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Viewing the Supreme Court of Canada's Decision in *Callow* Through a Compliance Lens

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The Supreme Court of Canada released its decision in *C.M. Callow Inc. v. Zollinger*[2] on December 18, 2020. This ground-breaking decision is can have far-reaching repercussions for contracting parties that act outside of their duty of honest performance as formulated in *Bhasin v. Hrynew*.[3] Prior to the decision in *Callow*, corporate compliance programs have focused on government regulation. Now, after the decision, corporate advisors looking to enhance their companies' compliance programs would be wise to focus also on the distinction between actively misleading conduct and innocent non-disclosure in contractual performance.

Factual Background

The Appellant, C.M. Callow Inc. ("Callow") signed a two-winter maintenance agreement with the Respondents, a group of 10 condominium corporations that were joined together through a Joint Use Committee ("Baycrest"). The term of the original contract ran from 2010 to 2012, and was subsequently renewed for the period of November 1, 2012 until April 30, 2014. Callow had a separate two-summer contract with Baycrest as well.

The winter contract included a unilateral termination clause ("Clause 9"), which allowed for unilateral termination of the contract by Baycrest if (1) Callow's services were unsatisfactory, or (2) if Callow's services were no longer required. Baycrest need only provide 10 days' notice to Callow when invoking Clause 9.

During the winter of 2012, there were several complaints regarding Callow's snow removal service from occupants of the condominiums. Mr. Callow, on behalf of Callow, attended a meeting with Baycrest on January 3, 2013 where the service issues were discussed and explained. The meeting was generally positive and the then-property manager wrote that there was "nothing outstanding to report".[4]

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[2] *C.M. Callow Inc. v. Zollinger*, 2020 SCC 45 ("*Callow*").

[3] *Bhasin v. Hrynew*, 2014 SCC 71.

[4] *Callow*, *supra* note 2, at para 9.

Several weeks later, a new property manager took over for Baycrest, Tammy Zollinger ("Zollinger"). Zollinger decided that the contract with Callow should be terminated due to poor workmanship. Baycrest voted and passed the decision to terminate the contract with Callow in either March or April of 2013, but did not inform Callow of this decision.

Throughout the summer of 2013, Callow continued to perform the summer contract work, even performing additional work that Mr. Callow described as "freebie" work in hopes of securing a renewal of the winter contract. Mr. Callow was under the impression that Baycrest was happy with his work and that a renewal was likely. A board member of Baycrest, Mr. Peixoto, was well aware of this based on multiple dealings with Mr. Callow during that time. He even stated in an email that "he is under the impression we're keeping him for winter again. I didn't say a word to him."[5]

Baycrest did not inform Callow of their decision to terminate the winter contract until September 12, 2013 in an email from Zollinger, whereby she notified Callow that Baycrest would invoke Clause 9.

Callow brought a claim against Baycrest for breach of contract based on acting in bad faith; loss of opportunity stemming from not bidding on other winter contracts due to Baycrest's conduct; and claiming that Baycrest was unjustly enriched by the freebie work provided by Callow.

Lower Court Decisions

Ontario Superior Court of Justice (O'Bonsawin J.)

Justice O'Bonsawin held that the principle of good faith performance and the duty of honest performance of contracts were engaged. She found that Baycrest actively deceived Callow between when the decision to terminate the winter contract was made and when the contract was actually terminated, some five months or so. She found that Baycrest "acted in bad faith by (1) withholding the information to ensure Callow performed the summer maintenance services contract; and (2) continuing to represent that the contract was not in danger despite Baycrest's knowledge that Callow was taking on extra tasks to bolster the chances of renewing the winter maintenance services contract".[6] The existence of active communication throughout the summer months between Baycrest and Callow without disclosure of any alleged performance issues or Baycrest's decision to terminate the winter contract evidenced deliberate deception by Baycrest, which was a breach of contract by reason of the duty of honest performance. O'Bonsawin J. awarded damages to Callow in order to put it in the same position it would have been had the breach not occurred, with an additional amount

[5] *Ibid.*, at para. 13.
[6] *Ibid.*, at para. 21.

representing a one-year rental of equipment that would not have been leased had Callow known the contract was to be terminated.

O'Bonsawin J. further found that Baycrest was unjustly enriched by the freebie work performed by Callow. However, no damages were awarded because Callow did not properly show the expenses incurred for this work.

Ontario Court of Appeal (Lauwers, Huscroft and Trotter JJ.A.)

The Court of Appeal unanimously overturned the trial judge's decision. The Court of Appeal had two lines of reasoning. First, Baycrest had no contractual obligation to disclose the decision to terminate the contract prior to the notice period. Second, Callow itself acknowledged that failure to disclose was not in and of itself evidence of bad faith. The trial judge had based her decision on what amounted to a "failure to act honourably";[7] however, that failure did not rise to the level of being a breach of the duty to perform honestly.

The Court of Appeal further noted that any deception was in relation to a potential renewal of the contract, and could not be linked to the existing contract.

Supreme Court of Canada: Decision by Kasirer J. (Wagner C.J. and Abella, Karakatsanis and Martin JJ. concurring)

Kasirer J., writing for the majority, began by offering a comprehensive analysis of the duty of honest performance as set out in *Bhasin*. This analysis has two main components, below.

1. The dishonesty must be directly linked to the performance of the contract.

Kasirer J. is very deliberate in his discussion of this point. There was no dispute that Baycrest was at perfect liberty to exercise Clause 9. However, the manner of the exercising of a contractual right is the main issue:

> Stated simply, no contractual right can be exercised in a dishonest manner because, pursuant to *Bhasin*, that would be contrary to an imperative requirement of good faith, i.e. not to lie or knowingly deceive one's counterparty in a matter directly linked to the performance of the contract.[8]

Kasirer J. utilizes a comparison from Quebec civil law's theory of the abuse of contractual rights in service of determining when dishonesty will be considered to be directly linked to a contract.

> Dishonesty is directly linked to the performance of a given contract where it can be said that the exercise of a right or the

[7] *Ibid.*, at para. 27.
[8] *Ibid.*, at para. 54.

> performance of an obligation under that contract has been dishonest.[9]

It should be pointed out that Brown, Moldaver and Rowe JJ., who concur with the majority's decision, did not agree with the comparison with Quebec law's abuse of rights. Brown J., writing for the concurring justices, states that while they object to utilizing Quebec law in this instance, they use the reasoning from *Bhasin* to reach a similar position.

The Court disagreed with the Court of Appeal in suggesting that the dishonesty was related to a future contract. Baycrest's decision was to exercise a right in terminating an existing contract through Clause 9. By leading Callow to believe that there was no danger to the existing contract, Baycrest's actions were linked to the performance of an existing contract.

2. Whether Baycrest's conduct constitutes dishonesty.

Kasirer J. states that outright lies and half-truths to knowingly mislead are dishonest practices that could constitute breach of contract. He also notes that the duty of honest performance does not reach the level of acting as a fiduciary in disclosing information where there is no contractual obligation.

The main point of contention is what actually constitutes knowingly misleading another party where lies and half-truths are not involved, as in the circumstances at issue. Baycrest for the most part remained silent. In *Bhasin*, the duty of honesty is recognized as a negative obligation not to lie rather than a positive obligation to act in good faith. With that in mind, Kasirer J. defines what can constitute knowingly misleading another party in light of the case at hand:

> At the end of the day, whether or not a party has "knowingly misled" its counterparty is a highly fact-specific determination, and can include lies, half-truths, omissions, and even silence, depending on the circumstances. I stress that this list is not closed; it merely exemplifies that dishonesty or misleading conduct is not confined to direct lies.[10]

Using this rather broad spectrum, Kasirer J. concurs with the findings of the trial judge that Baycrest knowingly misled Callow. Baycrest remained silent about its decision to terminate the contract with Callow despite active communications between Callow and Baycrest after the decision had been made. Board member Mr. Peixoto led Mr. Callow to believe that the services of Callow were to Baycrest's satisfaction and that the winter contract was likely to be renewed. In emails, Mr. Peixoto even admitted that he understood Mr. Callow's attempts to curry good favour with freebies and believed that a contract extension was likely, yet Mr. Peixoto had remained silent. Baycrest knew that Callow was under the false impression that the contract

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[9] *Ibid.*, at para. 73.
[10] *Ibid.*, at para. 91.

was in good standing and would likely be renewed, despite Baycrest's having already decided to terminate the contract, and having accepted the freebies willingly. To satisfy the duty to perform honestly, Baycrest ought to have corrected Mr. Callow's false beliefs. By not doing so Baycrest's conduct misled Callow.

Damages

Kasirer J. concludes with a discussion about the appropriate quantum of damages for the breach of the duty to perform honestly. He notes that the correct analysis for damages would be expectation interest, the amount that would put Callow into the position it would have been in had the duty been performed. Had Baycrest been upfront with Callow and made Callow aware of its intention to cancel the contract, Callow would have been able to seek contracts out for at least an equivalent amount for the upcoming winter. By breaching the duty, Baycrest deprived Callow of the lost profits associated with a one-year winter contract.

Further, Kasirer J. agreed with the trial judge's award representing the rental of a piece of machinery for the next winter. As he explains, the damages award was for lost profit, not lost revenue. Callow was rightly entitled to recover its expenses as well.

Once again, the concurring justices reach the same conclusion through a different approach. While Kasirer J. uses an expectation measure of damages, Brown J. notes that a reliance measure would be more appropriate. "In short, the plaintiff's complaint is not lost value of performance, but detrimental reliance on dishonest misrepresentations."[11]

A Strong Dissent

Arguably, a party should not accept "freebie" work provided by another party who may be operating under an unachievable expectation of compensation. However, the law of restitution or unjust enrichment already protects the interests of parties in such circumstances. A person claiming unjust enrichment for providing services must show that the recipient freely accepted the services and that the provider may have reasonably expected to be paid for providing them: *e.g. Sharwood & Co. v. Municipal Financial Corporation*.[12] In the case at hand, however, the parties had an existing contract. Its terms arguably ought to have framed Callow's expectations for compensation and the right of renewal (or lack thereof). Whether Baycrest was unjustly enriched as a result of freebie work provided by Callow is a matter of restitution rather than breach of contract, and Callow had failed to provide evidence of the value of the freebie work conferred upon Baycrest.

In a potent dissenting opinion, Côté J. framed the pertinent questions as follows:

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[11] *Ibid.*, at para. 142.
[12] 2001 CanLII 24066 (ONCA).

> What constitutes actively misleading conduct in the context of a contractual right to terminate without cause? Where should the line be drawn between active dishonesty and permissible non-disclosure of information relevant to termination? Does a party to a contract have an obligation to dissuade his counterparty from entertaining hopes regarding the duration of their business relationship?[13]

Côté J. agreed that there was a duty of honest performance of contractual obligations, pursuant to *Bhasin*. But she disagreed with the conclusion that Baycrest had a freestanding obligation to provide notice to Callow of its intention to exercise the termination provision in the contract.

Baycrest had a contractual right to terminate Callow's services "at any time" and "for any other reason than unsatisfactory services" upon 10 days' notice. The litigation arose from Baycrest's decision to wait before sending the notice of termination to Callow. Had Baycrest advised Callow immediately of the 10 days' notice there would not have been any issue. But why did Baycrest wait? Baycrest did not want to jeopardize the performance of other ongoing work being done by Callow and so Baycrest did not discourage Callow's unachievable hopes.

For Côté J., the issue came down to a single question: did Baycrest lie or otherwise knowingly mislead Callow into thinking that there was no risk Baycrest would exercise its right to terminate the winter agreement for any other reason than unsatisfactory services? Côté J. disagreed about the evidence as to whether Baycrest had specifically represented to Callow that the contract would be renewed.

The majority's driving concern was that Baycrest knew that Callow was hoping to renew the contract (even though Baycrest did not specifically do or say anything to contribute to such hope), and then accepted and implicitly encouraged Callow's continued services with no actual chance of renewing the contract. During this time, Callow conferred benefits onto Baycrest in the form of extra freebie services. Such services may have amounted to "incontrovertible benefits" under the law of unjust enrichment. But Callow had not adduced evidence for the expenses incurred in relation to such work and so the court did not address whether such a claim could succeed.

Baycrest had bargained for the right to terminate for any reason and at any time upon giving 10 days' notice. Nothing in the contract extended the 10 days' notice. However, that is the consequence of imputing a "good faith" obligation into the relationship. Going forward, if a party decides to exercise a termination option in a contract, then they will have to carefully assess whether they have an immediate obligation to give notice of the intention to terminate.

The questions posed by Côté J. will need to be carefully assessed in any situations where two parties are in an ongoing contractual relationship. What constitutes actively misleading conduct

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[13] *Ibid.*, at para. 183.

in such a context? Where should the line be drawn between active dishonesty and permissible non-disclosure of information relevant to termination? If decisions are made about the potential termination of a relationship, must this be conveyed immediately? The failure to dissuade a counterparty from entertaining hopes regarding the duration of their business relationship may indeed amount to "bad faith."

Regardless of size or bargaining power, compliance and truth are now important aspects of contract law. Although the Court does not explicitly refer to inequality of bargaining power, there is an underlying David versus Goliath theme in *Callow*. Perhaps this leads the way to a prescription. A right to terminate with only 10 days' notice might appear harsh and Courts may be tempted to offer relief to the smaller and less experienced party. Commercial actors would be well-advised to draft termination clauses that are more flexible and reasonable.

Callow and Moral Incrementalism

The reference in *Callow* to the spectrum of lies, half-truths, omissions, and even silence, depending on the circumstances, raises the issue of moral incrementalism.[14] A simple example is the "white lie" that escalates. The common perception of the white lie is that no one really gets hurt by it and it may save embarrassment. If a person gets away with a white lie, they are more likely to do it again, but the lie may be slightly more serious the next time. There are several problems caused by moral incrementalism, as illustrated by the white lie example. First, sometimes people do get hurt when they discover that they have been lied to, even though the intent may have been to save embarrassment. Secondly, the hard line between truth and falsehood has been crossed by the white lie. According to Immanuel Kant, lying is "the greatest violation of a human being's duty to himself regarded merely as a moral being."[15] Once a person has crossed this line, it is easier to do so the next time when the consequences are more serious.

Harvard Business Professor Eugene Soltes, has written a wonderful book entitled, *Why They Do It: Inside the Mind of the White Collar Criminal*,[16] Soltes gives the following example of grey areas in the haggling that often occurs when one is buying a car:

> When the dealer says "I'm giving you the best price I can," however, we don't normally think that it's literally the lowest price he could possibly offer. Few would think the seller acted wrongly if he had the authority to lower the price even further—we'd just say that they buyer should have negotiated more aggressively.

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[14] See Richard A. Epstein, *Skepticism and Freedom: A Modern Case for Classical Liberalism* (Chicago and London: University of Chicago Press, 2003), Chapter 4: Moral Incrementalism.

[15] Kant, Immanuel. 1996 [1797]. *The Metaphysics of Morals.*, ed. Mary J. Gregor (Cambridge: Cambridge University Press, 1996).

[16] (New York: PublicAffairs 2016).

> Few would accuse the dealer of outright fraud since what he said is understood as simply part of the negotiation process.[17]

Soltes gives several real life examples to illustrate his point:

> PEOPLE MISSTATE, MISREPRESENT, and exaggerate all the time in business. Sometimes these practices are tolerated as acceptable—as in negotiations for a new car—and sometimes they are fraudulent and possibly constitute crimes—as in the bond market. The legal ramifications are radically different, but the distinction between these different kinds of deception isn't always so clear.[18]

The recognition by the Court in *Callow* that "knowingly misled" can include lies, half-truths, omissions, and even silence, depending on the circumstances, requires that a new compliance lens be used in dealing with common business practices. Compliance training in organizations should include discussion of the philosophical reasons underlying truth telling and the dangers of moral incrementalism.

Although the Court in *Callow* did not refer to behavioral research, we believe that it is essential as part of compliance training. Of interest during the COVID-19 pandemic, studies have shown that dishonesty increases with social distance.[19] It is easier to lie over the internet than it is to lie to a person's face. The dangers of moral incrementalism become more acute with increasing distance and the resulting temptation to relax moral stances.

A recent 2020 study in the financial industry showed evidence of widespread dishonesty with the statistic that over 92% of subjects lie at least once.[20] Research has found that men are more likely than women to tell lies.[21]

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[17] Soltes at p. 165, in Chapter 9, "You can't make the argument that the public was harmed by anything I did: Misleading Disclosure".

[18] Soltes, *ibid*. at p. 167, in Chapter 9 above. See Chapter 10, "Unfortunately, the world is not black and white: Financial Reporting Fraud."

[19] Daniel Hermann and Andreas Ostermaier, "Be Close To Me and I Will Be Honest. How Social Distance Influences Honesty" (February 28, 2018). Available at SSRN: https://ssrn.com/abstract=3131732 or http://dx.doi.org/10.2139/ssrn.3131732. The authors observe: "The influence of social distance on honesty is interesting because it relates to most interactions that involve honesty. For example, public authorities usually appear as a distant and impersonal interaction partner to people, and honesty is indeed a major concern in tax collection. In this and other areas, people often interact through intermediaries, who increase social distance between the interaction partners. More generally speaking, the wide use of the internet has profoundly simplified but also depersonalized communication." (p. 4). Participants were less willing to lie at the expense of fellow students than at the expense of the experimenter (p. 14).

[20] Chloe Tergiman and Marie Claire Villeval, "The Way People Lie in Markets" WP 1927 – September 2019, revised June 2020. Electronic copy available at: https://ssrn.com/abstract=3635302. Regarding the nature of lies, absent reputation, up to 97% of subjects who lie make lies that can lead to detection. However, the introduction of reputation leads to a major change: detectable lies become infrequent, and project managers shift towards a "Deniable Lie Strategy" so as to not be detected as liars by the investors with whom they are in fixed relationships.

[21] Valerio Capraro, "Gender differences in lying in sender-receiver games: A meta-analysis" in Judgment and Decision Making, Vol. 13, No. 4, July 2018, pp. 345–55.

Group dynamics may also enhance lying. There is a stronger inclination to behave immorally in groups than individually if the culture promotes that immorality.[22] The reason for this is that communication exposes group members frequently to arguments in favor of violating the norm. Group think or behavior reinforces the danger of moral incrementalism. By way of contrast, group dynamics may work the other way and promote morality within the group if the culture of the group supports the values of truth telling. In 2021, organizations must consider that gender and racial diversity may counteract groupthink and the "old ways of doing things".[23]

These behavioral observations just scratch the surface of the vast amount of research that has been done on ethical conduct within organizations and which can be incorporated into training modules.

From the perspective of the person being told a half-truth, such as Mr. Callow, it is a fair assumption that strangers are being truthful. It is what Malcolm Gladwell describes as the "default to truth" that permitted fraudsters such as financier Bernie Madoff to go undetected.[24] Compliance systems should contain mechanisms to stress test the default to truth and make the necessary adjustments.[25]

Techniques such as encouraging peer review and dissonance within a workplace will assist in promoting truth in commercial dealings and good faith.[26] Soltes gives the example of an executive who questioned a stock options back-dating method authorized by his own firm, by getting a second opinion from his general counsel. The result was a decision to not implement the plan, which the general counsel warned was not strictly legal. The executive saved his company from being ensnared in the options back-dating scandal that caught many companies. This type of regular peer review is important.

Conclusion

Callow presents a unique challenge to those who design corporate compliance programs. These programs have traditionally been an important element in maintaining compliance with government rules and regulations. *Callow* changes this. Now these programs must also focus

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[22] Martin G. Kocher, Simeon Schudy and Lisa Spantig, "I Lie? We Lie! Why? Experimental Evidence on a Dishonesty Shift in Groups" CESIFO Working Paper No. 6008, Category 13: Behavioural Economics July 2016 (p. 4). The exchange of arguments and talking to people that argue in favor of violating the norm also changes the norm perception. The authors show that the expectation that other people (out-of-sample) lie increases significantly after the group interaction. A detailed analysis of the protocols from the group interaction suggests that groups lie more because communication enables them to justify dishonest behavior in a different way than individuals. Further, the authors find that the dishonesty shift in groups is very strong such that the group composition (in terms of the number of initially dishonest group members) only weakly affects the extent of dishonesty in a group.

[23] Todd L. Archibald and Kenneth E. Jull, *Profiting from Risk Management and Compliance* § 1:20. Gender, Diversity, Risk Management and Compliance, and see Aaron Dhir "Towards a Race and Gender-Conscious Conception of the Firm: Canadian Corporate Governance, Law and Diversity" (2010), 35 Queen's L.J. 569.

[24] Malcolm Gladwell, *Talking to Strangers* (New York: Little Brown and Company, 2019).

[25] Todd L. Archibald and Kenneth E. Jull, *Profiting from Risk Management and Compliance* (Toronto: Thomson Reuters, 2020 updated periodically) § 27:29. Step 16: Monitoring, Verification and Reporting Mechanisms—Verification and Stress Testing.

[26] Archibald and Jull, *ibid.*, , Chapter 21, Compliance Systems and Operational Change.

specifically on contractual relationships, with performance and dealing with counterparties. The extremely broad definition of what can constitute "knowingly misleading" a party to a contract can create confusion and difficulty for representatives of a corporation, especially given Côté J.'s particularly resonant dissent. The spectrum of "lies, half-truths, omissions, and even silence"[27] and the fact that "this list is not closed"[28] is begging for years of litigation, which may one day assist corporate advisors understand just what corporations can and cannot do. In the meantime, corporate advisors should be aware of the potential pitfalls and repercussions of "knowingly misleading" contractual partners is of the utmost importance.

[27] *Callow*, *supra* note 2, Kasirer J. for majority, at para 91.
[28] *Ibid*. This statement also appears in *Bhasin* at para 66.