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PUBLICATION

Good Faith: Two Court Decisions Bring Greater Certainty, Coherence to Law Governing Contract Negotiations, Performance

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If you negotiate a contract with another business, do you have a legal obligation to negotiate in good faith?

If you have signed a contract with somebody else, do you have a legal obligation to carry it out it in good faith?

In the U.S. and Quebec, the answer is yes, at least to the second question, where there is a recognized duty of good faith in the enforcement of contracts. If you are operating in Canada's common law jurisdictions, where there has not been a "free-standing" duty of good faith in commercial contracting historically, the answer is maybe.

The Supreme Court of Canada and the Ontario Superior Court of Justice have published judgments recently that add to the discussion.

As a practical matter, these judgments will provide businesses that are negotiating and/or performing contracts with greater insight as to what commercial behaviour Canada's common law courts may, or may not, find acceptable.

The Supreme Court's judgment in *Bhasin vs. Hrynew* published November 13, 2014, addresses good faith in contract performance and enforcement.

The Ontario Superior Court of Justice's judgment in *SCM Insurance Services Inc. v. Medisys Corporate Health LP*, published April 28, 2014, speaks to good faith in contract negotiations.

Good Faith in the Performance/Enforcement of a Contract

In *Bhasin v. Hrynew*, Canadian-American Financial Corp. (Can-Am) marketed education funds through a dealer network. Bhasin was one of those dealers. All sales were the sales of Can-Am and the dealers received a commission. The relationship resembled a franchise in many respects, but was not a franchise because no payments flowed from the dealers to Can-Am. Similarly, the relationship had many attributes of an employment relationship, but it was not because of the independence afforded the dealers in setting up their networks.

Hrynew was one of Can-Am's largest dealers and had very good working relations with the Alberta Securities Commission (ASC), an important ingredient in this business. Hrynew wanted to acquire Bhasin's business but Bhasin refused to sell. Hrynew actively encouraged Can-Am to force the sale.

Can-Am had concerns about its relationship with the ASC. In order to deal with those concerns, Can-Am appointed a Provincial Trading Officer (PTO). The PTO was Hrynew. Bhasin refused to let Hrynew, in his capacity as PTO, review Bhasin's books and records as Bhasin was concerned about his competitor accessing his confidential information. Can-Am assured Bhasin that Hrynew was bound by a confidentiality obligation and so Bhasin's concerns were misplaced. Additionally, Can-Am, in its dealings with the ASC, proposed a plan in which Bhasin would work for Hrynew's dealership. This was not communicated to Bhasin.

Can-Am threatened to terminate Bhasin's dealership if Bhasin did not permit Hrynew, as PTO, to audit the Bhasin records. Eventually, Can-Am advised Bhasin that Bhasin's dealership would not be renewed. Following the termination, the majority of Bhasin's work force was retained by Hrynew.

On its face, the case had two simple themes. (a) Can-Am had a right to refuse a renewal. (Parenthetically, how could Bhasin be entitled to damages when Can-Am was merely exercising its rights?) (b) Can-Am had deliberately misled Bhasin and acted in a manner that had the effect of Hrynew expropriating Bhasin's business.

The trial judge found that Can-Am did not act honestly and, had they done so, Bhasin might have acted differently and salvaged some value. The Alberta Court of Appeal ruled that the lower court was wrong in applying a duty of good faith, especially where there was an entire agreement clause, and the effective result was that Can-Am was doing nothing more than exercising its contractual rights.

The Supreme Court determined that there is a duty to act honestly in all contracts. It affirmed the trial judge's finding that Can-Am acted dishonestly with Bhasin throughout the period leading up to its exercise of the non renewal clause, both with respect to its own intentions and with respect to Hrynew's role as PTO. Can-Am was found liable for damages equal to what Bhasin's economic position would have been had Can-Am fulfilled its duty of honesty (being the value of the business around the time of the non-renewal).

While the Supreme Court recognized that the current Canadian common law regarding the duty of good faith in the performance and enforcement of contracts is: (i) uncertain; (ii) lacks

coherence; and (iii) is out of step with Quebec and the U.S., it chose to impose an incremental step moving Canada closer to the U.S. and Quebec.

It did this by recognizing that good faith is an organizing principle -- not a law but a standard that underpins and is manifested in more specific legal doctrines and may be given different weight in different situations. -- and that parties to a contract have a duty of honesty with each other.

This duty now applies to all contracts.

Duty to Negotiate in Good Faith

As a result of the *Bhasin* decision, a binding agreement containing an obligation to negotiate a future agreement now imposes a duty to act honestly. A party to a negotiation, where the negotiation is contemplated in a binding agreement, cannot mislead the other party. This may be nothing more than an obligation to refrain from negotiating in bad faith, but there can be no question that where a commitment is made in an agreement to negotiate in good faith, there will be restraints on the parties' conduct in the negotiation.

Bhasin v. Hrynew makes it clear that the new duty of honesty does *not* include a duty of loyalty or of disclosure. Clearly, parties to a negotiation, even where committing to act in good faith, are not required to reach an agreement, act in their own self-interest, or disclose all they know. (With respect to disclosure, caution must be exercised when an omission could be misleading.)

What is not clear is whether one party's refusal to negotiate at all confers any rights on the other party who wants to negotiate.

The case law already recognizes that 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.

The recognition of good faith as an organizing principle may result in more weight being given to the recognition of an enforceable right to negotiate in good faith that flows from *Molson Canada 2005 v. Miller Brewing Co.* In this case, the parties themselves understood from the circumstances, in which an express commitment to negotiate in good faith was given and intended, that any breach of the specific commitment was to have some legal consequences.

As a result, a refusal to negotiate, in the presence of a commitment to negotiate in good faith, especially where the parties clearly intended that some negotiation take place, may now, more than ever, mean the party refusing to negotiate is liable for damages.

This prospect emerges clearly in the Ontario Superior Court of Justice judgment in *SCM Insurance Services Inc. v. Medisys Corporate Health LP.*

SCM's subsidiary, Cira, is a national provider of independent medical assessment services. Medisys is a provider of preventive, diagnostic and consultative healthcare services. Until 2011, Medisys also operated an independent medical examinations business in competition with Cira.

Cira purchased Medisys's independent medical examinations business. As part of the transaction, Medisys provided a five-year non-competition and non-solicitation covenant.

Before the expiry of the five-year non-competition covenant, Medisys purchased, from Plexo, Plexo's business, which included a division that, if operated by Medisys, would result in Medisys being in contravention of its non-competition covenant with Cira.

Medisys sought a waiver of the non-competition covenant in connection with the Plexo acquisition. Medisys and SCM entered into an agreement in which they agreed to negotiate the sale of the Plexo assessment business to SCM. In order to permit the negotiations, SCM waived compliance with the non-competition covenant. In the event that SCM and Medisys could not reach an agreement in the sale and purchase of Plexo, Medisys would have eight months to divest itself of its offending division.

Medisys and SCM failed to reach an agreement. The parties proceeded on the basis of a price being five times sustainable EBITDA (earnings before interest, taxes, depreciation and amortization), but they could not agree on the value of the sustainable EBITDA. So, SCM rejected Medisys' offer to sell the division for $5.4 million. Medisys eventually entered into an agreement to sell the division to a third party for $4.35 million. SCM sought an injunction to prevent the sale to the third party.

The central issue in SCM's injunction motion was SCM's allegation that Medisys had a duty of good faith with respect to its obligation to offer SCM the first opportunity to negotiate the purchase of the division.

Although the judge recognized that there is case law that suggests that an obligation to negotiate an agreement or to negotiate an agreement in good faith is unenforceable, the judge did not think that this principle should be applied in this case.

The judge "proceeded on the basis that the parties intended that Medisys would be subject to an enforceable obligation to negotiate the sale of the business with the plaintiffs prior to offering it to any third party. Such an obligation is a necessary corollary of the fact that the plaintiffs' waiver constituted valid consideration in favour of Medisys. In these circumstances, the parties must have intended that the Medisys obligation to offer the business to the plaintiffs would constitute an enforceable obligation." [para 35].

It is interesting to note that 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.

The judge determined that the terms proposed by Medisys in its negotiations were not unreasonable and therefore were not in breach of Medisys' duty of good faith negotiation, and that Medisys had an honest belief that its approach to the estimation of sustainable EBITDA was reasonable and therefore consistent with its obligation to offer SCM the opportunity to purchase the division.

The SCM case seems to reinforce the following concepts regarding a duty to negotiate in good faith:

- where value is given for a right to negotiate, there can be an enforceable obligation to negotiate in good faith if the parties intend a consequence for one that does not do so. The obligation can be implied where that is the clear intention;
- parties' conduct cannot be with a view to defeating the purpose of the contract, and
- parties have to act honestly with each other.

Although parties to a contract have a duty to act honestly with each other, and although a duty of good faith may be applied more freely then previously, it does not appear that there has been any movement towards the concept of a duty of good faith with respect to negotiations in the absence of a contract.

It would appear that there has been no movement away from the concept that a duty to carry on negotiations in good faith is inherently repugnant to the adversarial position of the parties when involved in negotiations, and is as unworkable in practice as it is inherently inconsistent with the position of a negotiating party.