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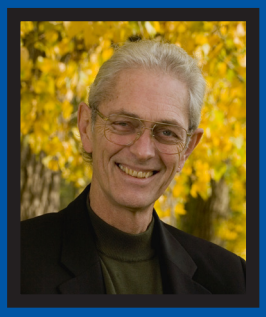

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CONTRACTING IN GOOD FAITH

This Bulletin is an excerpt from my book *Negotiation - Principles, Tips, and Tactics for Successful Deal-Making*, provided here as an educational supplement with the permission of LexisNexis, Canada's leading legal publisher.

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INTRODUCTION

The concept of bargaining in good faith traditionally has never been embraced by English or Canadian common-law, whether the bargaining occurs prior to a contract being formed (i.e., the pre-contractual stage) or even when a contract has been formed but one of the parties is acting in bad faith (i.e., the post contractual stage).

In part, at the pre-contractual things, this appears to be due to the difficulty of defining what bad faith would be and in part this appears to be due to the insistence of the judiciary to have a contract in place before any legal obligations on the parties are created.

At the post-contractual phase, when the parties already have a contract in place, Canadian common law has still resisted the idea that the parties could be obligated to do something so vague as to bargain in good faith, thereby limiting their commercial freedom in future.

This traditional view is seen in the following quote from Lord Ackner of the English House of Lords in the case of *Walford v. Miles* [1992] 1AllE.R. 453 at 460-461:

> *"How can a Court to be expected to decide whether, subjectively, a proper reason existed for the termination of negotiations? The answer suggested depends upon whether the negotiations have been determined "in good faith." However, the concept of a duty to carry on negotiations in good faith is inherently repugnant to the adversarial position of the parties when involved*

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> *in negotiations. Each party to the negotiations is entitled to pursue his (or her) own interest, so long as he avoids making misrepresentations. To advance that interest he must be entitled, if he thinks it is appropriate, to threaten to withdraw from further negotiations or to withdraw in fact in the hope that the opposite party may seek to re-open the negotiations by offering him improved terms…. A duty to negotiate in good faith is as unworkable in practice as it is inherently inconsistent with the position of the negotiating party."*

Thus, the uncertainty of bargaining in good faith as a legally recognized obligation and the uncertainty of estimating damages if there was such a legal obligation (the other traditional reason for refusal) has caused most Courts in Canada to decline to make good faith part of general Canadian law, except in specific situations:

- Canadian Courts have found an obligation on employers when terminating employment to act in good faith in how they dismiss an employee (although not in whether the employee should be dismissed).
- The Courts have used "good faith" to imply terms of reasonableness in franchise contracts.
- In insurance contracts, the Courts have used "good faith" to require insurers to deal fairly with claims made by insured parties and to require the insured to disclose to the insurer facts material to being insured
- Due to legislation, Canadian Courts have found a duty to act in good faith on both sides in union–management collective agreement negotiations, although the Courts still struggle with what that means exactly, based on the number of cases and confused decisions in that highly litigious area of law.

And...

- The Courts (or rather, some of them) have used the concept of good faith in competitive bidding cases, combining it with the implied legal obligation upon Owners to act equally and fairly to Bidders on how the Owner conducts a competition (see Canadian Law of Competitive Bidding topic for a more detailed discussion of this).

Outside of these areas, Canadian Courts did not recognize any obligation of good faith in post-contractual dealings between contracting parties until the Supreme Court of Canada (SCC) considered the case of *Bhasin v. Hrynew* in 2014 (decision issued in 2015 and found at 2014 SCC 71).

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BHASIN V. HRYNEW AND HERITAGE EDUCATION FUNDS INC.

Bhasin v. Hrynew and Heritage Education Funds Inc. (2015) is a ground-breaking decision in the Canadian law of contracts. For the first time, the Supreme Court of Canada (SCC), the highest Court in Canada, acknowledged that there was a legal obligation upon parties in a contractual relationship to act in good faith towards one another. This obligation of good faith is a common law duty which now applies to all contracts and requires parties generally to perform their contractual duties honestly and reasonably and not capriciously or arbitrarily. The parties in a contract must now have "appropriate regard for the legitimate contractual interests of the other party."

As an organizing principle of all contracts (as opposed to a rule), the principle of good faith will vary, perhaps a great deal, depending upon the exact circumstances of any given case (what the Court called a 'highly context specific analysis'). What having "appropriate regard" for the other party's legitimate contractual interests means, what "honesty and reasonableness in performance," means and what "bad faith" is will all depend upon what occurred when the contract in question was formed, what that contract said and what the parties did.

So, at this point in time, so soon after such a precedent-changing decision, it will be impossible to tell what is or is not "acting in bad faith" and now contrary to Canadian law. It will take many more cases in the lower and appellate Courts (and likely return to the SCC) over the next decade to know with any certainty how far this principle will be taken by our Courts and how much it will change Canadian law and practice in contracts. But the door has been opened to good faith being a foundational principle of all contracts in Canada.

In its decision, the SCC was very careful to place limits on what could be called "the new general duty of honesty in contractual performance." Parties must not lie or otherwise knowingly mislead each other about matters directly linked to performance of the contract. But, except in competitive bidding situations, there is no general duty of disclosure upon contracting parties nor is there any requirement that parties put the other side's interests first. Good faith to the SCC does not require a contracting party to forgo advantages flowing from the contract and parties are still free to pursue their individual self-interests, even though this may cause a loss or even be intended to cause a loss to the other party. According to the SCC, the principle of good faith should not be used as a pretext by the Courts for scrutinizing the motives of contracting parties. Good faith is supposed to be "a simple requirement not to lie or mislead the other party about one's contractual performance." Good faith does not do away with Freedom of Contract as the general principle of contracts but it does place equitable limits on it.

The *Bhasin* case involved a renewal clause in a contract between an Alberta company (that marketed educational savings plans to investors) and one of its independent sales agents, Mr. Bhasin. In the contract, the company had an absolute right to end the contract at the end of its term but in doing so, the company lied to Mr. Bhasin for months beforehand and misled him about its plans and its reasons for making those plans. As a result, the agent lost his

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entire business, which loss could have been avoided if the company had told the truth from the beginning. As a result of this "bad faith," the SCC awarded damages to the agent, Mr. Bhasin, of the entire value of his business.

Under past law, the agent would have had no remedy (*caveat emptor* rules) but under the new law, he did, because of the organizing principle of good faith and the new general legal duty of honest contractual performance.

To most non-legally trained people, this decision does not seem to be that big of a deal but that is primarily, we would submit, because people did not know that one could lawfully mislead the other side in a contract without punishment before. To lawyers, this case is a big deal but whether or not it is a "good thing" is much in dispute. For example:

- Some lawyers have commented that it really is not important as contracting parties in a commercial context have always expected honest performance from one another.
- Other lawyers have begun to advise their clients to stop talking to the other side in the contract and to avoid giving specific answers to questions the other contracting party may ask, stating that *Bhasin* does not require them to answer or to give reasons, so they should not say anything.
- Still other lawyers immediately began advising their clients to define "good faith" in their contracts as narrowly as possible (since "good faith" cannot be excluded all together according to the SCC – but it can be limited) to avoid allegations of bad faith being made. These lawyers are worrying that the SCC, with the best of intentions, may have opened Pandora's box or, as one lawyer's succinctly put it, that the SCC may by this decision have "set us on a road to hell."

The why's and wherefore's of the idea that a law requiring honesty would 'send us to hell' are best left unstated – but apparently we no longer live in a world where, as in past times, a handshake between two parties to bind an agreement is no longer a valid way of doing business – and a person's word is no longer their bond. The 'road to hell' reaction is a good illustration of why the SCC chose to create a general legal duty of honest performance in the first place. Freedom to make the contract you and another party choose is one thing – freedom to lie in a contractual relationship is quite another.

Despite the wide divergence between claims that this decision is "no big deal" and claims that it means "the sky is falling," we doubt that the *Bhasin* case is either. It will likely create more litigation as parties seek to find out what is bad faith in the context of their contracts – but we believe that:

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- most Courts will still follow what an actual contract states (or does not state) as being the rights of contracting parties, and
- that bad faith will only be found when there is egregious (i.e., remarkably bad conduct deserving condemnation) behaviour by one of the parties in exercising their rights.

Longer term, however, the opening of the door to claims of bad faith will have more profound effects on Canadian contract law as the lower Courts grapple with this new concept and seek to define its application. But these changes will take a long time to occur, will be incremental in nature, and everyone will have plenty of notice as to when they are occurring. And, what these changes will be is pure speculation at this point.

***Bhasin's* effect on negotiation**

The *Bhasin* decision does not directly affect negotiation between two parties seeking to form a contract. This is because the SCC very carefully limited the application of honest performance to a formed contract, not the process by which a contract was formed (i.e., the negotiation of the contract). So there is still no obligation in Canadian law to bargain in good faith in making a general contract … Yet. The decision in *Bhasin* will likely have effects on competitive bidding law as there is a contract formed at the close of bidding and may even have an effect upon the use of negotiation in the so-called non-binding competitive bids that we have begun to see being used in Canada (see Canadian Competitive Bidding Law topic for more comprehensive discussion of this issue).

Over time, however, it is not improbable that the principle of good faith will find expression in the process of negotiation to form a contract as well. Already, Canadian Courts do look at what parties did and said during negotiation to determine what those parties intended in the contract. It would, in some ways, be a relatively small step to extend some form of good faith – honesty obligation into what people say and do during a negotiation even though that negotiation did not actually result in an agreement. If, for example, one party reasonably relied upon what another party was saying in a negotiation and suffered a loss as a result of relying upon (what later turned out to be) statements made in the negotiation that were made in bad faith, it is hard to imagine a Court, given the *Bhasin* decision, not wanting to find a remedy.

So, in future, we believe such behaviours in negotiation as:

- a party negotiating with no intention of ever making a contract,
- a party actively misleading another party as to what their intentions were when negotiating,
- a party refusing to make any effort to reach agreement, and / or

- a party breaking off negotiations with one party for no good reason in order to cause the party a loss or in order to set up a contract with a competitor to harm the negotiating party…

… all could be seen as bad faith and deserving of judicial rebuke (i.e., damages to the victim).

We are not there yet and, given the legal hurdles to allowing such claims, we may never get there. But with the *Bhasin* decision, Canadian law may have moved several steps in that direction. Time will tell.

In the meantime, we believe that all parties in any negotiation should be honest and ethical anyway – it is the right thing to do. Acting ethically and honestly is always going to win more often in the end and, as we have said elsewhere in this book, a clear conscience is always the softest pillow.

An ounce of training is worth a ton of litigation!

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Happy good faith contracting!