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PUBLICATION

Supreme Court Establishes General Duty of Good Faith in Contracts

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Background

Contractual disputes have many different causes. Many result from gaps in the contract or different interpretations of the terms. Others arise where a party may have performed in accordance with the words in a contract but violated the spirit of the contract.

Courts and legislatures have struggled with how to address these disputes, seeking fair and practical results yet respecting the intent of the parties. Approaches have varied. Principles of contractual interpretation have evolved to address many such disputes. However, in a minority of cases some feel the results have been unsatisfactory.

Implied Obligation of Good Faith

One possible answer has been to impose an implied obligation of good faith governing contracts that supplements or modifies the other terms in the agreement. Many jurisdictions, including Quebec, have legislated such terms.

Even in the rest of Canada, legislation governing specific types of commercial relations, such as franchises, has imposed good faith obligations. But the courts in these jurisdictions have resisted the imposition of a general implied obligation of good faith applicable to all contracts. The primary reasons given are that:

- "Good faith" is an inherently unclear concept that will permit *ad hoc* judicial moralism to undermine the certainty of commercial transactions.
- Imposing a duty of good faith is inconsistent with the basic principle of freedom of contract.

So while we have seen cases where courts have referred to a good faith duty, generally these have been confined to particular types of obligations (such as the exercise of discretionary powers), or types of relationships (such as employment and insurance).

The recent Supreme Court of Canada decision in *Bhasin v. Hrynew* has fundamentally changed this.

Bhasin's dealership contract with CanAm could be renewed but the parties were free not to renew it. CanAm did not renew, thereby effectively putting Bhasin out of business. His competitor and fellow CanAm dealer, Hrynew, was then effectively given the dealership by CanAm.

Bhasin sued CanAm and Hrynew alleging that they conspired to take his business without compensation. He alleged that CanAm had breached an implied obligation of good faith. The Alberta Court of Appeal dismissed the claim finding there was no basis to imply an obligation of good faith and, in the absence of such a duty, there was no basis for a claim.

In reversing this decision, the Supreme Court of Canada directly addressed key questions related to a general implied obligation of good faith. Key points included:

- There should be an implied obligation of good faith applicable to all contracts, described as an "organizing principle."
- This does not impose a duty of loyalty or of disclosure or require a party to forego advantages flowing from the contract, even the right to act knowing this may harm the other party. But it does require some consideration of the interests of the other party.
- For now the court was satisfied that it should include a duty of honesty. Parties must not lie or otherwise knowingly mislead each other about matters directly linked to the performance of the contract.
- Concerns previously recognized about a general good faith duty were noted but found inapplicable to a duty of honesty.
- The Court chose not to articulate the scope of such a principle or related questions such as the meaning of good faith. Rather courts should approach the application of this principle in the future as specific cases arise.

This was sufficient for Bhasin to succeed as CanAm was found to have misled him with respect to their plan not to renew, and to lie about Hrynew's role. This had the consequence that Bhasin was denied a proper opportunity to protect his business in the event the agreement was not renewed. This lost opportunity was valued at $87,000, which Bhasin recovered. He was not awarded damages for the failure to renew but for the dishonest conduct related to this.

What Does the Future Hold for Commercial Parties?

The short answer is that the future is not clear. The Court has clearly invited further expansion of the good faith duty beyond honesty. However, any such expansion must be incremental and consider the noted concerns relating to a good faith duty.

We will see an increase in the allegations of bad faith, and probably more litigation. But the result in most cases is unlikely to change. However, in some cases the duty of honesty may make a significant difference, as it did in *Bhasin*.

To the extent that *Bhasin* establishes a good faith requirement to conduct oneself in accord with reasonable business standards of conduct, the consequences of the good faith duty may be

more dramatic. While a good faith duty may reduce some disputes and litigation, reducing the chances of litigation based on literal interpretations of contracts, we are likely to see a significant increase in litigation as parties seek to benefit from the duty, uncertain of its scope and meaning.

Canadian courts are likely to continue to take a conservative approach. One of the effects of the implied obligation of good faith may be to “fill in the gaps” to resolve disputes, recognizing that it may not be realistic to expect parties to fully set out the terms of an agreement.

The Court recognized that parties should be free to limit their responsibilities and in effect define their own standards of performance, but within limits which are not explained. So while the intent may be to provide certainty and clarity, the effect may be otherwise.

The reality is that the broader the concept, the greater the disputes likely to be generated. So while good faith may be seen as a way of reducing the need to have long detailed agreements, parties wishing to minimize the risk of disputes arising based on an obligation of good faith will need to address the risk in agreements with some care, particularly in the case of ongoing “relation contracts,” such as service agreements, as opposed to discrete “transaction contracts.”

Last it should be noted that *Bhasin* addresses many questions related to good faith but does not answer many of them. For example, can parties contract out of a good faith duty other than honesty? What is good faith? Is silence dishonesty? How can one reconcile a duty not to mislead but accept there is no general obligation of disclosure?

Some answers are to be found in other cases. But while one of the goals of the Supreme Court of Canada was to provide more certainty and clarity, it will take some time to see if this is achieved.