

CON·STRUCT

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CONTRACT NEGOTIATION AND PERFORMANCE - THE OPERATING PRINCIPLE OF “GOOD FAITH”

The obligation to either negotiate or perform in “good faith” is found in many commercial agreements. While these are “big picture” concepts, they can have very real implications when a dispute arises. In recent years, the Supreme Court of Canada and the Ontario Superior Court of Justice have issued judgments that provide guidance on what commercial behavior Canada’s common law courts may, or may not, find acceptable. An understanding of the principles emanating from these cases is important for everyone who enters into contracts.

The Supreme Court of Canada’s decision in *Bhasin vs. Hrynew* (November 13, 2014) imposes a duty to act in good faith in contract performance and enforcement and the Ontario Superior Court of Justice’s decision in *SCM Insurance Services Inc. v. Medisys Corporate Health LP* (published April 28, 2014) imposes a duty to act in good faith in contract negotiations. The principles espoused in each of these cases are briefly discussed below.

Good Faith Negotiations:

Traditionally, the courts have avoided implying a duty of good faith into the negotiation of commercial agreements, recognizing that each party is acting in own best interest. As such, if parties wish to impose a duty of good faith they must do so expressly. However, even express agreements to negotiate in good faith have been considered unenforceable due to lack of certainty. In these cases, courts have held that an agreement to negotiate in good faith is not sufficiently certain to create a binding contractual obligation because it is impossible to know what “good faith” in negotiation requires. For example, during the course of negotiations parties may withdraw or continue negotiations, accept, counter-offer or reject an offer, compromise or refuse, make trade-offs or concessions etc. Therefore, how can parties determine whether negotiations will be successful or will fall through, or if successful, what the outcome will be?

The Ontario Superior Court of Justice’s decision in *SCM Insurance Services Inc. v. Medisys Corporate Health LP* suggests that a duty to negotiate in good faith may be enforceable if the contract contains an objective standard by which good faith may be measured. The *SCM Insurance* case considered a motion by Medisys seeking an interlocutory injunction to restrain SCM Insurance from selling a business where Medisys had been given a right of first negotiation. In that case, Justice Wilton-Siegel found that, in the circumstances where a party was given the right of first negotiation, that party was therefore owed a duty to negotiate in good faith. In this case, the judge found that the parties created an enforceable obligation to negotiate, even though the agreement itself did not expressly state that the parties would negotiate in good faith. Notably, the Court held that this duty related only to the right of first negotiation and did not impose a new, unbargained-for right to match other potential purchasers. If an obligation to negotiate in good faith is expressly provided for in an agreement and includes objective standards by which the obligation may be measured (such that the obligation may be enforceable), it means, in practical terms, that parties must act reasonably and must refrain from adopting a negotiating position that defeats the objectives of the agreement (e.g. parties should not refuse to negotiate, be inflexible for no reason or purposefully undermine the expectations created in the process). Further, where an enforceable obligation is found, a party who fails to negotiate in good faith will be subject to a remedy for breach of contract, either by payment of damages or an equitable remedy (e.g. an order for specific performance or an injunction where damages are not adequate compensation).

Good Faith Performance:

In *Bhasin v. Hrynew* the Supreme Court of Canada reviewed the common law regarding good faith contractual dealing and

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concluded that the common law imposes a duty to perform contractual obligations honestly. Importantly, honest performance is not an implied contractual term, but a general doctrine of contract law and as such *it applies to all contracts*. Further, this doctrine operates irrespective of intention and irrespective of any “entire agreement” clauses.

What does good faith mean in the context of contract performance? Based on *Bhasin*, performance of a contract in good faith would require that (1) the parties act honestly; (2) each party have regard to the legitimate contractual interests of the other party; and (3) neither party is to act in a manner which is arbitrary, capricious or intended to cause harm to the other party. At a minimum, acting in good faith in relation to contractual dealings means being honest, reasonable, candid and forthright. Bad faith will be found where one party, without reasonable justification, acts in a manner that substantially nullifies the other party’s bargained objective of the contract or causes significant harm to the other party, contrary to the original purpose and expectations of the parties under the contract. As indicated above, this duty to act in good faith underlies all contracts, regardless of whether the duty is expressly set out in the contract. Importantly, the duty does *not* require a party to sacrifice its own self-interest. Thus, parties may still seek to strike the best possible bargain in their own interest. Nor does the duty include a duty of loyalty. Further, this duty does not necessarily include a duty of disclosure. A party cannot mislead the other party or seek to undermine the interests of the other party in bad faith (as such, in the context of disclosure, caution must be exercised where an omission could be misleading). The Supreme Court of Canada noted that the implications will be different in a context of a long-term contract of mutual cooperation (e.g. a master agreement or employment contract) than in a more transactional exchange.

Further, *Bhasin* does not stand for the general proposition that contract negotiations must be conducted in good faith or honestly. However, as indicated above, if parties have expressly agreed to negotiate in good faith, then the principles in *Bhasin* may apply to such negotiations. This will depend on whether an agreement to negotiate in good faith is an enforceable element of a contract.

Examples where courts have found a breach of this obligation include: failing to give an employee any reason for a suspension (this is not forthright), acting in a way that defeated the objects of the contract (this is not honest or candid), and exercising a strategy in rate renewal negotiations to trigger a termi-

nation of the contract.

Key Take-Aways:

- The duty to act honestly in the performance of a contract applies to all contracts, regardless of whether the obligation is expressly written and regardless of any “entire agreement” clauses. Accordingly, if you have control over the drafting of the contract, consider including language that defines the scope of the duty (e.g. specify activities that will not constitute “bad faith”).
- The enforceability of an obligation to negotiate in good faith is entirely dependent on the context of the obligation. As such, owners should proceed cautiously when entering into agreements which require them to negotiate in good faith. A contractual right to negotiate in good faith can be a binding obligation where what is being negotiated is fairly specific and where a party’s conduct regarding negotiations can be measured against an objective standard.
- Further, a refusal to negotiate, in the presence of a commitment to negotiate in good faith, especially where the parties clearly intended that negotiation take place, may now result in liability for damages.
- Finally, while there is no precise way to establish good faith when negotiating, acting honestly and avoiding making false or misleading statements will assist in establishing that you did not act in “bad faith”. Knowing and being able to articulate the broad goals you had sought to achieve in the contract, and being prepared to compromise during negotiations, where appropriate, may also be indicia of good faith. Contracts negotiated in good faith typically take the form of a compromise, with both sides making concessions to reach a deal.

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