

The Operating Principle of “Good Faith” in Construction Contracts

The obligation to either negotiate or perform a contract 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 have issued judgments that provide guidance on what commercial behavior Canada’s common law courts (i.e. Canadian courts outside of Quebec) may, or may not, find acceptable. An understanding of the principles emanating from these cases is important for the construction industry.

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 pre-contract negotiations. The principles espoused in each of these cases are briefly discussed below.

Pre-Contract Good Faith Negotiations

Traditionally, common law 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. Even express language to negotiate in good faith have been considered in some circumstances to be 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’s 2014 decision of *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 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 in contractual performance 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 also 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 termination of the contract.

Since *Bhasin*, there has been some confusion in the application of the principle of good faith in contract performance, where arbitrators or trial courts have found that the duty to act in good faith has been breached and the courts of appeal have overturned those decisions. Further, the appellate courts in common law provinces appear to have interpreted this principle narrowly. This was the case in *CM Callow Inc. v Zollinger* (November 9, 2018) and *Greater Vancouver Sewerage and Drainage District v Wastech Services Ltd.* (February 22, 2019), two cases that were heard before the Supreme Court of Canada in late 2019, and whose reasons are still pending.

In *CM Callow Inc. v Zollinger*, the plaintiff provided maintenance services to the defendants under 2 separate two-year contracts (one for the summer and one for the winter months). The winter contract allowed for early termination by the defendants on a 10-day notice. In the spring, the defendants decided to terminate the winter contract, but they did not provide the plaintiff with notice of termination until the following fall to avoid interfering with the plaintiff’s work under the summer contract. As incentive for the defendants to renew the contracts, the plaintiff provided free work in the summer. The defendants knew that the plaintiff was under the impression that the contracts were likely to be renewed. The plaintiff commenced an action for breach of contract. At trial, the Ontario Superior Court of Justice concluded that the defendants acted in bad faith by: (1) failing to disclose that they intended to terminate the winter contract to ensure that the plaintiff performed the summer contract; and (2) continuing to represent that the winter contract was not in danger of non-renewal. The Court of Appeal for Ontario disagreed with the trial judge, holding that, while the defendants may have acted dishonorably, their acts did not rise to the high level required to establish a breach of duty of honest performance. Further, the Court of Appeal held that *Bhasin* does *not* stand for the proposition that there is a unilateral duty to disclose information relevant to termination. It added that the duty of honest performance in this case required that the parties be honest with each other as regards the matters “directly linked to the performance of the contract” as opposed to a separate contract between the parties. Further, the Court held that the

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defendants were only required to provide the notice set out in the contract and were not obligated to address with the other party performance issues. The Court of Appeal's decision in this case suggested that acting in good faith does not require the parties to refrain from representations in anticipation of the notice of termination, since requiring this would amount to a substantial modification of the parties' express rights to terminate the contract. Further, it suggested that, when applying the principle of good faith, the courts will place great weight on the principle of freedom of contracting parties to pursue their self-interests.

In *Greater Vancouver Sewerage and Drainage District v Wastech Services Ltd.*, the plaintiff and Greater Vancouver Sewerage and Drainage District ("Metro") were parties to a long-term and complex agreement for the disposal of solid waste. Pursuant to the agreement, Metro had the discretion to allocate the waste between two landfills and an incinerator. In 2011, Metro substantially re-allocated the waste between the disposal facilities to reduce its costs, which, in turn, increased the plaintiff's costs and reduced significantly its profit under the agreement. The plaintiff referred the matter to arbitration. While the arbitrator did not find that Metro had exercised its discretion to re-allocate the waste capriciously or arbitrary, the arbitrator held that Metro breached the duty of good faith because it exercised its discretion without appropriate regard to the plaintiff's interests. The Supreme Court of British Columbia overturned the arbitrator's decision, stating that it improperly expanded the concept of good faith. The Court of Appeal of British Columbia upheld the Supreme Court decision, advancing two significant propositions. First, the Court of Appeal held that the parties' interests that mattered for the purpose of the good faith analysis were only the *legitimate expectations arising out of the agreement*. In this case, the agreement allowed Metro to re-allocate the waste the way it did, so, it was not open to infer that the plaintiff had a legitimate expectation arising out of the agreement that Metro would not exercise its discretion the way it did. Second, the Court of Appeal suggested that the parties may exercise discretion under the agreement in their own interest, even if it harms the other party's contractual interests, so long as the discretion is not exercised in bad faith or does not seek to undermine the other party's interests. The Court also emphasized that a breach of the duty of the good faith requires a subjective element of dishonesty, improper motive or bad faith.

We are currently awaiting the Supreme Court of Canada's judgments in relation to these two cases. It remains to be seen whether the Supreme Court of Canada decisions provide clarification on how to apply the principle of good faith in the performance of contracts in common law jurisdictions, such as

B.C. We will provide an update in a further edition of this newsletter, once these decisions are released.

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, parties 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 with the common goal of reaching a deal.

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Pam brings over 19 years of combined legal experience in local government and commercial real estate matters with a focus on land use planning, subdivision, rezoning and redevelopment of residential, mixed-use and industrial properties. Pam has worked on numerous large-scale development projects throughout the Province and provides strategic and practical advice on project development, infrastructure financing and transactional matters. Pam also has a Master's Degree in Public Administration and is a seasoned advisor for local governments in all aspects of their legislative authority, including bylaw development, constitutional jurisdiction, conflict of interest and FOIPPA.

Our lawyers combine legal experience in local government, commercial real estate development, and construction law to provide legal services to local governments, owners, builders and developers on a range of projects, from concept to completion, and beyond.

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