

# Can companies escape liability for unreasonable termination?

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### Introduction

A recent Ontario Court of Appeal decision recognised the enforceability of an exclusion of liability clause when a contractual termination was considered to be unreasonable by the court, but not in bad faith. (1) In *Chuang v Toyota Canada Inc* (2) the trial court found that although Toyota Canada Inc had unreasonably terminated its letter of commitment for a Lexus dealership entered into with Dr Chuang, the termination right was not exercised in bad faith and an exclusion of liability clause in favour of Toyota precluded Chuang from recovering damages resulting from the termination, even if the termination was exercised in a manner considered unreasonable. The Ontario Court of Appeal confirmed the decision, rejecting Chuang's argument that Toyota should be precluded from benefiting from the exclusion clause following its unreasonable termination of the agreement.

This case is an important example of the flexibility allowed by the courts regarding the exercise of discretionary termination rights in the context of a long-term contractual relationship. It also highlights the fundamental importance of including a broad exclusion of liability clause which can be exercised to preclude recovery of damages caused by the unreasonable actions of the party invoking it, provided that such actions are not taken in bad faith.

### Facts

Chuang entered into a letter of commitment with Toyota in April 2003 for the purpose of opening a Lexus dealership in downtown Toronto. The letter of commitment imposed several obligations on Chuang, including obtaining an operating line of credit, complying with various standards dictated by Toyota and respecting certain deadlines for beginning construction and opening the dealership. Chuang encountered certain difficulties with the construction of the dealership, including certain demands from the City of Toronto, which resulted in him being unable to start construction within the agreed timeline, causing an anticipated delay in the opening of the dealership. This led Chuang to request an extension of certain terms of the letter of commitment. In January 2005, an amended letter of commitment was signed, which included:

- a timeline identifying several specific dates by which Chuang undertook to complete certain milestones in the construction of the dealership;
- a termination right by which Toyota could, in its sole discretion, terminate if any of the specific deadlines were not met; and
- an exclusion clause whereby Toyota would not be liable for any losses, damages or expenses incurred by Chuang directly or indirectly in connection with the letter of commitment.

Additionally, Toyota required Chuang to provide a certificate of independent legal advice, confirming that he had obtained legal advice before agreeing to the amended letter of commitment.

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On April 20 2005, Toyota informed Chuang that it was exercising its right to terminate the amended letter of commitment based on his failure to tender the project by February 28 2005 and to have a final financing commitment in place by March 30 2005, as required under the letter of commitment.

## **Decision**

### ***Reasonable exercise of termination right***

While the letter of commitment provided that Toyota could exercise its termination right in its sole discretion in the event that certain deadlines were not met, the trial judge recognised that the letter of commitment was a "relational or relationship contract" whose nature and purpose were consistent with a requirement that the contractual rights be exercised reasonably.<sup>(3)</sup> In determining whether Toyota had acted reasonably in terminating the letter of commitment, the court considered how the delays had affected the ultimate objective and timing of opening the dealership and whether Chuang was actively trying to advance the project at the time the delays occurred. Based on the evidence at trial, the court determined that the missed deadlines would have been likely to have delayed the timing for the opening of the dealership by at most five to seven months; and that when Toyota had entered into the letter of commitment, it had been willing to accept such a delay as long as it determined that Chuang was actively advancing the project, which was found to be the case.

The court also noted that the letter of commitment did not provide an explanation as to why the dealership needed to be completed and opened by a specific date; nor did it state that time was of the essence in respect of the completion date. In fact, the court determined that there was no evidence to suggest that the completion date should be regarded as an essential date for Toyota's business. The court ruled that it was therefore unreasonable for Toyota to exercise its right of termination for the failure by Chuang to meet one or another of the deadlines in the course of the construction of a multimillion-dollar facility which was intended to be used by the parties to carry on a major business enterprise on a continuing basis.

### ***Bad faith***

The trial court also considered whether Toyota had exercised its termination right in bad faith based on Chuang's allegation that Toyota's real motivation for terminating the letter of commitment was based on its dislike of Chuang and doubts as to his ability to operate the dealership once it opened for business. Evidence at trial supported Chuang's allegation and confirmed the fact that the underlying reason for Toyota's termination of the letter of commitment was due to its lack of confidence in the adequacy of Chuang's financial and managerial resources for the ongoing operation of the dealership, along with reservations about the overall viability of the dealership in the long term. Relying on the Supreme Court of Canada's decision in *Bhasin v Hrynew*,<sup>(4)</sup> the court recognised that the duty to perform contracts in good faith includes a duty to act honestly, which involves an obligation not to lie to or otherwise knowingly mislead the other contracting party about matters relating to the performance of the contract. Based on this analysis, the court concluded that Toyota had not breached its obligation of good faith, given that it had provided Chuang with adequate reasons for terminating the agreement and was under no obligation to disclose to Chuang its reservations about his financial and management resources.<sup>(5)</sup>

### ***Exclusion of liability clause***

Finally, Chuang submitted that Toyota could not benefit from the exclusion of liability clause in the letter of commitment since the damages claimed resulted from Toyota's unreasonable termination of the letter of commitment. He pleaded that the clause should be interpreted to apply only in the event that the letter of commitment was lawfully terminated. However, Chuang's argument was rejected by the court, which ultimately found no basis for his interpretation and instead ruled that the clause should be enforceable to preclude recovery for all damages whether they resulted from lawful or unlawful termination of the letter of commitment. The free will to contract and the fact that both were sophisticated parties – a qualification partially evidenced by Chuang's certificate of independent legal advice – were additional factors which were considered in the court's determination that the clause should apply. Chuang also alleged that by terminating the letter of commitment, Toyota had terminated the exclusion clause. The court applied the principle set out by the Supreme Court of Canada in *Tercon Contractors Ltd v British Columbia (Minister of Transportation and Highways)*<sup>(6)</sup> which provides that exclusion clauses are ordinarily enforceable unless:

- the clause was unconscionable at the time the contract was made; or
- an overriding public policy justifies a refusal to enforce the exclusion.

Chuang did not argue that the clause was unconscionable or against public policy and it was found to be enforceable.

### ***Appeal***

The Ontario Court of Appeal rejected Chuang's appeal and upheld the trial court's decision, reiterating the principle that parties to an agreement – particularly sophisticated entities operating on a level playing field and engaged in a commercial relationship – are free to allocate risk as they see fit.<sup>(7)</sup> The court also emphasised the broad wording of the exclusion clause – in particular, the inclusion of the phrase "damages...of any kind whatsoever, suffered or incurred", in addition to the exclusion of liability for losses or expenses, which, read as a whole, indicated that the clause was meant to reach beyond terminations that were exercised in a reasonable manner. The court also noted that the exclusion of liability clause was not so broad as to exclude Chuang's ability to seek other remedies, such as that of specific performance. However, Chuang's demand for recovery was limited to damages, given that his earlier claim for specific performance had been abandoned following his conclusion of a subsequent agreement with another automotive company to open a dealership at the same location.

### **Comment**

#### ***Key principles***

This case is an important reminder of the principles that govern the exercise of discretionary termination rights under a commercial agreement. Essentially, all contractual rights – even those which are discretionary – must be exercised reasonably. What is considered 'reasonable' will be evaluated in the context of the contract as a whole and interpreted in accordance with the provision's purpose. The identity of the parties, as well as whether they received independent legal advice at the time of contracting, will also be factors to consider. Furthermore, if a party's right to termination is triggered by the violation of specific deadlines by its contractual counterpart, such deadlines should be brought to the latter's attention, so as to eliminate any ambiguity with respect to the parties' intent and the rights which may be exercised as a result of any late performance. Another useful provision in this regard would be a stipulation that time is of the essence for purposes of the agreement and that failure to comply with stipulated deadlines will result in the forfeiture of rights, without indulgence or forbearance.

In addition, in the event of contractual termination, it is crucial that the terminating party avoid misleading its co-contracting party with respect to the reasons for termination in order to comply with the requirements of good faith, which include a duty to act honestly. Any violation of the duty to act honestly may result in a termination right being considered to have been exercised in bad faith, giving rise to a claim for damages or specific performance.

Finally, this case highlights the importance of including broadly drafted and thoughtful exclusion of liability clauses in commercial contracts. If drafted carefully, such clauses can protect a contracting party from damages, even those resulting from its own unreasonable actions under the contract. However, caution should be exercised where a contractual counterpart may be considered to be particularly vulnerable or where independent legal counsel was not engaged, as these factual elements, among others, may prove to be instrumental in a court's analysis of whether a contractual exclusion of liability may be upheld in any given case.

#### ***Quebec***

While this case was decided under Ontario common law, the principles explored are consistent with the notion of reasonable exercise of rights and good faith under Quebec civil law. The evaluation of a party's reasonable exercise of its contractual rights and its compliance with the tenets of good faith in contracts correspond with the civil law approach to the obligation of good faith, which examines the conduct of contractual parties at the time their obligations arise and at the time these are performed and extinguished. However, Quebec courts usually take a more hardline approach regarding the obligation of good faith and consider the principles of both unreasonable exercise of rights and of bad faith to be determinative elements for finding an abuse of rights.<sup>(8)</sup>

Had this case been heard in Quebec, it is likely that Toyota's unreasonable exercise of its termination right would have also been considered a violation of its obligation to conduct itself in good faith. While an interesting convergence has recently emerged between the duty for parties to conduct themselves in good faith under Quebec civil law and the duty of good faith in contractual performance in Canadian common law provinces, this decision demonstrates that common law courts more readily accept that a party's conduct is unreasonable as opposed to being in bad faith. This suggests that these concepts can be interpreted distinctly depending on the facts and circumstances of any given case.

In addition, the common law courts in this case considered the duty of good faith in contracts in the context of the framework established in *Bhasin v Hrynew*, which specifically addressed honesty in contractual performance. This is a much narrower approach than the analysis generally undertaken by the courts in Quebec with respect to good faith in contracts. In fact, had the case at hand been governed by Quebec law, the courts may also have found that Toyota's failure to disclose its lack of confidence in the adequacy of Chuang's financial and managerial resources constituted bad faith – especially if such internal determination resulted from an investigation, study or other independent examination of data or evidence with respect to such matters.<sup>(9)</sup> Essentially, Quebec civil law generally prohibits a party from withholding any relevant information, particularly information that the party has made an effort to discover. It remains to be seen whether common law courts may eventually extend the application of the organising principle of good faith to circumstances where a party exercises its rights in an honest but unreasonable manner.

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## Endnotes

(1) *Chuang v Toyota Canada Inc*, 2016 ONCA 58.

(2) *Chuang v Toyota Canada Inc*, 2015 ONSC 885.

(3) *Ibid*, at para 41-42.

(4) *Bhasin v Hrynew*, 2014 SCC 71.

(5) *Supra* note 2 at para 102.

(6) *Tercon Contractors Ltd v British Columbia (Minister of Transportation and Highways)*, 2010 1 SCR 69.

(7) *Supra* note 1 at para 32.

(8) *Houle v Canadian National Bank*, 1990 3 SCR 122.

(9) See *9150-0595 Québec Inc v Franchises Cora Inc*, 2011 QCCS 1034; 2013 QCCA 531.

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