Good Faith in Contracts: New Law from the Supreme Court

Jake Bullen, Colin Ground, Colin Pendrith and Tim Pinos

January 21, 2015

AGENDA

1. Overview
2. The Story So Far
3. Bhasin v Hrynew
4. Advising re: “Honest Performance”
5. Negotiating and Drafting in the Shadow of Good Faith
7. Where will Good Faith take us next?
8. Questions and Discussion
The Story So Far – Essential Concepts

- Good faith may be:
  - Express
  - Implied
  - Statutory
- Distinction between:
  - negotiation/formation of the contract
  - performance/enforcement of the contract

The Story So Far - A general duty of good faith?

- “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 Story So Far – Other jurisdictions

- Compare to United States
  - Uniform Commercial Code imposes duty
    - **Art. 1-304:** “Every contract or duty within the Uniform Commercial Code imposes an obligation of good faith in its performance and enforcement.”
    - **Art. 1-201:** "Good faith," ... “means honesty in fact and the observance of reasonable commercial standards of fair dealing”

- Compare to Québec
  - The Civil Code of Québec recognizes a broad duty of good faith which extends to the formation, performance and termination of a contract and includes the notion of the abuse of contractual rights: see Arts. 6, 7 and 1375
  - **Art. 1375:** “The parties shall conduct themselves in good faith both at the time the obligation arises and at the time it is performed or extinguished.”
The Story So Far – When good faith arises

- In what circumstances has a duty of good faith in performance been recognized?
  - Types of clauses or relationships
  - Specific contract categories

The Story So Far - Clauses or Relationships

- *Where parties must cooperate to achieve the objects of the contract*

- *Where party exercises a discretionary power*
  - “sole discretion” – not what you think

- *Where one party seeks to evade contractual duties*
The Story So Far - Specific contract categories

- **Employment**
  - Manner of termination
- **Insurance**
  - Contract of utmost good faith
- **Tendering**
  - Contract A subject to duty of fair dealing
- **Franchise**

The Story So Far - What is good faith?

- An “excluder” of bad faith
  - *No ulterior motive*
  - *No arbitrariness or capriciousness*
  - *No animus or malice*
- Does not create new, unbargained-for rights and obligations
- Check and balance on performance and enforcement of contract
The Supreme Court Chimes in


- Facts
- Trial Decision
- Court of Appeal

- General organizing principle of good faith
  - Underlies and manifests itself in various more specific doctrines governing contractual performance
  - Not “ad hoc judicial moralism or palm tree justice” (limits on good faith)
  - “That organizing principle is simply that parties generally must perform their contractual duties honestly and reasonably and not capriciously or arbitrarily.”

---


- Specific duty of honest performance
- Finding of Breach: Can-Am acted dishonestly
- Remedy
  - Damages assessed as “what Mr. Bhasin’s economic position would have been had Can-Am fulfilled that duty”
What is the Duty of Honest Performance?

- Parties cannot lie or knowingly mislead
- Not a duty of disclosure or of fiduciary loyalty
- Distinction between “failure to disclose material fact, even a firm intention to end the contractual arrangement, and active dishonesty.”

What is the Duty of Honest Performance? (2)

- The problem of remedies
  - Speculative damages based on how another party would have acted
- Overlap with other causes of action
  - Misrepresentation?
  - Promissory estoppel and estoppel by representation?
  - Civil fraud?
Parties must not lie or otherwise knowingly mislead each other about matters directly linked to the performance of the contract

- How to avoid “actively misleading” or deceiving
  - Avoid partial disclosure
  - Avoid oral representations
  - Keep records of any representations
- No requirement to disclose material information to the other contracting party
  - Determine if any disclosure is necessary
  - Even if asked a question there may not be an obligation to respond
- Parties may establish their own standards for satisfying the duty, as long as they respect the core requirements of the duty of good faith
  - Where possible, contracts may clarify that there is no obligation to disclose certain categories of information
Advising re: Honest Performance

What constitutes appropriate regard for the other party’s interests?

- Not a duty of loyalty or a duty to put the interests of the other contracting party first
- Not intended to be a basis upon which to review the motives of contracting parties or for a court to impose its own sense of morality (from Bhasin)
- Not intended to supplant the freedom of parties to pursue their own economic interests

Negotiating and Drafting in the Shadow of Bhasin

Establish a framework for good faith

- Delineate the important expectations and motivations
  - Set forth explicitly these expectations and motivations in the recitals, mutual obligations, reps and warranties
- Make it clear that your client is relying on the obligations, reps and warranties of the other party in satisfying your client’s expectations and motivations
Negotiating and Drafting in the Shadow of Bhasin

Establish a framework for good faith (continued)

- Document process by which you arrived at discretionary decisions and exercised contractual rights, including the manner in which the interests of other party were considered.
  - Include language that works in conjunction with Entire Agreement and Limitation of Liability provisions to assist your client
- The objectives:
  - Help your client to achieve the desired remedy
    - E.g. termination; shortening payment terms or converting to COD;
  - Avoid disputes by clarifying the appropriate remedy;
  - If necessary, show the Court that the parties established the standards by which performance of obligations is to be measured

Negotiating and Drafting in the Shadow of Bhasin

Termination Provisions – Practical Suggestions

- Obtain legal advice on the reasons for termination
  - Privilege
- Review the facts
- Minimize email traffic
- Evidence reasonable process
  - Reasons needs to be defensible in light of purpose, objectives and reasonable expectations of parties based on the contract
- Confirm deliverable(s)
Negotiating and Drafting in the Shadow of *Bhasin*

**Commercial Considerations**

- The obligation means that you will not be able to engage in a bargaining technique that is inconsistent with the duty of honest contractual performance.
- How to manage the businesspeople who are involved in performance of the contract:
  - Controlling communications with the other party(ies)
    - Ensure that no misleading or false information is provided
    - Maintaining a consistent message, internally and externally

**Commercial Agreements – Entire Agreement clauses**

- In *Bhasin*, the Court stated “[a] generically worded entire agreement clause such as cl. 11.2 of the Agreement does not indicate any intention of the parties to depart from the basic tenets of honest performance.” (para. 78)
- Can an Entire Agreement clause expressly exclude the duty of good faith and/or honest contractual performance?
Negotiating and Drafting in the Shadow of Bhasin

Commercial Agreements – Entire Agreement clauses

- Drafting suggestions:
  - Make it specific to your contract
  - E.g. “No other agreements, conditions…, whether oral or written, with respect to the duties of good faith and honesty beyond the provisions of Section 6.”
  - Reference the specific, objective standards (the “complete code”, as per the Court in Molson) that govern the scope of good faith and honest performance

Commercial Agreements - Limitation of Liability

- Any cap on liability should relate to any and all losses for breach of any duties imposed or implied, including good faith and honest performance of the Contract
- Where applicable, the exclusion of heads of damages should include damages (direct, indirect, special, punitive, etc.; loss of goodwill, revenues, profits, savings or business; even if the party has been informed in advance of the possibility of such damages or such damages could have been reasonably foreseen) of any type under the Agreement or otherwise, including under warranty, strict liability, tort, duty of good faith and/or honest performance or any other legal principle
Negotiating and Drafting in the Shadow of *Bhasin*

**Commercial Agreements - Limitation of Liability**
- Where applicable, should confirm that indemnification is the *sole and exclusive* remedy for each party for any claim (attempting to exclude equitable remedies and any exceptions to the limitation)
- Court will apply limitation of liability provisions as long as:
  - the exclusion clause applies to the circumstances in question
  - the exclusion clause is not unconscionable, as assessed at the time the contract was made
  - the Court elects not to refuse to enforce the exclusion clause because of the existence of an "overriding public policy" that outweighs the "very strong public interest in the enforcement of contracts" (*Tercon Contractors Ltd. v. British Columbia*, 2010 SCC 4, [2010] 1 S.C.R. 69.)

**Commercial Agreements – Renewal Provisions in a Contract**
- A party should not be liable if it simply decides not to renew unless it has deliberately misled its counterparty about its intentions
- Implied limitation on the exercise of discretion
  - "sole discretion"
- Where desirable, insert in the contract express terms that confirm that contractual obligations expire with no duty to renew
- Courts will assess whether there was a strategy to terminate for a "collateral benefit ahead of a good faith attempt to fulfill the agreement" (*0856464 BC Ltd. V. TimberWest Forest Corp.*, 2014 BCSC 2433, 2014 CarswellBC 3902.)
Negotiating and Drafting in the Shadow of *Bhasin*

*Commercial Agreements – Renewal Provisions in a Contract*

- Drafting suggestions:
  - Set forth the standards by which performance of obligations is to be measured:
    - For example, confirm the criteria that a party can assess when determining whether to renew or terminate
    - Make it clear that a party is under no obligation to disclose its internal assessment results
    - Maintain documentary evidence of this assessment
    - Can the assessment include matters collateral to the performance of the contract?
    - Express provisions in the contract can limit the scope of the honest performance obligations of the parties

---

*Obligation to negotiate in good faith*

- An enforceable duty to negotiate in good faith can arise by contract
- “The issue is whether... the parties themselves understood from the circumstances in which an express commitment to negotiate in good faith was given, and intended in those circumstances, that any breach of the specific commitment was to have some legal consequences.” (See *Molson Canada 2005 v. Miller Brewing Company*, 2013 ONSC 2758, 116 O.R. (3d) 108; and *Barclays Bank PLC v. Metcalfe & Mansfield Alternative Investments VII Corp.*, 2013 ONCA 494, 365 D.L.R. (4th) 15).
Negotiating and Drafting in the Shadow of *Bhasin*

- Agree to negotiate in good faith
  - Clarify the matter to be negotiated in good faith
    - Objective criteria

  What are the implications for the failure to reach agreement after negotiating in good faith?
  - Expiry of the term in which the ‘definitive agreement’ is to be negotiated
  - Contractual Remedy (e.g., Dispute resolution; Termination)

  What are the implications of the breach of the duty to negotiate in good faith by either party?
  - Damages
  - Termination Right
  - Injunctive Relief

M&A Context

- *Bhasin*: “the general organizing principle of good faith would likely have different implications in the context of a long-term contract of mutual cooperation than it would in a more transactional exchange.”
Negotiating and Drafting in the Shadow of *Bhasin*

**M&A Context: Earn-Out Provisions**
- In the absence of specific obligations governing the Purchaser’s operation of the business during the “Earn-Out Period” will good faith apply? What will such obligations mean in this context?
- Parties should define, as between them, what the “good faith” obligations of the Purchaser shall be during the Earn-Out Period so that there is a clear understanding of the manner in which the business is to be conducted.
- Consider, for example, the effect of: sale of control of Target; amalgamation of Target with another entity; operation of the business of Target in a manner that is materially different than the manner in which it was conducted pre-Closing, including termination of key managers.

---

**Full Disclosure rep and warranty from Seller:**
- *No false statements or omissions.* None of the representations and warranties contained in [this Article] contains any false statement of [material] fact or omits to state any [material] fact necessary to make those statements made not misleading.
- *No failure to disclose information.* Without limiting the generality of the previous paragraph, the Vendor has not failed to disclose to the Purchaser any information that would be material to a purchaser of the Business and the Purchased Assets.
Negotiating and Drafting in the Shadow of Bhasin

M&A Context:
- Sandbagging/Transamerica
  - Prevalence in Canada
    - Provisions are used in agreements less frequently in Canada than in the U.S.: 29% and 51% respectively*
    - Where included in transactions in Canada, more likely to be “pro-sandbagging” than “anti-sandbagging” (15% to 14%)*
  - Implied duty of good faith?

- *Source: ABA 2014 Canadian Private Target Mergers & Acquisitions Deal Points Study

Transamerica

  - Transamerica purchased all of the shares of NN Life Insurance Company from ING
  - Transamerica performed due diligence “on all aspects of the business and operations of NN Life”
  - Transamerica brought a claim to recover substantial damages for misrepresentation and breach of warranties and covenants contained in the Share Purchase Agreement
Transamerica

- ING argued that:
  - Transamerica’s failure to disclose the alleged errors before closing (and failure to consult with ING after closing) breached implied duties of good faith

- The court stated:
  - “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” [emphasis added]

Tips for the Purchaser

- Insert a clause addressing relevant limitations legislation
- Use “Pro-Sandbagging” language
- Use “Entire Agreement,” “Amendment” and “Waiver” clauses
- Purchaser shouldn’t have an obligation to disclose its findings
- Bhasin: consider use of “best efforts” or “good faith” language in the Purchase Agreement
Tips for the Vendor

- Use “Anti-Sandbagging” language
- Make it clear that Purchaser has an obligation to disclose its discovery of a breach and/or deficiency
- *Bhasin*: consider use of “best efforts” or “good faith” language in the Purchase Agreement

Where are we headed?

- A party may breach the implied duty of good faith if its conduct results in a) denying the other party the benefit contracted for or b) substantially nullifying those benefits.
- Courts may imply a duty to ensure that the other party’s “reasonable expectations” are met.
- Where discretion is part of a contract and no methodology is supplied for applying that discretion, the duty of good faith may be imposed as a gap-filling measure to determine how that discretion should be applied.
Where are we headed?

- Industry practice and customs, the length of the parties’ relationship and the commercial context of the agreement are all factors a Court will consider.
- Limitation or modification of the duty of good faith may be accomplished through express provisions.
- Business people should be mindful that not only their conduct, but also their intentions, may be examined by the Court when contractual relationships sour.