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## Tell Me No Lies – The New Duty of Honesty in Contractual Performance

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There has been a flood of commentary and discussion since the Supreme Court of Canada (“SCC” or the “Court”) decision in *Bhasin v. Hrynew*, 2014 SCC 71 (“*Bhasin*”) was issued on November 13<sup>th</sup>.

The reasons the case has garnered so much attention from practicing lawyers and legal academics, are twofold:

- The Court created a new duty of honesty in contractual performance; and
- The Court articulated an organizing principle in relation to good faith in contract law more generally, namely that parties must perform their contractual duties honestly and reasonably and not capriciously or arbitrarily.

In this article I will address what these developments mean to contract law in the commercial contracting context. I will suggest how commercial law and litigation practices might change in the future to take this decision into account. I will also identify the questions that the decision leaves unanswered—questions that we may be in a better position to answer over the next few years, as lower courts apply the principles in *Bhasin* in subsequent cases.

### The Facts in *Bhasin*

I will summarize the facts in some detail as the relationships of the litigants and the behaviour of the defendants served as the perfect springboard for consideration by Canada’s highest court of the notion of good faith performance in contract law. The facts are likely the reason leave was granted in this case, when it had been denied in other cases involving good faith arguments in the past.

For over 10 years, Bhasin was an enrollment director for Canadian American Financial Corp. (“Can-Am”). Can-Am is in the business of marketing education savings plans (“ESPs”) to investors. Enrolment directors (“EDs”) like Bhasin operated as small business owners; they were the retail sales force for Can-Am. Bhasin and Can-Am had a commercial dealership agreement (the “Contract”) under which Bhasin was paid compensation and bonuses for selling ESAs.

While not a franchise agreement to which a statutory duty of fair dealing would apply,<sup>1</sup> the Contract had many components that would be found in a franchise agreement, and which underscored the dependence of Bhasin’s business on Can-Am.<sup>2</sup>

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<sup>1</sup> In provinces that have enacted a *Franchises Act*, or equivalent, including Alberta, Manitoba, Ontario, New Brunswick and P.E.I.

<sup>2</sup> Those components included:

- Bhasin was obliged to sell Can-Am products exclusively;
- He owed a fiduciary duty to the company;
- He could not sell, assign or merge his operation without Can-Am’s consent (not to be unreasonably withheld);
- Can-Am owned the client lists;
- Can-Am was responsible for branding; and
- Can-Am promulgated policies that applied to EDs.

While Bhasin originally had an indefinite term agreement with Can-Am, the term of the Contract under which the dispute arose was for three years, commencing in 1998. The Contract contained an express renewal clause, which was at the core of the dispute between the parties. The renewal clause provided that the Contract would automatically renew at the end of the three-year term unless one of the parties gave six months' written notice.

Despite the fact that Bhasin was one of top EDs in Canada, his Contract was not renewed. His relationship with Can-Am soured, primarily due to the machinations of another ED, the other defendant, Hrynew.

Hrynew was a direct competitor of Bhasin who wanted Bhasin's lucrative book of business. Hrynew had tried to convince Bhasin to merge their agencies and also had tried to convince Can-Am to force a merger. Bhasin wanted no part of any merger.

When the Alberta Securities Commission ("ASC") raised concerns about compliance by Can-Am's EDs and required Can-Am to appoint a single provincial trading officer to review its EDs for compliance with securities law, Can-Am appointed Hrynew. Hrynew apparently saw his opportunity to horn in on Bhasin's position. Other EDs, including Bhasin, were required to provide confidential business information to Hrynew in this role, which Bhasin objected to and refused to do. Can-Am, with Hrynew's participation, but without Bhasin's knowledge or consent, proposed a new structure to the ASC in which Bhasin would work for Hrynew's agency.

When Bhasin continued to refuse to allow Hrynew to audit his records, Can-Am threatened to terminate the Contract and ultimately, in May of 2001, gave notice of non-renewal.

Bhasin lost the value in his business. The majority of his sales agents were recruited by Hrynew. He ended up taking less remunerative work with one of Can-Am's competitors.

Bhasin sued Can-Am and Hrynew, alleging breach of an implied duty of good faith in relation to the decision by Can-Am whether to renew the Contract, the tort of inducing breach of contract and civil conspiracy. The trial judge found the defendants liable on all three theories of liability.

The trial judge found that Can-Am had repeatedly misled Bhasin in a number of ways (these findings are critical to the SCC's analysis):

- By telling him that Hrynew, as provincial trading officer, was required to treat information provided to him by EDs as confidential, which was not true.
- By telling him that the ASC rejected a proposal for an outside provincial trading officer, which was not true.
- By responding equivocally when he asked in August 2000 whether the merger sought by Hrynew was a "done deal" (this equivocal response was made despite the proposal Can-Am had already made to the ASC) and failing to communicate that Can-Am was working closely with Hrynew to bring about a new structure in which Hrynew's agency would be the main agency in Alberta.

The trial judge also made the critical finding that had Can-Am acted honestly, Bhasin could have acted so as to retain the value in his agency, although given the degree of control that Can-Am had in the business model, it is difficult to see exactly how he would have done so.

The trial decision was overturned on appeal, with the Alberta Court of Appeal finding the pleadings to be insufficient and that the trial judge had erred in implying a duty of good faith in exercising its discretion to renew or not into the Contract in the face of an entire agreement clause.

The pleading issue was dealt in a few paragraphs by the SCC. It held that the pleadings were sufficient to allow adjudication on the merits of the good faith issue.

The SCC agreed with the Court of Appeal's rejection of the tort claims.

It is the Court's treatment of the good faith claim that is precedent-setting and that will be the reason for this case being repeatedly cited over the next decade, and perhaps longer.

The Court articulated a new duty of honesty in contract performance and found Can-Am liable for breach of that duty and awarded damages based on the contractual measure, on the basis that had Can-Am performed its contractual duty, Bhasin would have been able to retain the value of his business rather than see it effectively expropriated and turned over to Hrynew.

### **Duty of Honesty in Contractual Performance**

In paragraph 73, the Court described the duty in these terms:

This means simply that parties must not lie or otherwise knowingly mislead each other about matters directly linked to the performance of the contract.

If you search for cases discussing a duty of honesty in contract law prior to this landmark decision, you will find precious few.

Of course you will find reference to a duty of honesty in cases involving fiduciaries and in some cases considering an employee's duty of fidelity.

There are a few cases out of the Maritimes, where a duty of honesty was said to arise where one party to a contract is exercising a contractual discretion, such as the right to terminate the contract.<sup>3</sup> In the same vein, there have been cases dealing with honesty as a component of an employer's duty of good faith in contract termination.

So while there were slim threads in the pre-existing law, the duty of honesty in contractual performance is essentially newly minted.

So what do we know about it?

- a) It is limited to performance – so it presumably does not apply in negotiations.
- b) It is not a fiduciary duty of loyalty or disclosure – the Court takes some pains to explain that contracting parties will not be expected to abandon their own self-interest.
- c) It does not arise as a term implied in law or fact. Rather, it is a contractual doctrine akin to unconscionability.

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<sup>3</sup> *WCI Waste Conversion Inc. v ADI International Inc.*, 2011 PECA 14; *McKenna's Express Ltd. v. Air Canada*, 1992 CanLII 2849 (P.E.S.C.T.D.); *Arton Holdings Ltd. v. Gateway Realty Ltd.* (1991), 106 N.S.R. (2d) 180 (S.C.), aff'd (1992), 112 N.S.R. (2d) 180 (C.A.).

- d) Because it is a doctrine, you cannot exclude it (e.g., by way of an entire agreement clause), though you may be able to modify it by express language.
- e) Breach of the duty gives rise to a cause of action for which contract damages may be awarded.

What still remains unclear:

- a) Does performance include enforcement?
- b) Aside from outright lies, what sort of conduct does “otherwise knowingly mislead” cover? Failure to answer questions? Silence? Failure to alert the other party to a proposed course of action?
- c) The Court said that contracting parties must not lie or knowingly mislead each other about matters “directly linked” to the performance of the contract. What does “directly linked” encompass?

Lawyers will have to advise clients on this new duty of honesty at several points in time.

First, when negotiating a contract, parties will have to consider including clauses detailing standards of performance so as to modify the duty (since it cannot be excluded outright). If you want to be able to exercise a power or discretion arbitrarily or capriciously, you should say so.

Second, when a party is considering carrying their contractual performance (or perhaps not carrying it out) in a way that is likely to harm the counterparty, they may seek advice on how to avoid breaching the duty. Arguably, based on the way the duty was formulated by the SCC, there is no duty to disclose, for example, planned underperformance of an obligation to deliver product. But if the other party asked for confirmation of the amount to be delivered, the party with the delivery obligation could not lie without risking liability.

Third, when a counterparty’s performance negatively impacts on a client, they may want to consider suing for damages based on a breach of the duty of honesty in contractual performance. Of course, success in such an action will mean establishing that the other party “knowingly misled” the plaintiff about matters directly linked to contract performance. Motivations behind modes of performance or lack of performance and the communications between the parties about performance will therefore be subject-matters for discovery in breach of contract cases more generally.<sup>4</sup>

### **Overarching “Organizing Principle” of Good Faith Performance**

Bhasin urged the Court to rule conclusively that a general duty of good faith arose wherever a contract gave a party the power to unilaterally defeat a legitimate contractual objective of the plaintiff and the contract did not clearly allow the party to exercise its power without regard for that objective.

While the Court highlighted the unsettled state of the law on whether there was a more general doctrine of good faith in Canadian contract law, it declined Bhasin’s invitation and instead took what it described as an “incremental step” to bring more certainty and coherence to the law.

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<sup>4</sup> When discussing the organizing principle (at para. 71), the Court stated that it should not be used as a pretext for scrutinizing the motives of contracting parties. But practically speaking, in seeking to prove dishonest conduct, counsel will necessarily delve into motivations for conduct.

The Court recognized what it described as an “organizing principle of good faith” that underlies and manifests itself in various more specific doctrines governing contractual performance, which provides that parties generally must perform their contractual duties honestly and reasonably, and not capriciously or arbitrarily.

The Court made it clear that it was going to let the law develop incrementally in this area, analogizing its planned approach going forward to the approach that Canadian courts have taken to unjust enrichment. Anyone who has pleaded or defended such a claim recently will be aware of the challenges posed by this incrementalism.

Other things the Court said about the organizing principle:

- a) It is not a doctrine or a free-standing rule, but rather a “standard” that underpins and is manifested in more specific legal doctrines.
- b) Good faith claims will generally not succeed if they do not fall within “existing doctrines”.
- c) The list of good faith doctrines is not, however, closed.
- d) Future developments will be context-specific, based on what honesty and reasonableness in performance require so as to give appropriate consideration to interests of both contracting parties, and will occur where the existing law “is found wanting.”

What the Court did not do:

- a) List all the circumstances in which good faith performance already forms part of an existing doctrine. In its survey of the current state of the law prefacing its articulation of the “organizing principle”, the Court canvassed a range of scenarios where good faith plays some sort of role. Some of those scenarios might be describe as involving a doctrine that incorporates good faith, such as unconscionability. Others cannot be said to involve a doctrine *per se* but rather involved statutory imposition or implication of a good faith term in particular scenarios or contract interpretation exercises that made certain assumptions about the parties intending certain minimum standards of conduct.<sup>5</sup>
- b) Reject or embrace the body of case law in which a duty of good faith performance of some kind had been found to exist (outside of specific types of contract, such as insurance, franchise, tendering and employment contracts). Professor McCamus has grouped that case law into three broad categories:<sup>6</sup> (1) where the parties must cooperate in order to achieve the objects of the contract; (2) where one party exercises a discretionary power under the contract;<sup>7</sup> and (3) where one party seeks to evade contractual duties. To what extent are the decisions within these three categories still precedential?
- c) Resolve the question of whether good faith duties could or should be implied as a matter of fact or law (or must invariably be birthed as contractual doctrines, like the new duty of honesty).

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<sup>5</sup> For a comprehensive review of the role of good faith in contract law prior to the decision in *Bhasin*, I recommend the “Consultation Paper on Proposal for Unfair Contracts Relief” issued by the British Columbia Law Institute in December of 2010: [http://www.bcli.org/sites/default/files/2010-12-10\\_BCLI\\_Unfair\\_Contracts\\_Relief\\_Consultation\\_Paper.pdf](http://www.bcli.org/sites/default/files/2010-12-10_BCLI_Unfair_Contracts_Relief_Consultation_Paper.pdf).

<sup>6</sup> In his textbook, the *Law of Contracts*, 2nd ed. (Toronto: Irwin Law, 2012) at 840-56, cited by the Court at para. 47.

<sup>7</sup> The SCC referred to these categories and seemed to acknowledge their currency when, at paragraph 72, it concluded that, “Classifying the decision not to renew the contract as a contractual discretion would constitute a significant expansion of the decided cases under that type of situation.”

- d) Draw a bright line between the type of duties imposed on fiduciaries and the notion, expressed at paragraph 65, that in carrying out his or her own performance of the contract, a contracting party should have appropriate regard for the legitimate contractual interests of the contracting partner. I am not sure what to make of the sentence, “While ‘appropriate regard’ for the other party’s interests will vary depending on the context of the contractual relationship, it does not require acting to serve those interests in all cases.”

Clients and their lawyers will obviously have to be aware of the clear-cut circumstances where good faith performance duties have been consistently imposed, either because of statutory provisions<sup>8</sup>, or because the specific nature of the contract or relationship.

But they will also have to keep in mind the “organizing principle” and therefore the potential for assertion of a good faith performance duty (and its breach) in any case where the relationship between contracting parties goes bad. Skilled litigators were already doing so in the pre-*Bhasin* world, but now they will have an organizing principle under which to frame their argument and the SCC’s assurance that the list of doctrines in which good faith manifests itself “is not closed.”

As I alluded to above when discussing the duty of honesty, communications between the parties on performance issues will take on heightened importance and therefore should be approached with care. Internal communications that, once produced in litigation, might later be characterized as illustrating bad faith or callous disregard for the other party’s legitimate contractual interests, will be fodder for good faith claims.

I also think we can expect counsel to build arguments based on how good faith performance obligations have developed in other jurisdictions, particularly in Quebec and the U.S. given that the Court alluded to the desirability of being in step with the law of those important trading partners of the common law jurisdictions in Canada.

### **What about Freedom of Contract and Commercial Certainty?**

Parties arguing against recognition or implication of a good faith duty invariably point to the importance of freedom of contract to the law of contract and the desirability of commercial certainty.

This case was no different. The SCC goes to great lengths to explain that it is not minimizing those concerns or negating the importance of both freedom of contract and commercial certainty.

So, for example, at paragraph 70, the Court recognizes the concept of efficient breach and goes on to warn against *ad hoc* judicial moralism or palm tree justice.

In the specific context of setting out the new duty of honesty in contract performance, the Court said that this duty would interfere very little with freedom of contract, since parties will rarely expect that their contracts permit dishonest performance of their obligations.

The reality is that the decision in *Bhasin* has altered the bedrock of commercial transactions, the law of contract. Commercial certainty will necessarily suffer, particularly where the Court has signalled that the law will continue to develop incrementally.

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<sup>8</sup> For example, s. 68(2) of the *Personal Property Security Act*, R.S.B.C. 1996, c. 359, provides: “All rights, duties or obligations arising under a security agreement, this Act or any other law applicable to security agreements or security interests must be exercised or discharged in good faith and in a commercially reasonable manner.”

## Bottom Line

It will take several years before we will understand the full implications of the *Bhasin* decision.<sup>9</sup> It may be that the SCC will provide additional direction by granting leave on cases in which parties have sought to develop the law under the organizing principle. The Court may also grant leave in cases that are working their way through the lower courts now on the related topic of whether there is a duty of good faith negotiation.

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<sup>9</sup> To date there are only two cases that cite *Bhasin*, both decisions of Nova Scotia Justice Peter Rosinski. *Landry v. Tivey*, 2014 NSSC 426, involved a successful plea of *non est factum*. In *Oliver v. Elite Insurance Company*, 2014 NSSC 413, *Bhasin* was cited in the context of a consideration of an insurer and insured's obligation to act in utmost good faith.

