<u>Leading cases on Letters of Intent (LOI) and Non-Disclosure Agreements (NDA) in Canada</u>

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I. Letters of Intent and the Obligation to Act in Good Faith in Canada

In the course of the acquisition or the sale of a business, buyers and sellers will typically sign a LOI to set forth the key terms of the deal which forms the basis on which buyer and seller will negotiate the terms and conditions of the definitive contract. Buyers and sellers will often ask their legal counsel about the legal implications of signing an LOI, and in particular, about its effects on their right to terminate negotiations.

In answering such questions in Canada, it is important to understand the governing law of the LOI and the transaction, as there are differences between Quebec and the common law provinces. In Quebec there is a statutory obligation to act in good faith during the pre-contractual phase. Generally in the common law provinces, unless there are exceptional circumstances, there is no general duty to act in good faith during the pre-contractual phase. I say "generally" as there was an important decision from the Supreme Court of Canada in 2014 called *Bhasin v. Hrynew* ("*Bhasin*") which established good faith contractual performance as a general organizing principle of the common law of contract. The case created a duty of honesty and good faith in contractual performance. While the actual impact of this new duty on Canadian business law continues to be discovered, *Bhasin* was notably silent on whether there is a duty of good faith when parties are negotiating an agreement. Could the Canadian courts expand the duty of good faith to include pre-contractual negotiations? Some commentators have noted that, after all, the negotiation process is the very genesis of a contractual relationship and it would be reasonable that parties would expect honesty and fair play in the performance of their contractual obligations, including the underlying negotiations of the contractual terms. While *Bhasin* has yet to impact LOIs specifically, this may change in common law provinces in Canada as the jurisprudence evolves, and it would be prudent to be keep in mind when entering into a contract during the LOI phase.

Quebec: Civil Code of Quebec and *Friedman* v. *Ruby*

In *Friedman v. Ruby*, the Superior Court of Quebec considered what it means to act in good faith during the course of negotiations where the parties signed a non-binding LOI for the sale of a business but failed to come to a final agreement.

In that case, Jeffrey Friedman (Buyer) and Stephen Ruby (Seller) started negotiating the terms of an LOI regarding the sale of a software company in late 2007. Between February and May 2008 the parties signed an LOI and started negotiating a draft of the purchase agreement. During this period, only Buyer's attorney was involved. Seller had, with Buyer's knowledge, decided not to involve his attorney until May 2008 when the second draft of the purchase agreement was circulated by Buyer.

After several drafts of the purchase agreement were exchanged in June 2008, Seller advised Buyer that he could not go ahead with the agreement as provided in Buyer's latest draft. In July 2008, Seller's lawyer sent a revised draft with changes to many provisions as well as a letter explaining the changes. Buyer's attorney responded that (i) the Seller's latest draft was unacceptable, (ii) Seller's actions showed bad faith, and (iii) Buyer would not consummate the transaction contemplated by the LOI but reserved the right to sue for damages. Notwithstanding Seller's subsequent communications to Buyer advising Buyer that he remained open to negotiate, Buyer started court proceedings against Seller.

The Court noted that, as suggested by its drafting, the LOI was not a binding contract for the sale of the company but rather a pre-contractual agreement which entails an obligation to act in good faith. The Court reiterated that "[a]s long as a party acts in good faith and reasonably, it may withdraw from ongoing negotiations if it comes to the conclusion that it is no longer in its interest to conclude the proposed agreement." Citing a prior decision, a breach of the obligation to act in good faith during the pre-contractual phase was described as ending negotiations "without valid reason or in an abusive manner which causes damages to the other party." The Court noted that a breach of the obligation to act in good faith does not require bad faith but merely the lack of good faith. In determining whether a party lacked good faith a court will compare the conduct of the party alleged to be lacking good faith to that of a reasonable person facing the same circumstances and acting in a prudent and diligent manner.

In the case at hand, the Court found that Seller did not breach his obligation to act in good faith during the course of negotiations based on the following factors:

- signing an LOI even with the knowledge that it is not binding does not amount to a lack of good faith;
- a party's failure to consult with his attorney from the early stages of negotiations does not amount to a lack of good faith especially where the other party is aware of it and accepts it;
- the involvement of a party's attorney only at the later stages of negotiations does not amount to a lack of good faith where the other party fails to incorporate elements previously discussed, even if such involvement results in significant changes in most of the terms of the contract (it may in fact show the party's intent to proceed with the transaction and be viewed as reasonable prudent and diligent behavior in the context);
- the breakdown of communications between the parties' attorneys does not amount to a lack of good faith; and
- finally, it is difficult to imply a lack of good faith where the party alleged to be at fault shows that he (i) remained open to negotiations even after the other party withdrew from negotiations, and (ii) never acted in such a manner as to bring the negotiations to an end.

Conclusion

In Quebec, following the signing of a non-binding LOI, the parties thereto should act with caution as they have an obligation to negotiate in good faith. The obligation to negotiate in good faith does not imply that a party cannot pursue its own interest, rather it means that, in its dealings with the other party, it has to act reasonably, with prudence and diligence. Whether a court will find that a party has acted reasonably, with prudence and diligence during the negotiation process, or in ending the process, will depend on the facts and circumstances. The consequences of not acting in good faith during the negotiation process can lead to liability for damages and, where a court finds that the parties had agreed on the essential terms of the deal and the party found to be lacking good faith is the one who walked away from the negotiation process, a court may, under certain circumstances, impose the sale of the business if the aggrieved party so desires. In order to avoid such consequences, when beginning the negotiation process it is best to consult legal counsel to help you prepare an LOI and guide you through the negotiation process.

II. Non-Disclosure Agreements: *Certicom Corp.* v. *Research in Motion*

It was during the middle of the financial crisis, that the Canadian courts once again raised the issue of the effect and effectiveness of confidentiality and standstill agreements in Canadian M&A practice.

By way of back ground, in February 2007 the parties began discussing the possible acquisition of Certicom by RIM. For this purpose, a non-disclosure agreement was signed on July 11, 2007 (the "2007 NDA"), which limited the use of confidential information that Certicom provided to RIM for certain permitted purposes for five years. "Purpose" was defined to mean: "assessing the desirability or viability of establishing or furthering a business or contractual relationship between the Parties, which may include, without limitation, some form of business combination between the Parties."

The 2007 NDA applied to confidential disclosures made within six months of the agreement and the agreement included a standstill provision preventing RIM from making a hostile bid for 12 months.

Pursuant to the agreement, Certicom provided RIM with a disclosure package in September 2007. In February 2008, a second tranche of disclosure was provided to RIM despite the fact that Certicom's interim CEO had put the potential acquisition "on hold" in anticipation of the appointment of a new CEO. In March 2008, the new CEO advised RIM that Certicom was intending to focus on its business fundamentals and would consider the potential acquisition in a few quarters.

2008 NDA and Disclosures

In June 2008, the parties signed a new non-disclosure agreement (the "2008 NDA"). The 2008 NDA, however, was not completed in contemplation of an acquisition, but was signed in the ordinary course of the parties' commercial relationship. The term of the agreement was five years and it limited, to certain permitted purposes, the use of information disclosed within three years. The 2008 NDA did not contain a standstill provision, nor did its definition of "purpose" include the language regarding "some form of business combination" found in the 2007 NDA. Specifically, the agreement provided that confidential information could only be used for the purpose of: (i) assessing the desirability or viability of establishing or furthering a business or contractual relationship between the Parties; and (ii) to the extent this agreement is incorporated by reference into any other agreement between the Parties, achieving the objectives of that agreement.

In September 2008, however, discussions began anew regarding a potential acquisition. Despite the fact that the 2008 NDA was not signed in contemplation of an acquisition, the parties agreed that it was sufficient for their needs and Certicom subsequently provided further disclosure to RIM in October 2008.

Bid

On November 7, 2008, RIM communicated its desire to acquire 100% of Certicom in a friendly takeover to Certicom's CEO. Certicom, however, refused to provide RIM exclusivity, as it had a standing non-disclosure agreement with another potential acquirer. RIM thus eventually initiated a hostile bid, announcing its intentions in early December. In response, Certicom commenced an auction process and sought an injunction against RIM, claiming that it had used confidential information improperly. Of note, RIM conceded that it had used confidential information provided by Certicom in assessing the prospects of launching its hostile bid.

Arguments and Analysis

Certicom argued that RIM's offer to its shareholders did not satisfy the definition of "purpose" under which the 2007 NDA was signed and disclosure subsequently provided, since the offer was not "between" the two parties. Certicom also cited the language of the 2007 NDA's standstill provisions in support of its argument, which employed disjunctive language to prohibit "any merger or other business combination or tender, takeover bid or exchange offer". The language of the provision, thus, suggested that a business combination was distinct from a takeover bid. RIM, however, cited language in the 2007 NDA that referred to "an offer for the assets, securities of [Certicom] or other business combination" in support of its argument that a business combination included its offer to shareholders.

The Court, meanwhile, found that such a take-over bid could constitute a business combination under the 2007 NDA. It rejected, however, the idea that such a combination would be "between" the parties. As the Court found: "[b]ased on the ordinary and usual meaning and dictionary definition of the word "between" and the manner in which the word is used in the 2007 NDA, a takeover bid would in my view only amount to a business combination between the parties if Certicom consented to, or endorsed, the transaction and in that manner participated with RIM in RIM's bid."

The Court also considered RIM's argument that where parties employ a standstill agreement, the confidentiality provisions should not be interpreted in such a way as to effectively extend the duration of the standstill. The Court, however, found that the confidentiality and standstill agreements operated independently and provided different protections for different terms. "A standstill provision is better protection, removing the need for proof, and costly litigation." After the conclusion of the term of the standstill provision, therefore, RIM could still mount a hostile bid as long as it had not used confidential information in assessing its bid.

With respect to the interpretation of the 2008 NDA, RIM argued that Certicom consenting to disclose confidential information without signing a new NDA with standstill provision incorporated the 2008 NDA by reference, under part (ii) of the definition of "purpose". The "entire agreement" clause to the 2008 NDA, however, prevented the success of this argument. Further, the Court rejected RIM's argument that a hostile bid satisfied part (i) of the definition of "purpose" under the 2008 NDA: "it makes no business sense to conclude that in July of 2008, when the 2008 NDA was signed, the parties intended to permit RIM to use information disclosed at any time in the ensuing three years for the purpose of a hostile bid."

Thus, RIM was found to have used confidential information provided by Certicom in a way not permitted by either the 2007 NDA or 2008 NDA. In considering relief, the Court found damages to be an inadequate remedy, since RIM would be paying itself should its bid be successful. RIM's policy arguments against an injunction, meanwhile, failed to convince the Court.

The Court, therefore, issued a permanent injunction against RIM, preventing it from taking any steps to further its hostile bid. RIM, however, was free to engage Certicom in a friendly bid or to launch another hostile bid that did not make use of the confidential information it had acquired from Certicom.

Looking Forward

This decision highlights the importance of carefully drafting a non-disclosure clause to ensure that exchanges of confidential information occur for the purposes addressed by the agreement. Companies looking to use confidential disclosures in order to consider the viability of an acquisition will have to include clear language to that regard or set up a "firewall" to ensure that those working on a bid do not have access to confidential material. The former option is obviously the most practical.