention to be bound upon the signing of the document”.[16]

Mitigating risk through precise drafting

Precise drafting stands as a cornerstone of all successful M&A transactions and is particularly important to accurately delineate good faith obligations at the LOI stage. The following tips are suggested and utilized by our lawyers in this regard:

- Clearly declare the parties' intent concerning enforceability of the various provisions in the LOI or the LOI generally.
- Expressly disclaim or include any duty to negotiate in good faith generally or as it relates to various provisions in the LOI.
- Filter provisions for which the parties wish to be binding and deal with those in a separate agreement.
- Use express language to explicitly reserve the right not to be bound by any term or future actions.
- Explicitly permit negotiation or renegotiation of all terms and conditions, including those not described in the LOI, generally or based upon certain conditions being met or not met.
- Consider if appropriate to make all business terms in the LOI subject to due diligence of the buyer.
- Consider including an expense reimbursement or break fee concept, thereby signalling to a court that the parties' intent was allow for parties to walk away from the transaction and the payment of the agreed amount was the remedy for such a decision.
- Consider whether to explicitly disclaim the remedy of specific performance.

Contrast with Québec law

Parties should exercise greater caution when considering entering LOIs in Québec as the *Civil Code of Québec*, S.Q. 1991, c. 64, codified in articles 6, 7 and 1375, the obligation to act in good faith, which has been recognized by the Québec courts to apply to pre-contractual negotiations. For example, in *Friedman v. Ruby,* the Québec Superior Court stated, "the obligation to act in good faith must be respected by the parties even before a contract is concluded, as early as during the pre-contractual negotiations."[17] More recently, the SCC in *Ponce c. Société d'investissements Rhéaume ltée* reiterated, "good faith during the pre-contractual phase —and, by extension, the duty to inform arising from it—is assessed in light of the parties relationship, which in this case includes the atmosphere of trust that existed between them. This pre-contractual duty to inform does not require a party to disregard their own interests or subordinate them to those of another."[18] It is clear from both legislation and case law that parties wishing to enter LOIs governed by Québec law will be subject to good faith obligations that exceed those applicable elsewhere in Canada. Such obligations will regulate the parties' behavior and potentially restrict their ability to exit commercial negotiations. We strongly encourage consulting our legal counsel to assist in navigating through this complex and dynamic landscape.

Please contact your BLG lawyer for assistance in understanding the complexities associated with M&A transactions. You may also contact the authors of this article or any of the key contacts noted below.

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