In the absence of an express provision in a distribution agreement that deals with the termination of the contract, Canadian courts will adhere to established contractual principles that govern the relationship between the parties.

Considering the extensive integration of the U.S. and Canadian economies, it is not surprising that American manufacturers frequently have distribution agreements with Canadian distributors to sell their products in Canada. However, as in all contractual arrangements, relations can deteriorate, and manufacturers may need to terminate these agreements. When distribution contracts involve Canadian distributors, American manufacturers imperatively need to understand the Canadian legal principles that govern the termination of distribution agreements. This article will provide an overview of Canadian law related to this topic. Quebec is a civil law jurisdiction and is unlike all the other Canadian provinces, which have adopted common law principles. So some important differences result from the provisions of the Civil Code of Quebec that governs distribution agreements, and this article will discuss these differences later.

How Difficult Is It to Terminate for Cause?

Without an express agreement between the parties regarding the termination of a distribution agreement, the parties must give reasonable notice before terminating a contract under Canadian law. Hillis Oil & Sales v. Wynn’s Canada, [1986] 1 S.C.R. 57, para. 16. See also 11934430 Ontario Inc. v. Boa-Franc, 2005 CanLII 39862 (ONCA), paras. 44–45. The concept of reasonable notice of termination will be discussed further below. However, under certain circumstances parties can terminate a distribution agreement for cause without notice.

Under Canadian contract law, parties are free to negotiate express conditions which, if breached, provide one or both parties an excuse not to perform their obligations under the contract. John Swan, Canadian Contract Law, LexisNexis Butterworths 455 (2006). Thus, if a distribution agreement expressly specifies that the occurrence of certain events permits terminating it, a Canadian court will likely permit the termination of the contract without notice should those events occur.

Further, in limited situations a party can terminate a distribution agreement...
for cause without notice even when the distribution agreement failed to address this issue expressly. However, in this context, Canadian common law establishes a high threshold for terminating the agreement for cause without notice. The Ontario Court of Appeal considered this issue in 11934430 Ontario Inc. v. Boa-Franc holding that "the cause must amount to a fundamental breach of the contract before the innocent party can terminate and be relieved of its obligations to continue to perform." Boa-Franc, 2005 CanLII 39862 (ONCA), para. 48. Fundamental breach has been characterized as a breach that "goes to the root of the contract" or a breach that deprives the innocent party of substantially the whole benefit that the parties had intended the contract to confer. Hunter Engineering Co. v. Syncrude Canada Ltd., [1989] 1 S.C.R. 426. To determine whether a breach of contract meets the threshold for fundamental breach, Canadian courts will consider the following factors:

- The ratio of the obligation that a failed to perform to the obligation as a whole;
- The seriousness of the breach to the innocent party;
- The likelihood of repetition of the breach;
- The seriousness of the consequence of the breach; and
- The relationship of the part of the obligation performed to the whole obligation. Shelanu Inc. v. Print Three Franchising Corp. 2003 CanLII 52151 (ONCA), paras. 117–118.

As such, a mere breach of a distributorship agreement does not entitle the innocent party to terminate the contract for cause unless a court would characterize it as a fundamental breach of the contract as evaluated by the factors listed above. Without a fundamental breach, a party to the distribution agreement can only terminate the agreement for cause without notice if the agreement expressly specifies that they may terminate it if certain events occur or if a party fails to perform in certain ways.

How Does a Court Evaluate and View an Unwritten Agreement?

Canadian courts will consider unwritten distribution agreements valid if they find some evidence that the parties intended to be bound by a distribution contract. 1248671 Ontario Inc. v. Michael Foods Inc., 2005 CanLII 32926 (ONSC), para. 14. However, a failure to reduce the agreement to writing will affect the parties’ ability to govern the terms upon which they can terminate the agreement. As previously noted, without a provision that deals with how the parties can terminate a contract, or when and how the parties can terminate the contract is ambiguous, a court will imply a term of reasonable notice of termination. Hillis Oil, [1986] 1 S.C.R. 57, para. 16. See also Boa-Franc, 2005 CanLII 39862 (ONCA), paras. 44–45. What constitutes reasonable notice will depend on the facts and circumstances of each case. This topic is discussed in further detail below.

However, if a party to a contract challenges the existence of an unwritten distribution agreement, the party seeking to enforce the agreement will have to submit evidence before the court to establish the existence of an oral contract. Durotest Electric Ltd. v. Floralight Gardens Canada Inc., [1996] O.J. No. 1165, para. 12. Failing to prove that the parties had agreed to the essential terms of a distribution agreement may doom a plaintiff’s claim for reasonable notice of termination. In Durotest Electric, the court rejected the plaintiff’s assertion of an oral distribution agreement:

Too many of the essential terms of a distribution agreement with respect to guaranteed price and discount, minimum product purchase, assured supply of product, restriction on competitive products, minimum sales level to be achieved […] payment terms, advertising and marketing plans, and contributions by Durotest to advertising, were not dealt with between the parties even on the evidence of the plaintiff’s witnesses. Id. at para. 8.

As such, the court found that the alleged distribution agreement was unenforceable and that providing notice of termination was not required. Further, the mere existence of an ongoing business relationship in which one party manufactures products sold by another, probably would not sufficiently establish that a distribution agreement existed without other evidence. In these circumstances, a plaintiff seeking to uphold a distribution agreement risks having the relationship characterized as a series of independent sales contracts that the other party can terminate without notice on the expiration of each transaction. Atec Marketing Limited v. Heart and Stroke Foundation of Canada, 2005 CanLII 44381 (ONSC), paras. 32–33, aff’d on other grounds in Atec Marketing Limited v. Heart and Stroke Foundation of Canada, 2007 ONCA 1.

Thus, manufacturers clearly have greater ability to maintain a degree of control over their distributors’ obligations when they have written distribution agreements and expressly include provisions governing agreement termination in them.

What Constitutes Reasonable Notice?

When Canadian courts consider a distribution agreement to include implicitly a termination term of reasonable notice, they will look to the circumstances of each case to determine what is “reasonable.” Factors considered in determining the appropriate amount of notice include:

- The length of the association between the parties;
- The dependency of a distributor on a principal’s line of business;
- The level of investment made by a distributor to distribute a principal’s product and the volume of business derived from the sale of the principal’s product; and
Further, courts will consider previously unexecuted draft agreements that had proposed a notice of termination period as one relevant factor in determining what is reasonable in the circumstances. Id. at para. 53. Without an express and binding agreement regarding the appropriate notice of termination, courts can view previous negotiations as relevant, and they may use them to determine what the parties had contemplated as a reasonable notice period. Exchange Corporation Canada v. Swytch Delivery Solutions Inc., 2007 CanLII 30661 (ONSC), paras. 15–16.

Additionally, notice periods that have been negotiated between a manufacturer and other third party distributors may also guide a court’s analysis when attempting to discern what constitutes reasonable notice periods. See, e.g., Delivery Solutions Inc. v. Arton Holdings Ltd., 46 B.C.L.R. 64, paras. 22–42 (summarizing several such cases). The high watermark is two years. Id. at para. 32. See also Weram (1975) Inc. v. EMCO Ltd. 2 B.L.R. (3d) 183, para. 44.

### Manufacturers Clearly Have Greater Ability to Maintain a Degree of Control Over Their Distributors’ Obligations When They Have Written Distribution Agreements and Expressly Include Provisions Governing Agreement Termination in Them.

Conclusion that the plaintiff distributor was entitled to a significantly longer notice period, the court compared the substantial investments that the original distributor had made over 13 years with the fledgling operations of the new distributor when manufacturer executed the new distribution agreement with the distributor that replaced the plaintiff. Id. at paras. 35–38.

Determining what constitutes reasonable notice depends highly on the facts of each case, and as such, implied reasonable notice periods can vary widely. The case law indicates that without an express agreement between the parties, Canadian courts will consider any relevant factors to assist them in determining the appropriate amount of notice under the circumstances. The jurisprudence reveals that Canadian courts most frequently view a reasonable notice period as 12 months. See, e.g., Western Equipment Ltd. v. A.W. Chesterton Co., 46 B.C.L.R. 64, paras. 22–42 (summarizing several such cases). The high watermark is two years. Id. at para. 32. See also Weram (1975) Inc. v. EMCO Ltd. 2 B.L.R. (3d) 183, para. 44.

### Does a Contractual Relationship Involve an Obligation of Good Faith?

Canadian courts have recognized the existence of a duty of good faith in a variety of contractual relationships requiring the parties to exercise their contractual rights honestly and fairly. Arton Holdings Ltd et al. v. Gateway Realty Ltd., 1991 CanLII 2707 (NSSC), aff’d in Arton Holdings Ltd. v. Gateway Realty Ltd., 1992 CanLII 2620 (NSCA). In TSP-Intl Ltd. et al. v. Mills et al., the court reviewed the jurisprudence regarding an implied duty of good faith and identified two categories of cases in which a duty of good faith would apply to contract execution:

- Contracting parties will owe a duty of good faith regardless of the specific terms of a contract when the contracting parties’ relationship has an inherent vulnerability or a power imbalance; and
- A duty of good faith may arise from the parameters of the parties’ contractual relationship and conduct.

TSP-Intl Ltd. et al. v. Mills et al., 2005 CanLII 3945 (ONSC), paras. 60–64.

Some other courts have decided that an implied duty of good faith exists in executing distribution agreements under the first relationship category, an inherently vulnerable relationship. In Agribands Purina Canada Inc. v. Kasameka, the court held that Purina breached an implied duty of good faith by selling its animal feed to another distributor within the exclusive geographical area of the plaintiff distributor, effectively putting the plaintiff out of business. The court analyzed the nature of the relationship and cited the weaker bargaining position of the distributor and the continuing power imbalance between the parties as justification for imposing an implied duty of good faith. 2010 Carswell Ont. 98, para. 103. The trial judge awarded $30,000 in punitive damages against Purina for breaching its duty of good faith and unlawful conspiracy. On appeal, the Ontario Court of Appeal dismissed the claim of unlawful conspiracy but upheld the $30,000 punitive damages award against Purina for breaching its implied duty of good faith. Agribands Purina Canada Inc. v. Kasameka, 2011 ONCA 460, paras. 75–84. Purina did not contest that an implied duty of good faith existed but instead contesting that it hadn’t breached the duty, so the Ontario Court of Appeal proceeded on the basis that it was rightfully implied.

Moreover, the Ontario Court of Appeal has recognized that the ongoing nature of distributorship agreements might oblige the parties to act in good faith toward each other. See Boa-Franc, 2005 CanLII 39862 (ONCA), para. 35. Hence, it appears that Canadian courts may find that a distribution agreement includes an implied duty of good faith due to the parties’ relationship under the second relationship category even if an inherent vulnerability or a power imbalance does not exist between the parties. In TSP-Intl, the court identified some indicia that would identify when a breach of a duty of good faith may arise under the second relationship category:

- If one party by its actions eviscerates or defeats the objectives of the contract; or
- If the parties’ conduct fails to meet objective, legitimate expectations and community standards of honesty, reasonableness, and fairness; and
- If one party unilaterally nullifies contractual objectives or causes significant harm to the other contrary to the original expectations of the parties; or
• If one party benefits from a conflict of interest.  
TSPInt, 2005 CanLII 3945 (ONSC), para 81.

Consequently, a distribution agreement terminated on bad faith premises has the potential to attract judicial scrutiny in Canada. In some instances Canadian courts have held a manufacturer liable for the wrongful termination of a dealership agreement because the contract was terminated in bad faith. Valley Equipment Ltd. v. John Deere Ltd., [2000] N.B.J. No. 28, paras. 208–221. See also Great Lakes Harvestore Systems Ltd. v. A.O. Smith Engineered Storage Products Co., [1998] O.J. No. 873, para. 7.

However, Canadian courts have hesitated to recognize a stand-alone duty of good faith that operates independently from the express terms of a contract. As stated in Transamerica Life Canada Inc. v. ING Canada Inc., Canadian courts have not recognized a stand-alone duty of good faith that is independent from the terms expressed in a contract or from the objectives that emerge from those provisions. The implication of a duty of good faith has not gone so far as to create new, unbargained-for, rights and obligations. Nor has it been used to alter the express terms of the contract reached by the parties. Rather, courts have implied a duty of good faith with a view to securing the performance and enforcement of the contract made by the parties, or as it is sometimes put, to ensure that parties do not act in a way that eviscerates or defeats the objectives of the agreement that they have entered into.

Transamerica Life Canada Inc. v. ING Canada Inc., 2003 CanLII 9923 (ONCA), para. 53.

A recent decision of the Ontario Court of Appeal has emphasized that an implied duty of good faith cannot alter the express terms of a contract, including the right to terminate a distribution agreement on notice. Agribands, 2011 ONCA 460, para 51. See also Allarco Entertainment 2008 Inc. v. Rogers Communications Inc., 2011 ONSC 5623, paras. 150–156. In light of this judicial pronouncement, a manufacturer that terminates a distribution agreement in accordance with an express contractual provision that permits the termination of the agreement likely would have protection against wrongful contract termination allegations based on bad faith principles. However, given that courts generally wish to protect the interests of distributors in the face of arbitrary or high-handed conduct by manufacturers, a prudent manufacturer will want to consider good-faith principles when terminating a distribution agreement. The standard of good faith does not prevent a manufacturer from acting in its own self-interest as long as the manufacturer shows regard for the legitimate interests and expectations of a distributor. Rogers & Rogers Inc. v. Pinehurst Woodworking Co., 2005 CanLII 45977 (ONSC), para. 116. See also Allarco Entertainment, 2011 ONSC 5623, para. 155.

**When May a Distributor Secure an Injunction?**

A distributor that disputes the circumstances under which a manufacturer terminates a distribution agreement may seek an injunction to restrain the manufacturer from terminating the contract until a trial can resolve the dispute. The availability of an interlocutory injunction will depend on whether the applicant can establish that it meets the three-part test outlined by the Supreme Court of Canada in R.J.R.-MacDonald Inc. v. Canada (Attorney General), [1994] 1 S.C.R. 311. Specifically, the test requires that an applicant demonstrate the following:

- There is a serious issue to be tried;
- The party seeking the injunction will suffer irreparable harm if the injunction is not granted; and
- The balance of convenience favors granting an injunction.

Id.

The Supreme Court of Canada has described the threshold to establish a serious trial issue under the test’s first prong as a low one. Id. However, in subsequent cases courts have held that the standard will vary depending on whether the injunction sought is a mandatory injunction or a prohibitory injunction. A mandatory injunction is an order that establishes a new right that the parties had never agreed to, whereas a prohibitory order is simply an order requiring the parties to act in accordance with their agreement. TDL Group Ltd. v. 1060284 Ontario Ltd., [2001] O.J. No. 3614, para. 9. When a court characterizes this higher standard, an applicant will need to establish that it clearly is right and almost certain to succeed at trial. Barton-Reid Canada Ltd. v. Alfresh Beverages Canada Corp., 2002 CanLII 34862 (ONSC), para. 9. See also Cana International Distributing Inc. v. Standard Innovation Corporation, 2010 ONSC 6273, para. 16. To meet a sought-after injunction as a mandatory order, the applicant must demonstrate a higher standard of a strong prima facie case under the first prong of the test. Barton-Reid Canada Ltd. v. Alfresh Beverages Canada Corp., 2002 CanLII 34862 (ONSC), para. 9. See also Cana International Distributing Inc. v. Standard Innovation Corporation, 2010 ONSC 6273, para. 16.

With distribution agreements the jurisprudence has divided regarding the applicable standard under the first prong of the test. Thus, in Barton-Reid Canada, the court held that when a distributor sought an injunction that would have the effect of forcing the parties to continue to do business together in accordance with the distribution agreement terms a court would consider that order mandatory. Id. at para. 7. See also Natrel Inc. v. Four Star Dairy Ltd., [1996] O.J. No. 1145, paras. 1, 9. Canadian courts have also held that when the disputed issue is whether or not a distribution agreement exists, a court should characterize a sought-after injunction as a mandatory order, and the court should apply the strong prima facie case standard. Cana International, 2010 ONSC 6273, 17.

However, in another line of decisions the courts have held that an order restraining...
a manufacturer from terminating a distribution agreement pending a trial simply maintained the rights to which that the manufacturer and distributor had agreed under the existing agreement, and therefore, the injunction would constitute a prohibitive order. 674834 Ontario Ltd. (c.o.b. Coffee Delight) v. Culligan of Canada Ltd., [2007] O.J. No. 979, para. 37. See also Erinwood Ford Sales Limited et al. v. Ford Motor Company of Canada Limited, 2005 CanLII 16616, para. 61 (holding in the context of a dealership agreement that “notwithstanding that it can be argued that there is a mandatory nature to the order sought by the plaintiffs, in that it requires the defendant to continue to comply with the terms of the Dealership Agreement, there is no question that granting the injunction creates no new rights. The plaintiffs seek to preserve the status quo pending trial and in my view, as a result, the order sought is not a mandatory injunction.”) In these decisions the courts held that they appropriately would use the lower standard of a “serious issue to be tried.” Obviously, a manufacturer opposing an application for an interlocutory injunction will seek to characterize the order as a mandatory order. In doing so the manufacturer will attempt to dispute that a distribution agreement exists, characterize the agreement as having come to an end, or argue that the manufacturer properly terminated the agreement in accord with the terms of the contract. In any event, a court will need to examine a case’s factual matrix in detail to determine whether an order is mandatory or prohibitory because the line between positive and negative covenants is not clear cut. TDL Group, [2001] O.J. No. 3614, para 4. See also Culligan, [2007] O.J. No. 979, para 4.

Under the second prong of the test, a party seeking an injunction must demonstrate that it will suffer irreparable harm if a court does not grant the injunction. Irreparable harm is harm that cannot be quantified in monetary terms or which damages cannot cure. R.J.R.-MacDonald, [1994] 1 S.C.R. 311. In Vivitar Canada Ltd. v. Vivitar Corporation, the Ontario Superior Court considered the following factors in holding that the distributor would suffer irreparable harm if it did not grant an injunction:

- The distributor would have to shut down its entire business if it could not sell the manufacturer’s products, which comprised 75 percent of the distributor’s business;
- The distributor had a high level of inventory on hand and in transit representing nearly one full year’s worth of products;
- If the distributor was forced to dishonor its commitments to sell the manufacturer’s products to its customers, it could severely damage the distributor’s credibility with those customers;
- The distributor had renewed its warehouse lease for an additional five years based on the distribution agreement;
- The distributor had hired a new sales manager to market the manufacturer’s products;
- The distributor had declined offers to distribute products on behalf of other large-scale manufacturers because of its commitments under the current distribution agreement;
- The distributor made substantial investments to develop the market for the manufacturer’s products; and
- The distributor would have to lay off at least eight employees if the distribution agreement was terminated.


Considered together, the court believed that the above factors sufficiently established that the distributor would have suffered irreparable harm. However, a court probably would not view losing sales and losing market share without additional factors as sufficient to constitute irreparable harm that damages could not compensate. Barton-Reid, 2002 CanLII 34862 (ONSC), para. 18. See also Cana International, 2010 ONSC 6273, paras 18–20. Further, any evidence advanced to demonstrate irreparable harm needs to be clearly established. Speculation of harm will not suffice. Barton-Reid, 2002 CanLII 34862 (ONSC), para. 18.

Finally, the third prong of the test requires a court to determine which party will suffer the greater harm if the court either grants or denies an interlocutory injunction until a trial resolves the disputes. R.J.R. MacDonald, [1994] 1 S.C.R. 311. The factors considered at this stage of the analysis will vary. In the context of exclusive distribution agreements, Canadian courts have been sensitive to the vulnerable position of a manufacturer that relies on a single distributor to sell its products in a region. For example, in Cana International Distribution Inc. v. Standard Innovation Corporation, the Ontario Superior Court of Justice dismissed the plaintiff distributor’s application for an interlocutory injunction out of concern that enforcing the exclusive distributorship would “unfavourably submit the business of the Defendant [manufacturer] to the power of the Plaintiff [distributor].” Cana International, 2010 ONSC 6273, paras. 21–24. See also Saan Stores Ltd. v. Effigi Inc., 2006 CanLII 39315 (ONSC), paras. 87–95.

Further, the courts have hesitated to bind a manufacturer to a distribution contract when the relationship between the parties has clearly deteriorated making it unlikely that the distribution agreement would benefit either party. Natrel Inc., [1996] O.J. No. 1145, para 13. See also Healthy Body Services Inc. v. Muscletech Research and Development Inc., [2001] O.J. No. 3257, paras. 20–23. However, in cases in which a distributor’s business has relied almost entirely on a manufacturer’s products and when the distribution agreement has been executed profitably over a number of years, the manufacturer may have difficulty tipping the balance of convenience in its favor. Vivitar, 2003 CanLII 13974 (ONSC), paras. 38–40. See also Culligan, supra, at paras. 44–47; Barton-Reid, 2002 CanLII 34862 (ONSC), para. 20.

How Does the Province of Quebec Differ from Other Canadian Provinces?

As mentioned, unlike all other Canadian provinces, which have adopted common Distribution, continued on page 64
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law principles, Quebec is a civil law jurisdiction, so some important differences emerge in Quebec from the Civil Code of Quebec, which govern distribution agreements.

As in the rest of Canada, parties in Quebec are free to negotiate express conditions which, if breached, provide one or both parties with excuses for failing to perform their obligations under their contracts. Under Quebec civil law, despite the relevant contractual provisions, a manufacturer may not terminate a distribution agreement unilaterally without cause.

In Quebec, the duty of good faith governs the right to terminate a distribution agreement. Pursuant to article 2805 of the CCQ, the duty of good faith is presumed. As such, the duty of good faith governs all distribution agreements in Quebec. Articles 6 and 7 of the Civil Code of Quebec specify that “every person is bound to exercise his civil rights in good faith” and “no right may be exercised with the intent of injuring another or in an excessive and unreasonable manner which is contrary to the requirements of good faith.” Furthermore, article 1375 of the Civil Code of Quebec mandates that the parties “shall conduct themselves in good faith both at the time the obligation is created and at the time it is performed or extinguished.” (emphasis added).

Hence, the parties’ relationship under a distribution agreement necessarily implies a duty of good faith in Quebec. More particularly, the courts will look for a material reason, referred to as a “serious reason” in the language of the Civil Code of Quebec, for termination, such as a fundamental breach of the contract by a distributor. Moreover, as in the rest of Canada, the parties must supply reasonable notice of termination in Quebec. This too derives from the obligation to exercise rights in good faith. However, in certain circumstances parties to a distribution agreement can terminate the distribution agreement without notice, such as when an agreement specifically includes a provision permitting it. Rogers Cantel inc. c. Elbanna Sales Inc., [2003] R.J.Q. 745 (C.A.). Determining whether a party has to supply reasonable notice and what constitutes reasonable notice will depend on the facts and circumstances of each case.

Consequently, terminating a distribution agreement in bad faith, whether the manufacturer or the distributor does it, will attract judicial scrutiny in Quebec. A court will hold the party which has acted in bad faith liable as a result of the termination. In numerous instances Quebec courts have held a manufacturer liable for the wrongful termination of a dealership agreement because the manufacturer terminated the contract in bad faith. For example, the courts have frequently found that a manufacturer abusively terminated a distribution contract and acted with bad faith when the reasons and notice supplied for the termination were insufficient given the nature of the relationship between the parties. Richman c. Adidas Sportchuhabriken, J.E. 97-480; Thalasso P.D.G. inc. c. Laboratoires Aeterna inc., J.E. 97-1115 (C.S.); Bertrand Équipements inc. c. Kubota Canada ltée, REJB 2002-32020 (C.S.), par. 33; Bussières (Véhicules récréatifs Gascon enr.) c. Yamaha Motor Canada Ltd., J.E. 2006-806 (C.S.). Terminating distribution agreements in Quebec can therefore be somewhat trickier matters than in the other Canadian provinces, and manufacturers must deal with those terminations with care.

Conclusion

In the absence of an express provision in a distribution agreement that deals with the termination of the contract, Canadian courts will adhere to established contractual principles that govern the relationship between the parties. Examples of various tools that inform the analysis are the doctrine of fundamental breach, implied reasonable notice of termination, and an implied duty of good faith. Many of these doctrines will protect a distributor by preventing a manufacturer from terminating a distribution agreement on its own terms. Not surprisingly, the applicability of each of the above doctrines and the impact it will have on the ability to terminate a distribution agreement will depend highly on the facts of the specific case. To avoid uncertainty and to maintain a greater degree of control over the contractual relationship, manufacturers will want to clearly and expressly delineate the circumstances under which they can terminate their distribution agreements.