The Binding Force of Contract *versus* Good Faith under Canadian Contract Laws: The Impact of *Churchill Falls* on Business Negotiations

Linda Frazer, L.L.D.

Résumé – **Dans l'arrêt *Churchill Falls*, la Cour Supreme du Canada a décidé que même les contrats à long-terme doivent être interprétés selon les règles classiques de contrat transactionnel. La cour n'a pas considéré que le répondant a violé le principe de bonne foi selon le cadre du nouveau *Code civil du Québec*. L'appelant a demandé que la cour ordonne au répondant de renégocier le contrat sous réserve de bonne foi et de l'équité tandis que les circonstances ont changées depuis la paradigme du contrat original, mais sa demande a été refusée. La caractérisation du contrat reflète les conséquences des obligations légales ainsi que le recours qui sera imposé par la loi. Le résultat de la décision de *Churchill* n'est pas étonnant. Durant les années courantes, les systèmes juridiques canadiennes ne peuvent identifier les intentions des parties, laissant les parties d'affaires de commerce dans le tort. Il y a un manque d'outils juridiques qui démarquent que les juges et arbitres ne peuvent déterminer les intentions des parties durant tous les processus de négociations y compris la formation, performance et extinction de contrat ce qui laisse les parties faisant des affaires de commerce dans une situation imprévisible. La loi n'a pas pu trouver une façon à guider les standards de communications et les standards d'éthique durant les processus des négociations, y compris le stage post-contractuel. Récemment, les décisions des cours suprêmes aux Royaumes Unies et au Canada ont reconnu que la bonne foi doit être imposer durant la performance d'un contrat. Cet article énonce l'évolution historique du principe de bonne foi au Canada et comment la loi détermine quand, comment et la source du principe de bonne foi. En la conclusion, cet article requiert une évolution à l'avenir, afin de trouver une façon à mettre en place des normes de communications et des normes d'éthiques pour que les parties faisant affaires puissent démontrer d'une façon autonome des arrangements significatifs afin d'établir une certitude et prévisibilité durant la résolution des différends.**

Abstract— **The Supreme Court of Canada has considered that a long-term contract must be upheld on a classical contractual level under Quebec laws in the case of *Churchill Falls*. The court did not consider that the respondent breached good faith under the new framework of the *Code Civil du Québec*. The request by the appellant to re-open negotiations based on good faith and equity since the very paradigm of the contract had altered and circumstances had arisen that could not have been contemplated by the initial contract, was denied. The primary reason for the decision was that the contract was characterized as a transactional-based contract rather than a relational contract. The characterization of a contract leads to the consequences of the implications of the parties' obligations and, therefore, the remedy that is imposed by law. The result of *Churchill Falls* is not surprising. Over modern years, Canadian legal systems have left business parties with the threat that party intention will not be properly identified. Insufficient juridical tools cause this inadequacy as adjudicators have no tools to identify party intention through the entire negotiation processes, including formation, performance and post contract to the extinction of the contract, leaving business parties surprised. Law has failed to provide a way to guide standards of communications and standards of conduct during all the stages of negotiations, including post-contract. Recent Supreme Court decisions in the United Kingdom and Canada have recognized that a standard of conduct *does* exist on a contractual level during the *performance* of a contract. This article lays out the historical evolution of the concept of good faith in Canada and how, when and under what source a minimum standard of conduct can be identified by law. The conclusion calls for a need for future development; to find a manner to set default standards of communications and standards of conduct to monitor meaningful business arrangements autonomously that would aid law to provide the certainty, predictability and foreseeability that business parties need during dispute resolution.**

Keywords— alternative resolution disputes [ADR], good faith, juridical security, legal regulation, business negotiations.

I. Introduction

Good faith "means different things to different people at various times".[1] The concept of good faith has been considered a universal norm that is based on honesty, derived from the *ius naturale*. Yet, this concept is so broad that it must be brought into context to better comprehend it and expand on its future development for business dealings.

There are no specific rules regarding a duty to negotiate in good faith under Canadian domestic laws. In fact, Canadian common laws [CCL] have demonstrated a tremendous resistance to the application of a duty of good faith under contract law until the recent developments of the Supreme Court of Canada in *Bhasin v. Hrynew*[2]. Quebec civil laws rely on general obligations of the Civil Code of Quebec [C.c.Q.], such as Article 6 that provides, "Every person is bound to exercise his civil rights in good faith".

On a contractual basis, the binding force of contract rests on the autonomy found in the will theory and *pacta sunt servanda*, a universally accepted norm adopted into classical contract

Linda Frazer, L.L.D., practicing notary; phone: 514-631-6977; fax: 514-631-9972; e-mail: linda@lfrazernotary.com).

doctrine, upholding the sanctity of contract; the recognition that promises must be kept because a binding force of law is created between contracting parties. Interpretation of the contract, however, is determined according to the categorization of the type of contract. The courts may rely on the literal meaning of the contract or courts may infer terms by the conduct of the parties. Both methods of interpretation are legitimate fashions for a court to proceed. *Churchill Falls (Labrador) Corporation Limited* [CF] and *Hydro-Québec* [HQ], is an example of the courts adhering to the literal meaning of the contract. Since HQ was not considered in breach of the contract, the court could not identify a breach of good faith.

Business parties find both the ability to autonomously record business arrangements and the necessity of having a minimum standard of conduct important. When business parties negotiate, they are aware that trust and cooperation are essential for successful maintenance of the business relationship and, therefore, deserve legal protection. Therefore, it is possible to breach good faith in long-term contracts even though parties have adhered to the terms of the contract. Yet, courts have had difficulty establishing what business parties are actually arranging while they negotiate pre-contractually or post-contractually and the emphasis on the trust and cooperation that is the very breath of a long-term relationship and contributes to the successful maintenance of the parties' mutual goals in long-term contracts remains indistinguishable in law.

Understanding negotiations includes understanding that the negotiation processes move forward from stage to stage from pre-contractual relations to contractual relations through to post-contractual relations until the extinction of the project. The purpose and function of negotiations is intertwined so the first step towards successfully grasping that good faith operates throughout the stages of negotiations: "The purpose of negotiations is to strike mutual goals…beneficial to all parties, by placing parties in a better position within their association…than without each other. Parties accomplish this goal through the function of negotiations…which takes place through specialized communications; tactics and strategies exchanged at the bargaining table whereby parties must synchronize their differing interests and potential conflicts to advance from one stage of negotiations to the other to achieve the negotiation purpose".[3] While business parties are negotiating, there is a certain interdependence that arises while they strive towards the perception of the outcome in order to attain and sustain mutual goals. This perception influences the functioning of the negotiation processes.[4] The value of the negotiation relationship and the importance of promoting the trust necessitated to preserve the business relationship is a measurable commodity, essential to the maintenance of successful relations and recognized by business commentators. Negotiation functions do not end with the signature of a contract, rather the processes of negotiation are continuous. In Western culture, negotiations begin in long-term contracts during a pre-contractual stage and as they mutate, arrangements of various preliminary agreements are arranged, formulating mini contracts and continue the relationship beyond the terms of these contracts. This value exists under long-term contracts as the parties are in a continuous relationship that necessitates the continuance of negotiations.

Despite the intrinsic value of the relational contract and the importance of the preservation of the relationships to business parties, law has not promoted a manner for business parties to continue to record these dynamic communications past a static contract. Due to their dynamic nature, negotiations necessarily arise during long-term contracts after the signature of a contract, but law has no manner to recognize party intention. Concurrently, law has not provided universal standards of conduct for business purposes. *Churchill Falls* is a clear example of how courts are using antiquated juridical tools to resolve modern disputes between business parties who are using dynamic, innovative and cyber-based methods to move forward in their business arrangements. Business parties deserve better juridical tools to allow them to choose, autonomously, the level, scope and intensity of the communications and conduct they desire to maintain for their business relationship, enabling adjudicators to have a better regard of the parties' intentions.

II. WHERE CHURCHILL FALLS FITS IN THE SCHEME OF THINGS

Churchill Falls (Labrador) Corporation Limited [CF] and *Hydro-Québec* [HQ], rendered by the Supreme Court of Canada was decided based on the literal interpretation of classical contract law, upholding the sanctity of a binding contract[5].

Let us glance at the facts of the case. Although the parties were in a long-term contractual relationship entered into on May 12th, 1969 for a period of 40 years, renewable for an additional period of 25 years, the courts did not recognize the contract as a relational contract. The parties' contract formed a framework to construct and operate a hydroelectric plant on the Churchill River in Labrador, whereby HQ undertook to purchase the bulk of the electricity produced despite whether it was needed (or not). The contract contained a term for a fixed price for the purchase of power that would decrease over time based on the financing requirements of CF and the anticipation that electricity prices would fall. There was, intentionally, no price adjustment clause foreseen in the contract since electricity prices were expected to fall, the hermeneutic paradigm was statutorily confined to provide electricity to the Quebec public and, at the time the contract was entered into, no exportation of electricity was permitted. It was originally conceded that electricity would fall in price due to these restrictions and the fact that nuclear power was on the rise. When a nuclear power plant suffered an explosion, the price of oil rose, and the legislature loosened her belt to allow private sales of electricity across borders, the tables turned, and electricity became a profitable commodity that no one ever thought possible. HQ honoured the original terms of the contract and provided the returns to CF that the parties had anticipated at the time of the conclusion of the initial contract. Yet, when profits soared, HQ's position was that they were entitled to keep the excess profit, unwilling to share, for the most extent, with CF.

Initially, CF filed action in the Quebec Superior Court against HQ February 23, 2010, claiming that the distribution price of the power resulted in profits unforeseeable in 1969 causing detriment for loss of profit of CF to the betterment of HQ. By 2010, the contract had produced a profit of $27.5 billion for HQ but only about $2 billion for CF, fulfilling the literal terms of the contract. Plaintiff argued that HQ had an obligation to act in good faith during the performance of the contract which imposed a duty of cooperation on HQ, and therefore the obligation to renegotiate new terms of the contract since the very paradigm had altered and circumstances that had arisen could not have been contemplated at the time of the formation of the contract. HQ argued it assumed all the risks relating to market fluctuation which made the deal possible for CF to ensure financing of the project and that HQ honoured the terms of the contract. The trial judge dismissed the action in favour of HQ as it found no exceptional case of hardship that would serve to cater to the general principles of good faith set out in Articles 6, 7 and 1376 C.c.Q. The Court of Appeal also dismissed the case. CF appealed to the Supreme Court of Canada, which agreed to hear the case.

A majority ruling of the Supreme Court of Canada rendered a judgment in favour of HQ: "In the final analysis, CF[LCo] has not provided any compelling factual or legal basis for the courts to reshape the contractual relationship it has had with Hydro-Québec for the last 50 years". The Supreme Court of Canada was not blind to the fact that CF would own the power plant when the contract finalizes in 2041 [valued at the time of judgement at 20 billion dollars]. Incidentally, as over 34% shareholder of CF and holding a guaranteed director's seat, HQ also participates in the capital investment.

The pivot point of the decision was based on the characterization of the contract. The majority, led by Gascon J., elaborated two of the three characterizations that could be identified by law: a joint venture, a relational contract and a transactional-based contract. The court did not consider that CF provided enough evidence that the parties intended a joint venture. In other words, that "the parties intended to combine their resources to carry out a major project and intended to share the benefits of the venture equitably." [at para. [60]. The court considered that the parties' relationship lacks the characteristics generally associated with that form of arrangement. There is no indication that the risks were allocated equally and that the parties therefore intended to jointly assume full responsibility for the project" [at para. [65]. Furthermore, the court could not find reasons to characterize the contract as a relational contract. It relied on its interpretation of Prof. Belley's definition that "To begin, a relational contract can roughly be defined as a contract that sets out the rules for a close cooperation that parties wish to maintain over the long term" at para. [67] and Prof. Belley's point of view that "in essence, relational contracts provide for economic coordination as opposed to setting out a series of defined prestations." [at para. [68]. Shouldn't all contracts, including relational contracts, set out as many details of defined prestations as they know at the time? But the court concludes, without actually precisely defining *transactional-based contracts*: "The Power Contract sets out a series of defined and detailed prestations as opposed to providing for flexible economic coordination. It is not therefore a relational contract." [at para. [71]. Consequently, the parties were considered to fall within the scope of classical contract law by default.

Ancillary to the characterization of the contract, the court was not convinced that unforeseeability or hardship could be claimed with regard to loss of profits since it saw no evidence that the two conditions of hardship were met: (i) that the party who was disadvantaged by the change in economics had accepted the risk and (ii) that "the new situation makes the contract less beneficial for one of the parties, and not simply more beneficial for the other". [at para. [89]. The court dismissed the appeal ruling that HQ was not in breach of good faith under the contract and that the contract was not relational: "There was no indication that it [HQ] had acted in bad faith. Looking out for the interests of the other contracting party does not require a party to sacrifice his or her own interests." [at para. [35]. Therefore, "[t]he fact that the electricity market has changed significantly since the parties entered into the Contract does not on its own justify disregarding the terms of the Contract and its nature." [at para. [137].

The only dissenting judge, Rowe, J., offered convincing argumentation that the contract should be considered a relational contract, which would have changed the outcome of the decision of the court:

"On one hand, transactional contracts — i.e. generally contracts of instantaneous execution — do not create a relationship between the parties in any meaningful sense. They impose precise obligations to be performed at a specified time without the need for further cooperation (Baudouin, Jobin and Vézina, at No. 76). Relational contracts, on the other hand, typically require successive performance, whereby the parties have obligations to perform on a continuing basis (*ibid.*). This presupposes the existence of a deeper relationship based on trust between the parties and requires that each party have an interest in maintaining the relationship for the long term." [at para. [157]. Rowe, J., acknowledged the continuous nature of the business relationship and the necessity that the relationship required trust and cooperation, to preserve the contractual relationship, frowning on HQ who he considered took advantage of CF by a "unilateral exploitation" of the contract.

Churchill Falls is a clear example of how the characterization of a contract leads to the consequences of the implications of the parties' obligations and, therefore, the remedy that is imposed by law. It also demonstrates how contractual interpretation can alter whether a court can see a breach in a duty of good faith: whether an implied term to the contract can be found and the recognition that the intensity of good faith is a higher level in relational contracts to protect cooperation and trust between the parties as opposed to transactional-based contracts.

III. HOW A DUTY OF GOOD FAITH CAN BE RECOGNIZED BY LAW

The Canadian common law [CCL] has not overtly recognized a duty of good faith until Supreme Court of Canada, *Bhasin*, in 2014, which recognized that a certain degree of *honesty* must be applied to the *performance of contracts* by *operation of law*. Commentators hoped that this judgement would bridge Canada's dual legal tradition and reconcile the duty of good faith in common law contracts under CCL with her parallel sister who has recognized, to a larger extent, the principle of good faith under Quebec Civil Law [QCL] for the last three decades, now neatly codified in the framework of the new *Code civil du Québec* [C.c.Q]. Yet, this expectation that uniformity is in process has left a great divide between the two legal systems and may have opened even more uncertainty[6].

Although the UK Supreme Court decision in *Yam Seng* impacted the Supreme Court of Canada [S.C.C.] in *Bhasin*, the Canadian Supreme Court did not identify, as did *Yam Seng,* that a duty of good faith could be applied both *objectively* by law and that the duty could be *implied by the parties themselves*. The decision in the S.C.C. in *Bhasin* abandoned any implied duty of good faith by the parties themselves, imposing only a general duty of good faith in common law contract *by operation of law* thereby minimizing the impact that a duty of good faith could have on a contractual relationship.

A closer look of the discussions in the lower courts in *Bhasin* may contribute to the development of a good faith duty under CCL and bridge some of the gaps between CCL and QCL.

IV. THE FACTS OF *BHASIN V. HRYNEW*

Bhasin and Hrynew were enrollment directors for Canadian American Financial Corp [Can-Am]. Both parties sold education savings plans to investors through an agreement with Can-Am governed by an "Enrollment Director's Agreement" [EDA] which had an automatic renewal clause subject to a termination notice six months prior to the date for renewal.

Can-Am was secretly negotiating a merger between Bhasin and Hrynew without Bhasin's knowledge. Can-Am requested Bhasin to allow Hrynew to access confidential records in an audit by Hrynew which Can-Am feigned was required by the Alberta Securities Commission. When Bhasin refused to give access to his confidential records, Can-Am sent a notice to terminate the EDA.

Even though the contract did not provide for a duty of good faith, Moen, J., at trial level, decided that an implied duty of good faith could override the "entire agreement clause" in the EDA as he considered that the duty of good faith could be *imposed by law* regardless of the absence of expressed terms of this duty in the agreement[7]. Furthermore, the court provided that the duty of good faith was also *implied by the parties themselves*, justifying his position as it "reflects the unstated intentions of the parties at the time of the *formation* of the contract"[8]. It was the opinion of the court that Cam-Am had breached its duty of good faith by attempting to force Bhasin to enter into a merger agreement with its competitor by exercising its non-renewal clause. As a result, the court found that Cam-Am had been dishonest, in a misleading fashion, about the restructuring of the business and pending merger of Bhasin and Hrynew's businesses.

The court of appeal found no such breach. In fact, the Court limited the manner that a court can imply terms in contracts to only three justifiable situations and decided that Bhasin did not qualify for these exceptions. The court of appeal considered that a new term comprised of an implied duty of good faith would have to be "(i) so obvious that it was not even thought necessary to mention, or (ii) truly necessary to make the contract work at all, not merely reasonable or fair." The court added that "both parties must have intended the term" emphasizing that there is a presumption in law against implying terms. Most importantly, the court held that "a term cannot be implied in a contract which would contradict an expressed term of that contract" and that (iii) "some degree of inequality in bargaining power, need, or knowledge, is not enough to upset or amend the terms of a contract, short of actual unconscionability"[9].

The Court of Appeal considered that "Courts should not attempt after the fact to rewrite the contract to accord with what the court now thinks, or one party now believes, is more just or more businesslike, especially in the full light of hindsight." It held that "[t]he trial Reasons relied on evidence of oral promises. The entire-contract clause bars such evidence from entering the courtroom and makes such promises inoperative." In the Court's opinion, there "were no ambiguous words", consequently no breach of contract and therefore allowed the appeal and dismissed the action[10].

The Supreme Court of Canada took, yet, another approach. While the court concluded that there was a general organizing principle of good faith in common law contract law, the court found that the source of such obligation was implied by *operation of law* rather than because of implied party intention. The court also recognized that the timeframe ancillary to this general organizing principle of good faith is a common law duty that applies to all contracting parties to act honestly in the *performance* of their contractual obligations. It did not go so far as to find that the duty of good faith includes loyalty or cooperation, recognized by Mr. Justice Leggatt in *Yam Seng*[11], nor did the court recognize a duty of good faith during the *formation* of a contract, thus the application of what constitutes a duty of good faith and when it can be imposed by CCL was subject to limitations[12].

The break down to understand the impact of a good faith duty on negotiations rests on the addressing the following issues:

1) When a duty of good faith is recognized by law;
2) The scope of a duty to negotiate in good faith; and
3) The sources of a duty of good faith.

V. WHEN A DUTY OF GOOD FAITH IS RECOGNIZED BY LAW

CCL and QCL are divided in their approaches to the application of a good faith duty during the *formation*, *performance* and *extinction* of contracts.

When good faith can be recognized is contingent on context hence "varies widely, depending on the relation created... Any long-term relation is certain to assume that each party will behave in good faith"[13]. The recent decision of the Supreme Court of Canada in *Bhasin* decided that there was an imperative organizing duty of good faith in the *performance* of common law contracts but ignored its application to the *formation* and *extinction* of contracts.

On the other hand, QCL recognizes a wider scope to the duty of good faith under Article 1375 C.c.Q. that says: "The parties shall conduct themselves in good faith both at the time the obligation is created and at the time it is performed or extinguished."

While the *formation* of a contract may not be considered part of the negotiation processes in short-term negotiations, they have certainly been recognized in long-term negotiations that result in a contract. In *Addison Chevrolet Buick GMC Ltd*. v. *General Motors of Canada Ltd*. Justice Dunphy noted that: "Good faith and honesty are the boundaries of the field to which the contractual relationship is *negotiated* and performed"[14].

In the context of long-term negotiations, *formation* of a contract begins once the negotiation processes have begun. The problematic is that law has no way to determine the line between window shopping and when negotiations begin and when the parties shift from one stage of negotiations to another. Even though business parties consider themselves cognizant of these borders of stages of negotiations, these communications remain intangible to law. Therefore, either law must devise a formula that can detect these lines or the parties themselves must have a manner to indicate where they are situated in the stages of negotiations.

Under QCL, a general obligation applies as an overriding principle to contracts as well as other acts or facts attached by law. Parties to a contract must act in good faith at the time of the *formation* of the contract, during *performance* of the contract, and upon *extinction* or discharge of the contract[15].

The principle of good faith now infused in Quebec laws under a general duty, but it wasn't always. In fact, it was not included in our original *Civil Code of Lower Canada* [C.c.B.C.]. The matter came to light in 1981 with a decision by the Supreme Court of Canada in *Banque National v. Soucisse* [*Soucisse*], later confirmed by *Banque National du Canada v. Houle* and *Banque du Montreal v. Bail* [*Bail*][16]. Mr. Justice Beetz in *Soucisse* used article 1024 of the C.C.B.C. (now 1434 C.c.Q.) to imply an obligation of good faith in the *performance* of a contract through equity. This obligation was required of the bank to disclose to the heirs at law that a suretyship had been entered into by a deceased in which the heirs at law would be bound. The Court considered that failure to disclose this fact resulted in a breach of good faith and the bank being unable to proceed with an action against the estate ("fin de non recevoir").

Justice L'Heureux-Dube in *Houle* extended the precedence of *Soucisse* to a principle of good faith *imposed by operation of law* that can override express contractual stipulations: "While the doctrine may represent a departure from the absolutist approach of previous decades, consecrated in the well-known maxim "la volonté des parties fait loi", it inserts itself into today's trend towards a just and fair approach to rights and obligations."[17]

The decision in *Bhasin*, thus, appears to align the CCL position regarding good faith in the performance of a contract to the embryonic QCL's position recorded in *Houle* in 1992.

Under QCL, and in the same hermeneutic timeframe as *Houle*, Gonthier, J. in *Bail* extended the duty of good faith during the performance of contract to a good faith duty in the *formation* of a contract, opening an argument that the very principle of good faith can be sustained during pre-contractual and post-contractual negotiations[18].

Quebec laws have gone even further in recent years. What is fair no longer requires that one of the parties behave unreasonably, rather the focus of good faith has been on the contractual balance of the contract[19].

VI. The Scope of a Duty to Negotiate in Good Faith

The second distinction to a duty of good faith between QCL and CCL is that the Supreme Court of Canada limited the scope of good faith under CCL to include only *honesty*, rather than the QCL broader acceptance of *honesty*, *loyalty* and *cooperation*.

Should good faith comprise only honesty? Cromwell, J. in *Bhasin*, acknowledged that parties must be free to pursue their own individual self-interests, but to do so is accompanied with a minimum standard of honesty in contractual arrangements. The court was only willing to hold that this duty is a "requirement to act honestly...it is a simple requirement not to lie or mislead the other party about one's contractual performance"[20]. Mr. Justice Cromwell underlined that the scope of the good faith principle was limited, obliterating Mr. Justice Leggatt's broader vision of the concept of good faith which included loyalty and cooperation with the proviso that: "This does not impose a duty of loyalty or of disclosure or require a party to forego advantages flowing from the contract"[21].

Where QCL and CCL converge is demonstrated by the leading case in Canada that purports to protect honesty during the processes of negotiations, as in *Lac Minerals Ltd*. v. *International Corona Resources Ltd*.[22] While parties were in the process of negotiating, Defendant misused confidential information attained from Plaintiff during negotiations and purchased a contiguous lot in competition with the on-going negotiations of a joint venture to resource a mine with Plaintiff. The court decided that negotiating parties must conduct themselves with a certain standard of honesty in good faith. The court held that Defendant injured the Plaintiff by taking dishonest measures and procuring the land wrongfully. Therefore, since there is no tortious duty to conduct negotiations in good faith in Canada, the Court clothed the Plaintiff's entitlement to protection by considering that Defendant's action was equivalent to a constructive trust in favour of the Plaintiff to protect the expectations of the Plaintiff regarding honest disclosure.

CCL and QCL do not merge on *what* constitutes a duty of good faith. QCL recognizes a wider range of good faith, enlarging the scope from a simple concept of honesty to include loyalty and cooperation. This enlargement was found in *Provigo Distribution v. Supermarché ARG*[23]. Cromwell, J. himself recognized the "broad duty of good faith" present in our new C.c.Q. during the deliberations in *Bhasin*. Cromwell specifically referred to the wider scope of the duty of good faith under QCL: "which extends to the formation, performance and termination of a contract and includes the notion of the abuse of contractual rights"[24]. *Dunkin' Brands* extended the duty of good faith to include a heightened duty of good faith in relational contracts when parties must continue to strive to meet their goals over a long period of time[25]. This duty does not entail giving up one's own interests but does impose an obligation to refrain from hindering and to consider the other party's interests[26].

If only law could envision precisely *when* the parties desire to be legally bound to at any moment in time. Where does a standard of good faith stand when parties are negotiating long-term relationships? Although there are commentators who predict a merge of some standard of good faith duty in the *performance* of contracts in the Canadian systems, we are still a far stretch from conjugating the two legal systems together uniformly.

VII. THE SOURCES OF A DUTY OF GOOD FAITH

Three sources of the standard of good faith have been explored by the courts: whether industry standards determine that parties should have had a certain standard of conduct by virtue of custom or general acceptance within a particular trade, whether it can be implied as the parties themselves, in virtue of their relationship that would have expected a standard of good faith, or whether by operation of law a minimum standard of good faith standard is imposed on contracting parties[27]. There is also a fourth source, which has not been used to its full extent partly due to the CCL resistance to recognize agreements to negotiate in good faith; that of a good faith standard expressly chosen by the parties themselves.

The discussion can be broadened to a discussion in four instances:

- good faith expressly chosen by the parties themselves;
- good faith deemed to be implied by the parties in virtue of their relationship;
- good faith imposed objectively by operation of law (divided into type of contract, failure of disclosure, unequal bargaining power, or abusive action, confidentiality etc.
- good faith imposed by custom or trade usage

Good faith expressly chosen by the parties themselves

While business commentators have recognized a minimum standard of honesty or decency between negotiating business parties to promote trust, it has also been recognized that the parties can exercise their freedoms to contract by selecting a "relaxed" standard or even an "enhanced" standard. Consequently, the parties are free to define the nature and scope of the good faith duty they intend to apply to their business relationship[28]. There is no current way of monitoring a duty of good faith in negotiations other than resorting to an expressed, unambiguous valid contract. A square peg in a round hole; yet long-term business negotiation parties deliberately conclude skeletal agreements to organize their business arrangements[29] because there are always factors they cannot foresee in advance.

Good faith implied in virtue of the parties' relationship

The second way a term can be implied in a contract is by the parties themselves, if it "reflects [the] unstated intentions of the parties or parties have expressly agreed that a standard of good faith would "govern their relationship"[30.] How, then, can party intention be identified and measured by the parties conduct during the *formation* of the contract?

Where parties have specifically expressed that their contract is governed by a certain standard of good faith, the courts will enforce this standard by acknowledging the freedom of contract. Where parties have not specifically expressed a standard of good faith in a contract, the courts may review how the parties have dealt with one another in the past or use an objective test of what would be reasonable between the parties, by considering "the whole relationship and whether a duty of good faith were required to preserve "business efficacy".

O'Byrne suggests that in long-term "complex contracts, it is particularly difficult to recite all the rights and obligations of the parties or to expressly enumerate how contractual powers can and cannot be exercised. Exploiting such a vacuum, one party may grow into a dominating position and find itself with the opportunity to take undue advantage of a power granted to it under the contract…Whether the contract includes an implied term of good faith is a matter of contractual interpretation and a legal conclusion"[31].

The subjective approach of the QCL implies a standard of good faith based on subjective party intention through application of the principle of good faith as an implied obligation. The intention to conduct themselves in good faith can, therefore, be inferred by the parties' actions or oral presentations. If a contract includes implied terms owing an obligation of good faith and such implied term is breached, the court will favour an injured party. The "quality" and "fitness for [the] purpose" in which the goods are intended is taken into consideration by the courts as implied obligations that are considered "essential conditions of the contract."

If a person's behaviour is deemed to have breached good faith, the opposing party may exercise the option to resiliate a contractual term. For example, in *Domaine de la Côte Mont-Rigaud Inc.* v. *Laura Sabourin* [*Sabourin*], a repeat customer filed for the return of its deposit due to inferior Icewine juice compared to past acquisitions between the parties. The question before the Court was whether the Defendant breached implied obligations under the contract to supply the same quality of IceWine juice as prior dealings. The court concluded that: "[the IceWine juice] breached the quality and fitness for purpose conditions of the contract, entitling DCMR [plaintiff] to reject it" and, consequently, concluded that "DCMR was entitled to repudiate the Contract and obtain the return of the deposit"[32].

Negotiations are not free from an implied principle of good faith. *Lennie Ryer* v. *Stephen R. Potten* [*Potten*] addressed whether there was a breach to negotiate and cooperate in good faith towards the conclusion of an agreement regarding the terms of a letter of intent. Defendant established a company that had distributed barbecues and accessories throughout the Canadian provinces since 1978. The court was of the opinion that an offer to sell the company was made by the Defendant which was not considered seriously accepted by the Plaintiff. Plaintiff alleged that Defendant acted in "bad faith and unlawful repudiation of his obligations under the Letter of intent" seeking $3,686,517.84 for compensation of various damages. The Court concluded that:

"It is a well-known principle that the right to disagree and to refuse to enter into a contract is part of the contractual freedom of parties. The obligation to negotiate in good faith and collaborate towards the conclusion of a contract does not amount to an absolute obligation to ultimately agree. If a material disagreement arises, a party can terminate the negotiations, provided that such termination is done in a reasonable manner, not abusively"[33].

Where parties have concluded a long-term contract and, as circumstances change after the signature of the contract, the parties must also continue to *perform* the contract in good faith until the extinction of the contract.

Good faith imposed by operation of law

Under the CCL a good faith duty applies to parties during the *performance* of contract by *operation of law*. Firstly, the duty of good faith can operate by law in virtue of the nature of the contract itself, such as employment, franchise and insurance contracts or where the term is "necessary for the fair functioning of the agreement"[34]. Secondly, the court will find a duty of good faith if there has been unequal bargaining, (including matters of disclosure, including misuse of confidential information or misrepresentation) or where the parties are in a relationship where one party has exercised a certain quantum of unconscionability; To qualify the source of the good faith principle, Mr. Justice Cromwell recognized that:

"An organizing principle therefore is not a free-standing rule, but rather a standard that underpins and is manifested in more specific legal doctrines and may be given different weight in different situations"[35].

Cromwell, J. disregarded the debate of whether the duty of good faith is an implied term by law or an implied term by fact, and decided that this duty is imposed by law:

"It operates irrespective of the intentions of the parties and is to this extent analogous to equitable doctrines which impose limits on the freedom of contract, such as the doctrine of unconscionability"[36].

Thus, it the belief of the court that a good faith duty imposed by operation of law supersedes the parties' freedom of contract. In *Transamerica Life Canada Inc*. v. *ING Canada Inc*:

"Canadian common law courts have not recognized a stand-alone, general duty of good faith between commercially contracting parties…They do, however, recognize such a duty in specific cases and in certain categories of cases" and where "parties do not act in a way that eviscerates or defeats the objectives of the agreement"[37].

The circumstances of when the application of a duty of good faith between contracting parties is recognized by law has been divided into categories of application, but the courts do not always distinguish between the categories. For example, in *Wallace*, an employment case, the court did not distinguish between the type of contract and unequal bargaining power. Furthermore, the court determined that the bargaining power at the time of the formation of the contract was unequal and therefore there were disclosure issues since the weaker party could not access the appropriate information for more favourable terms, bordering on matters of disclosure[38]. Disclosure can be identified in any one of three forms: misuse of confidential information to one's own self-interests disregarding the interests of the other negotiating party, such as identified in *Lac Minerals*, a lack of disclosure to allow the opposite party to see that negotiations were frivolous or induce the other party to purchase or other misrepresentation.

Obiter dictum of Justice Wagner considered that the scope of the party's obligations in commercial negotiations rested on whether there was unequal balance of power between the parties. Unequal bargaining power has been identified in the formation of a contract between parties having unequal bargaining power, where the weaker person cannot access information and where the power imbalance affects other aspects of the contractual relationship. Mr. Justice Moen considered that in *Bhasin* trial that "[t]he very nature of this contract was not balanced from its inception"[39]. Meanwhile, *Canadian National Bank* v. *Houle* extended the principle of good faith in an objective manner to recognize that the measurement of the standard of prudence required by a reasonable person does not require malice. It is simply a standard which is imperatively imposed by the operation of law[40]. We must be wary of how much intervention by law is needed to guide the regulation of negotiations without hindering its natural path in the business world.

Good faith imposed by custom

Custom serves as a compliment to how parties *should* behave in a certain social circle or within a given trade. There are boundaries that presume a certain behavior or social normativity. Party autonomy is the very reason for the development of custom and trade usage in the first place, considered as expected social practices, recognized by domestic laws. The greatest difficulty is determining which side of the line obligations are situated. In other words, there are customs in every society that are not tantamount to law, rather simply social norms, and other customs that have been treated as law, and therefore have the force of law[41].

Under Canadian contract laws, customs were initially accepted as a separate source of law identified more fully during the nineteenth century through the works of Blackstone and Lord Mansfield's recognition of merchant custom. The separation between law and custom was based on context; that in commercial contexts, custom may be more suitable as an application than common law. The development of custom and its ability to spawn legal norms fell into a broader range of contexts, such as civil rights law, reinforcing its influence on commercial matters.

The rise of legal positivism and legal formalism denied that sources of law exist outside the legislative paradigm; in other words, claiming that the state alone is responsible for recognition and enforcement of law and even a contract is "related to some positive law which gives legal effects to the reciprocal and concordant manifestations of intent made by the parties." Even though custom has influenced the law, it is not considered to have the ability to supersede official public decisions[42]. American common law, as opposed to English common law, was able to break through the influence of legal positivism by enacting legislatively the Uniform Commercial Code that has swept across the United States, recognizing both merchant custom and the principle of good faith in commercial dealings.

Custom has had its place as a source of juridical obligations. In *Wabasso* the Supreme Court of Canada allowed a delictual recourse resulting from recognition of custom even though the relationship between the parties was a contractual one. Justice Haanappel's position was that the delict was independent of the contract. Therefore, obligations may be applied because of normative constraints established by custom and industry standards that initiate obligations between the parties[43].

Usage and custom look somewhat similar, yet Lluelles differentiates the two terms under Quebec laws. Lluelles argues that the nature of custom *imposes* a legal norm of behaviour objectively on the parties regardless of party consent if it has been widely accepted within a certain trade and has a minimum formation of law. On the other hand, usage requires a contractual relationship between the parties and serves to *fill gaps* in a contract where a court finds a *presumed intention* of the parties, which is considered part and parcel of the parties' relationship when an agreement has been formed between them in a given trade, even if the parties have not expressly stipulated[44].

This distinction wades in murky waters during negotiations where it is not always evident whether there is a contract, an agreement, a partial agreement or some other commitment to a business relationship. Nevertheless, commercial circles recognize that there is an implied customary standard of conduct when business parties exercise their autonomy, making arrangements together, that are accompanied by a certain expected standard of behavior to promote trust.

VIII. Conclusion

A wave of change debuted in 2013 with positive conjecture regarding the duty of good faith under the common law contract law. Mr. Justice Leggatt in *Yam Seng* stated emphatically that: "There is nothing unduly vague or unworkable about the concept [of good faith]…Its application involves no more uncertainty than is inherent in the process of contractual interpretation"[45]. Cromwell J. inserts that "Recognizing a duty of honesty in contract performance poses no risk to commercial certainty in the law of contract. A reasonable commercial person would expect, at least, that the other party to a contract would not be dishonest about his or her performance. The duty is clear and easy to apply"[46]. Cromwell, J. referred both to QCL and the American UCC, expressing that, "[e]xperience in Quebec and the United States shows that even very broad conceptions of the duty of good faith have not impeded contractual activity or contractual stability"[47].

The Supreme Court of Canada intention when rendering its decision in *Bhasin* was to end the fragmented approach the common law has taken to the duty of good faith, being "piecemeal, unsettled and unclear". It was anticipated by the legal community that perhaps this stand would close the divide between Canadian legal systems. The judgement was meant to end the discussion revolving around when, how and what application good faith had over contracting parties and harness the good faith principle to a manner that would provide certainty as to its application[48].

Unfortunately, the decision of *Bhasin* has not provided the certainty under Canadian laws that the Court desired. The scope of the duty of good faith did not open beyond that of a duty of *honesty*, yet Quebec laws generally recognize that the scope of duty includes *honesty*, *loyalty* and *cooperation* in relational contexts. Nor did the court in *Bhasin* open the scope to a duty of good faith implied by the parties themselves, rather good faith applies through operation of law, *imposed by law*. These restrictions may very well have impacted the decision in *Churchill Falls* to restrict the scope of the duty of good faith, causing even more uncertainty regarding the application of good faith in contract law.

The characterization of a contract leads to the consequences of the implications of the parties' obligations and, therefore, the remedy imposed by law. There is no uniformity in Canadian laws on how a duty of good faith is identified, nor how to determine its scope and intensity. Notwithstanding the progression in recent Quebec jurisprudence, such as *Dunkin' Brands*, regarding a heightened good faith in relational contracts, this intensity was not considered by the court to be a viable application in *Churchill*. CCL still has a lot of catching up to meet with QCL standards of good faith prior to the decision in *Churchill*. But with the outcome of *Churchill* on the table, the law is even more indeterminate, sundry and uncertain.

The binding force of contract need not be opposite to a duty of good faith. Even where no breach of contract is apparent, there can be a breach of good faith in a relational contract. Insufficient juridical tools cause this uncertainty as there is currently no way for law to guide standards of communications and standards of conduct during long-term business relations other than a static contract, based on 18th century contract doctrine. Business commentators and behavioural scientists acknowledge the dynamic nature of long-term relations and that negotiations do not cease upon signature of a contract. Rather, the relationship continues to mutate well after the contract has been signed. Why should law have to guess? There is a need for future developments from inspiration of legal scholarship theory as well as a practical means to allow business parties to monitor their relations autonomously, outlining the scope, intensity and degree of good faith they intend for their relationship.

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[1] Homes, Eric M., "A Contextual Study of Commercial Good Faith: Good-Faith Disclosure in Contract Formation", 39, U. Pitt. L. Rev. 381, 1977-1978 at 400. Homes concurs: "In an effort to keep the pure theory of contracts *pure*, courts … failed to articulate the real grounds for decisions. Their fictions led to inequity, uncertainty and unpredictability. Rather than recognizing the lack of good faith as an appropriate invalidating device, courts masked their decisions in the guise of interpretation and construction, implication, want of mutuality, particularized rules of offer and acceptance, mutual mistake, and lack of consideration… But with a change in societal values and expectations, the standard is being unearthed." at 388.

[2] 2014 SCC 71 [2014] S.C.R. 494.

[3] Frazer, Linda, *Juridical Gyroscopic Orientation of Transnational Business Negotiations*, In progress with Papyrus, Montreal, 2018 at 55.

[4] Lewicki, Roy J., Joseph A. Litterer, John W. Minton and David Saunders, "Interdependence" in *Negotiations*, Illinois, Irwin Professional Publishing, 1995 at 32. *See also* Ghauri, Pervez N., "A Framework for International Business Negotiations", in Pervez N. GHAURI and Jean-Claude Usunier, (Eds.), *International Business Negotiations*, 2nd Edition, Bingley, UK, Emerald Group Publishing Limited, 2008. Ghauri concurs: "This process which requires trust and security for each party, is critical to successful interdependent relationships. This trust can be developed by including the other party in the negotiation process and ensuring that her needs are met as well as your own. Following a fair process will contribute to feelings of satisfaction and success to both parties." at 33.

[5] 2018 SCC 46.

[6] Grosswell, Mitchell, "Duty of Good Faith in the Performance of Contracts Post-Bhasin", Nov. 28, 2014, Western University's Law Students' Association, Canliiconnects.org. *See also* Swan, A., Canadian Contract Law, 3rd Ed. Markham, Ontario, LexisNexis Butterworths, 2006 at 532 and 533.

[7] *Bhasin* v. *Hrynew*, 2011 ABQB 637 at para. [111].

[8] *Ibid* at para. [89]. The extension of a duty of good faith to the *time that the obligation has arisen*.

[9] *Bhasin* v. *Hrynew*, 2013 ABCA98 (CanLII) at para. [G. 3.], G. [4.] and G. [4.].

[10] *Ibid* at para. G. [10.] and H. [30.].

[11] *Yam Seng Pte Limited* v. *International Trade Corporation Limited*, [2013] EWHC 111 (QB).

[12] *Supra* note 5. Cromwell, J. is sensitive to business needs: "The organizing principle of good faith exemplifies the notion that, in carrying out his or her own performance of the contract, a contracting party should have appropriate regard to the legitimate contractual interests of the contracting partner. 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. It merely requires that a party not seek to undermine those interests in bad faith." at para. [65].

[13] *Supra* note 6. Swan at §8.136 at 1046.

[14] *Addison Chevrolet Buick GMC Limited et al.* v. *General Motors of Canada Limited et al.*, 2015 ONSC 3404 (CanLII) at para. 116. Lluelles, Didier, and Benoît Moore, *Manuel de doctrine sur le régime des obligations*- tome 1, Montreal, Quebec, Les Éditions Thémis, 2005; *Pegasus Partners Inc. v. Groupe Larue Inc. 2007 QCCS 476* at para. [29] and *Friedman* v. *Ruby*, 2012 QCCS 1778 at para. [49].

[15] *Ibid.* Lluelles/Moore at 1069 to 1070. *See also supra* note 984. *Formédica Ltee* v. *Silipos Canada Inc.*, 2010 QCCS 6074 at para 89; Péloquin, L., *Droit contractuel: La lettre d'intention*, 40 R.J.T.n.s. 175, 2006 at 189.

[16] *National Bank of Canada* v. *Soucisse*, [1981] 2 S.C.R. 339; *Banque National du Canada v. Houle*, 3 S.C.R. 122; and *Bank of Montreal* v. *Bail Ltée*, [1992] 2 S.C.R. 554 at para. [85].

[17] *Ibid*. *Houle* at [120]. For CCL *see*: O'Byrne, Shannon Kathleen, "The Implied Term of Good Faith and Fair Dealing: Recent Developments", (2007) 86 CBR 193.

[18] *See Union Carbide Canada Inc*. v. *Bombardier Inc*., 2014 CSC 35, [2014] 1 R.C.S. 800. The question of interpretation of a term in the contract was considered on the basis of the origin of the intention of the parties; *Sobeys Québec inc. c. Coopérative des consommateurs de Sainte-Foy*, 2005 QCCA 1172, [2006] R.J.Q. 100 : « Il faut pour déterminer la volonté réelle des parties et leur commune intention au sens de l'article 1425 C.C.Q. examiner le texte même du contrat, bien sûr, mais aussi, comme le prescrit l'article 1426 C.C.Q., sa nature, les circonstances dans lesquelles il a été conclu, l'interprétation que les parties lui ont déjà donnée ou qu'il peut avoir reçue, ainsi que les usages… at para [60].

[19] *Banque Toronto-Dominion* v. *Brunelle*, 2014 QCCA 1584 at para. 94 (CanLII).

[20] *Supra* note 5. *Bhasin* at para. [73].

[21] *Ibid Bhasin* at para. [73].

[22] *Lac Minerals Ltd. v. International Corona Resources Ltd. (1989) 2 R.C.S. 574.; Comeau* v. *Société Immobilière Trans-Quebec Inc*. JE-97-112 (S.C.).

[23] [1998] R.J.Q. 47 (C.A.). The court decided that the franchise agreement between Supermarché ARG and Provigo imposed a high expectation of a standard of good faith and that Provigo breached its obligation to act in good faith by aggressively providing lower prices to Provigo stores adjacent to ARG stores.

[24] *Supra* note 5. *Bhasin* at para. [83]. Cromwell refers to Articles 6, 7 and 1375 C.c.Q.

[25] *Dunkin'Brands Canada Ltd.* v. *Bernice Inc. et al*, 2013 QCCA 867 at para.71.

[26] *Hydro-Quebec* v. *Construction Kiewit cie*., 2014 QCCA 947 at paras. 90-92(CanLii).

[27] *Supra* note 7. *Bhasin* trial at para. [93].

[28] *Supra* note 5. *Bhasin* at para. [77].

[29] *See supra* note 6. CCL Swan explains "While the parties are free at any time not to move to the next stage, they are not free at any stage from the restrictions the agreements they have executed have already imposed on them." at 533.

[30] *Supra* note 7. *Bhasin* trial at para. [89] and [90]. *See also supra note* 17. O'Byrne at 203.

[31] *Ibid*. Bhasin trial at para. [33].

[32] *Domaine de la Côte Mont-Rigaud Inc.* v. *Laura Sabourin* [*Sabourin*], 2016 QCCQ 14368 at para. [46]. Similarly, in *Multipix Communications Inc.* v. *Midland Walwin Captial Inc*., 2013 QCCA 2058 the court regarded that the Defendant's conduct fell short of the "openness and good faith" that Plaintiff was entitled to by virtue of the relationship. *See* para. [41] and [42] of the judgement referring to Article 1375 C.c.Q.).

[33] *Lennie Ryer v. Stephen R. Potten*, 2014 QCCS 3349 at para. [111]. *See also supra* note 14. *Pegasus* at para. 31, 32 and 33.

[34] *Supra* note 7. *Bhasin* trial at para. [68] and [74].

[35] *Supra* note 5 at para [64]. Cromwell references examples: *R. v. Jones*, [1994] 2 S.C.R. 229, at 249; *R. v. Hart*, 2014 SCC 52, [2014] 2 S.C.R. 544, at para. [124].

[36] *Ibid. Bhasin* at para. [74].

[37] [2004] 68 OR (3d) 457 (Ont. CA) at para. [51].

[38] *Wallace* v. *United Grain Growers*, 197 CanLII 332 (SCC), 3 SCR 701, 219 NR 161. Where a contract has ensued, the courts have, nevertheless, limited the application of a duty of good faith imposed by law to three categories: the type of contract, unequal bargaining power between the parties and issues of disclosure.

[39] *Supra* note 7. Bhasin trial at para. [75]. *See Guay Inc. v. Payette*, 2013 SCC 45, J.E. 2013-1588, 363 D.L.R (4th) 445. The court evaluated the scope of the party's obligation during the parties' negotiations suggested: "…it is also necessary to consider the circumstances of the parties' negotiations, including their level of expertise and experience and the extent of the resources to which they had access at that time." at paragraph 62.

[40] *See also Trust La Laurentienne du Canada inc*. c. *Losier*, J.E. 2001-254 (C.A.).

[41] Rutherglen, George, "Custom and Usage as Action under Color of State Law: An Essay on the Forgotten Terms of Section 1983", 89 Va. L. Rev. 925, 2003 at 926. *See also* Gélinas, Fabien, « Codes, silence et harmonie- Réflexions sur les principes généraux et les usages du commerce dans le droit transnational des contrats », (2005) 46 *Les Cahiers de Droit* 941 ; Stephan, Paul B., "Privatizing International Law", 97 Va. L. Rev. 1573, 2011 at 1585 and 1586.

[42] *Ibid.* Rutherglen at 970. *See also* Maniruzzaman, Abul F.M.,"The *Lex Mercatoria* and International Contracts: A Challenge for International Commercial Arbitration?" American University International Law Review, 14, no. 3, 1999:657-734.

[43] *Wabasso Ltd.* v. *National Drying Machinery Co*. [1981] 1 S.C.R. 578 at 590. *See also* Haanappel, Petrus P.C., "La relation entre les responsabilités civiles contractuelle et délictuelle: L'arrêt Wabasso en droit Québécois et en droit comparé", Revue internationale de droit comparé, Vol. 34(1) janvier-mars 1982, 103-118.

[44] Lluelles, Didier, « Du bon usage de l'usage comme source de stipulations implicites », 36 R.J.T. n.s. 83, 2002 at 98 and 99.

[45] *Supra* note 11. *Yam Seng* para. [152].

[46] *Supra* note 5. *Bhasin* at para. [80].

[47] *Supra* note 11. *Yam Seng* respectively at paras. [83], [84] and [85].

[48] *Supra* note 5 at para [59]. *See also* David Stack, "The Two Standards of Good Faith in Canadian Contract Law", 62 Sask. L. Rev. 201, 1999.