WeirFoulds LLP

CLIENT ALERT

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A Leap of Good Faith? Practical Implications of the Supreme Court of Canada's Decision in *Bhasin v. Hrynew* for Contracting Parties[1]

In *Bhasin v. Hrynew*,[2] the Supreme Court of Canada recognized a new general duty of honesty in contractual performance. Writing for the unanimous Court, Justice Cromwell stated that the new duty falls under the "broad umbrella of the organizing principle of good faith performance of contracts."[3] In the Court's view, this decision is not a leap for Anglo-Canadian contract law, but rather a timely and incremental development which "will make the law more certain, more just and more in tune with reasonable commercial expectations".[4]

The practical implications of this case are potentially wide-ranging and parties will need to consider their performance obligations and behaviour in light of this ground-breaking decision.

The Facts

A detailed description of the facts of the case is beyond the scope of this piece, but a few key points are worth remarking on to provide some context for the Court's decision. Mr. Bhasin, the appellant, ran a successful business under a contract with Canadian American Financial Corp. ("**Can-Am**"). The contract provided for an automatic renewal at the end of the term unless one of the parties gave six months' written notice terminating the agreement. Following Can-Am's exercise of the non-renewal clause, Mr. Bhasin argued that he suffered damages in the form of the lost value of his business because of Can-Am's dishonest conduct. This conduct included (i) misleading Mr. Bhasin about its intentions with respect to a proposed merger of Mr. Bhasin's business with the business of one of his competitors; and (ii) deceiving him about certain related discussions it was having with his competitor and with its provincial securities regulator.

"Two Incremental Steps"

The SCC set out in its decision to resolve the "piecemeal, unsettled and unclear"[5] state of Anglo-Canadian common law dealing with the concept of good faith in contract. In contrast with Quebec's civil law and the common law in many jurisdictions in the United States, Anglo-Canadian common law has resisted a general and independent doctrine of good faith performance of contracts.

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[2] *Basin v. Hrynew,* 2014 SCC 71 [*Bhasin* (SCC)].

[3] *Ibid* at para 72.

[4] *Ibid* at para 1.

[5] *Ibid* at para 59.

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Accordingly, the Court introduced "two incremental steps" to "put in place a duty that is just, that accords with the reasonable expectations of commercial parties and that is sufficiently precise that it will enhance rather than detract from commercial certainty."[6]

Step One: Good Faith as an Organizing Principle
First, the Court acknowledged an organizing principle of good faith underlying the existing doctrines in which the common law recognizes obligations of good faith contractual performance. Justice Cromwell explained that the organizing principle "is simply that parties generally must perform their contractual duties honestly and reasonably and not capriciously and arbitrarily."[7]

Good faith as an organizing principle is not a free-standing rule, but rather an underlying standard which underpins and manifests itself in existing doctrines about the types of situations and relationships in which the law requires an element of good faith. The Court stated that this list is not closed, so it is possible for the courts to recognize additional duties in future decisions.

The organizing principle of good faith is meant to guide the law in a coherent and principled way. Where the law is found to be wanting, the courts may apply the organizing principle of good faith to develop the law incrementally. However, any application of the organizing principle of good faith must be consistent with the fundamental commitments of the common law of contract and in particular, with the freedom of contracting parties to pursue their individual self-interest.[8] The Court was clear that the organizing principle of good faith is not an invitation for *ad hoc* judicial moralism.

Step Two: The Duty of Honest Performance
Second, the Court recognized a new common law duty, applicable to all contracts, to act honestly in the performance of contractual obligations. The Court declined to adopt a general duty of good faith in all contractual dealings. Instead, the Court recognized a more narrow common law duty of honest contractual performance, which it explained to mean "simply that parties must not lie or otherwise knowingly mislead each other about matters directly linked to the performance of the contract."[9]

The Court also emphasized that this new duty is consistent with commercial parties' expectation of a "basic level of honesty and good faith in contractual dealings" for the proper function of business.[10]

While the scope of this new duty will be determined in subsequent cases, the Court provided some helpful examples of what the new duty is not:

(1) The duty of honest performance is not a duty of disclosure. While there is no duty to disclose information, a party may not actively mislead or deceive the other contracting party in relation to performance of the contract.

(2) The duty of honest performance is not a duty of loyalty. A contracting party is not required to put the interests of the other contracting party first.

(3) The duty of honest performance is similar to, but is not the same as or subsumed by, the law relating to civil fraud and estoppel.

Practical Implications
What do these two incremental steps mean for contracting parties? While subsequent case law will provide the true measure of the impact of this decision, contracting parties can glean several takeaway points from the Court's decision:

(1) Negotiations between Parties: While the Court did not recognize a new duty of good faith in the context of negotiations between parties, based on the logic used in *Bhasin*, it is not unfathomable that such a duty may be recognized in the future. At the very least, contracting parties should be wary of any negotiation conduct that is actively misleading or otherwise deceitful.

(2) Drafting of Agreements: The Court left open the possibility that parties can vary the "precise content of honest performance" in different contexts (presumably through drafting a contractual provision that establishes the standards the parties wish to live by). The Court stated that modifications must be express, and that parties cannot contract out of the "minimum core requirements" of the duty. Since the parameters of the duty of honest performance, including its "minimum core requirements", are yet-to-be determined, it remains to be seen what modifications the courts will permit.

(3) Communications with Counter-Parties: It is unclear whether the newly-recognized duty will lead to behaviour between parties which is more aligned with the reasonable expectations of commercial parties with respect to mutual cooperation and general forthrightness. If parties are concerned about violating (or appearing to violate) a new duty of honesty in contractual performance with which they are unfamiliar, they may well be tempted to say less to each other in general. Parties should balance this cautious disposition with an awareness that, while there is no duty to disclose information, allegations of "dishonesty by omission" may also contribute to litigation risk. This risk would be amplified in a situation where one party posed a direct question to another.

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[6] *Ibid* at para 34.
[7] *Ibid* at para 63.
[8] *Ibid* at paras 66, 70.
[9] *Ibid* at para 73.
[10] *Ibid* at paras 60-61.

(4) Exercise of a Contractual Right: The Court stated that "capricious" or "arbitrary" behaviour was inconsistent with the new duty. To avoid these characterizations, parties may wish to put in place systems to document their internal decision-making processes so that they can readily explain their motivations and behaviours with regard to contractual performance. This kind of contemporaneous record-keeping may assist them in defending against a charge of being "capricious" or "arbitrary". For example, this might prove useful if one party has always intended to renew a contract with another party (and communicated those intentions to its counter-party) and then abruptly changes course and decides not to renew the agreement. Is that behaviour capricious or arbitrary? It might seem that way to the counter-party faced with an unexpected non-renewal. However, at the same time, it is possible that there was a sudden change in market conditions or an unexpected loss of a major customer for the non-renewing party. In such circumstances, utilizing a non-renewal clause is neither dishonest nor unreasonable and having a solid record of when and why a decision was made could help to lower the risk of litigation based on misperceived conduct.

(5) Disputes between Parties: While litigants can expect to see a rise in arguments regarding good faith, claims of good faith will generally fail if they do not fall within existing doctrines manifesting the organizing principle (such as the duty of honest performance). Contracting parties engaged in litigation should be prepared to confront arguments seeking to introduce new duties manifesting the organizing principle of good faith. This is particularly likely to occur where there is conflicting case law on the role of good faith in particular contractual doctrines. At a broader level, this case, along with the Court's decision in *Sattva Capital Corp v. Creston Moly Corp* (decided earlier this year),[11] should signal to parties that the Court is ready to tackle areas of uncertainty in contract law and to introduce changes that, while incremental, may have wide-reaching effects.

[11] *Sattva Capital Corp v. Creston Moly Corp,* 2014 SCC 53. In *Sattva*, the Court held that contractual interpretation involves issues of mixed fact and law. This marked a departure from the historical approach, which treated contractual interpretation as a question of law.

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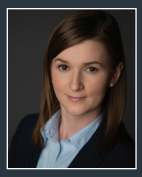

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