

Deal or No Deal: Do You Have a Duty to Negotiate in Good Faith?

Date: April 03, 2012

Original Newsletter(s) this article was published in: Commercial Litigation Update: April 2012

The following scenario may be familiar to you: You have been negotiating an important deal. A letter of intent or some other preliminary agreement has been signed. You have exchanged numerous drafts of the agreement with the other side. Then, negotiations break down, you withdraw from the deal and the other party sues your company for breaching the preliminary agreement. The question then becomes, did the preliminary agreement constitute a contract at law and will a law suit for breach of contract succeed?

It is quite common for parties to enter into some form of a negotiating or preliminary agreement, whether it takes the form of a letter of intent or a memorandum of understanding. Common standard terms in such preliminary agreements include that the agreement is “non-binding”, that the deal is subject to certain conditions precedent (conditions that must be met for the deal to close), such as the execution of definitive agreements with specific terms, and a clause that the parties “agree to negotiate in good faith”.

If the preliminary agreement stated specifically that it was “non-binding” or contained unfulfilled conditions precedent, the court would have a difficult time finding that there was an enforceable contract, and the breach of contract claim would likely fail. It will not matter that the preliminary agreement contained an enforceable duty to negotiate in good faith clause to reach a definitive agreement --- if there is no contract, there is no breach of contract. This is in contrast to some American jurisdictions, such as Illinois, that have established a separate cause of action for breach of the duty to negotiate in good faith. Similarly, under New York law, agreements to negotiate in good faith are enforceable if the parties have reached an agreement on the fundamental terms and have expressed an intent to work together to finalize an agreement.

While the implied duty of parties to negotiate in “good faith” has been entertained in Canadian jurisprudence, the common law generally has not recognized an independent duty between arm’s length parties to negotiate in good faith in ordinary commercial transactions. However, if there are certain special or unique contracts resulting in a special relationship, or there is an

existing contract where the parties' prior conduct may be relied upon, then there may be a duty to negotiate in good faith.

Special relationships that have given rise to a duty of good faith include, but are not limited to, employment contracts, the relationships of franchisor and franchisee or insurer and insured, fiduciary relationships contracts, classic tendering situations and specific cases relating to some requests for proposal.

Given the present state of Canadian law, we make three suggestions to clients involved in negotiations:

1. Take care before signing any type of negotiation agreement. You may find yourself bound to something before you are ready;
2. An agreement to negotiate in good faith can be a powerful tool to settling the parameters of a proposed transaction and establishing a duty to work toward contract completion, so think carefully about the language of the agreement and use an objective standard (e.g. fair market value) to establish good faith, and
3. Incorporate a deposit or a "kill fee" into your negotiation agreement that establishes specifically when the negotiation agreement ends.

As with many areas of the law, no matter the jurisdiction, the key to success lies in foresight and careful drafting.