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THE IMPLIED TERM OF GOOD FAITH AND FAIR DEALING: RECENT DEVELOPMENTS

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This article assists common law practitioners to predict when good faith obligations are owed in the context of contractual performance by organizing recent case law. The article concludes by advocating for express recognition of a common law rule that would mandate good faith as the governing, default standard out of which parties must expressly contract.

Par une systématisation de la jurisprudence récente, cet article tente d'aider les praticiens de common law à prévoir à quel moment les parties à un contrat sont tenues de respecter les obligations de bonne foi dans le contexte de l'exécution de leur contrat. L'article conclut en préconisant la reconnaissance expresse d'une règle de common law, selon laquelle la bonne foi constitue le standard auquel doivent nécessairement adhérer les parties lors de la conclusion des contrats.

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1. Introduction

Alleging breach of terms going to good faith and fair dealing is an increasingly common feature of modern pleadings, particularly in the area of franchise and construction contracts.[1] Even a cursory review of the case law demonstrates that good faith is exerting a growing influence in other areas, including employment and insurance. There is also every argument that express recognition of good faith has improved the law because, as noted by Meehan J. of the Ontario Superior Court, it brings simplicity and clarity.[2] But simultaneously, as the number of cases in the area grows, practitioners can find it challenging to advise clients on the occasion and scope of this obligation. F. Paul Morrison notes:

> [T]he resilience of the concept testifies to its utility. Good faith is a flexible and pragmatic concept which addresses inherent inadequacies in rights-conferring language. Rights are not absolute – they are tempered by responsibility and are not to be abused. However, applying good faith on an *ad hoc* basis with inconsistent views regarding its legal basis gives legitimacy to the critics' complaints of unpredictability, which is so dreaded in the commercial world.[3]

The role of good faith has traditionally been understood in relation to three distinct areas: contractual negotiations; contractual performance or execution; and contractual enforcement. While there are judicial indications that good faith obligations *may*, on an exceptional basis, be owed in contractual negotiations[4] and that good faith obligations can be

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my attention. Finally, I would like to extend my appreciation to the two anonymous reviewers of my manuscript. Errors and omissions remain my own.

1 For example, Frank Zaid observes that virtually all franchise litigation includes a claim that the franchisor breached its duty of good faith and fair dealing; see Frank Zaid, "Canadian Franchise Litigation is Proliferating for a Variety of Reasons" *The Lawyers Weekly* (3 October 2003) 17. Joel Richler has made a similar comment in the context of construction litigation; see Joel Richler, "Good Faith & Construction Contracts" (2004) 34 C.L.R. (3d) 163.

2 See Meehan J. in *Elite Specialty Nursing Services Inc. v. Ontario*, [2002] O.J. No. 3009 (S.C.J.) (QL) at para. 90 [*Elite*].

3 F. Paul Morrison and Hovsep Afarian, "Good Faith in Contracts: A Continuing Evolution" in Justice Todd Archibald and Michael Cochrane, eds., *Annual Review of Civil Litigation, 2003* (Toronto: Carswell, 2004) 197 at 224. See also John McCamus, *The Law of Contracts* (Toronto: Irwin Law, 2005) at 783, where he observes that the principal argument against recognizing a duty of good faith is that it will bring "an unattractive degree of uncertainty to the law. With increased uncertainty comes increased difficulty in giving advice and the prospect of more protracted litigation" [footnotes omitted].

4 For a recent discussion of good faith duties owed in the context of contractual negotiations, see Morrison and Afarian, *ibid*. These authors note that while *International Corona Resources Ltd. v. Lac Minerals Ltd.*, [1989] 2 S.C.R. 574 at 672 may have left

owed in the context of enforcement,[5] it is contractual performance litigation that has captured centre stage. Indeed, this area has already been the subject of considerable academic commentary.[6]

The purpose of this article is to assist practitioners in predicting when good faith obligations are owed in the context of contractual performance by organizing some of the more recent common law cases

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the door open for finding such a duty, subsequent jurisprudential developments have "generally disavowed" such a duty, including *Martel Building Ltd. v. Canada*, [2000] 2 S.C.R. 860 at para. 73 [*Martel*] wherein the Court stated that, absent a special relationship, "a duty to bargain in good faith has not been recognized to date in Canadian law." See also *978011 Ontario Ltd. v. Cornell Engineering Co.* (2001), 53 O.R. (3d) 783 at 793 (C.A.), additional reasons at (2001), 148 O.A.C. 250 (C.A.), leave to appeal to S.C.C. refused, [2001] S.C.C.A. No. 315 (QL) [*Cornell Engineering*]. As the Ontario Superior Court observes in *TSP-Intl Ltd. v. Mills* (2005), 74 O.R. (3d) 461 at para. 59 [*TSP-Intl*], the "imposition of the duty of good faith in the formation of a contract is evolving and somewhat controversial...." *TSP-Intl* was reversed on procedural grounds in [2006] 19 B.L.R. (4th) 21 (Ont. C.A.).

As an example of uncertainty in the area, see *Cornell Engineering*, *ibid*. At trial, the court found that a special relationship – although short of a fiduciary one – required a good faith obligation from the defendant such that he was obligated to have pointed out to the plaintiff any unexpected terms in the proposed service agreement. The Court of Appeal reversed this decision, noting at para. 3 of its judgment that while the defendant and plaintiff had been in a mentor/mentee relationship, the plaintiff had become "ascendant" and the normal principle of contractual self-reliance should apply. As the Court of Appeal observes at para. 32: "We have a judicial system that emphasizes individual responsibility and self reliance. Generally, parties negotiating a contract expect that each will act entirely in the party's own interests. Absent a special relationship, the common law in Canada has yet to recognize that in negotiation of a contract, there is a duty ... to act in good faith." See also *Innisfree Management Ltd. v. Verspeeten*, [2002] O.T.C. 880 (S.C.J.) 156, at para. 57, where the court concluded no good faith was owed in bargaining because "there was no special relationship between the ... [parties] outside the framework of a standard commercial contract." Finally, see cases cited in *TSP-Intl*, *ibid*. at para. 73 of the trial decision, where good faith in bargaining may be owed in the tendering and construction contract context.

For further readings on point, see the articles cited in McCamus, *supra* note 3 at 158-59.

5 As Morrison and Afarian note, *supra* note 3 at 223-24, the doctrine of good faith is well recognized in enforcement of contract scenarios, including as a judicial way of supervising the manner in which assets see disposal. See e.g. *Bank of Montreal v. Korico Enterprises Ltd.* (2000), 50 O.R. (3d) 520 (C.A.), leave to appeal to the SCC refused (2001), 150 O.A.C. 200.

6 There are numerous articles on the question of good faith performance. In addition to Morrison and Afarian, *supra* note 3, see the articles cited by McCamus, *supra* note 3 at 808-09. For a list of articles addressing good faith performance in the specific context of construction law, see Harvey Kirsh, *Kirsh's Index to Canadian Construction Law Literature* (Toronto: Thomson, 2007) at 316-17.

in the area. By relying on patterns in the jurisprudence, I hope to provide a general sense of when members of the judiciary tend to identify the good faith obligation as being present and potentially breached.

This article is divided into several parts. Part 2 locates the meaning of good faith, based on recent and leading pronouncements. Part 3 presents a structure for predicting *when* good faith will be implied in common law Canada. Part 4 tests the descriptiveness of this structure through assessing the extent to which it captures existing case law. Part 5 considers the matter of contracting out of good faith. Part 6 of this article offers some very brief conclusions.

2. Locating Good Faith

The Supreme Court of Canada in *Wallace v. United Grain Growers* acknowledged that "[t]he obligation of good faith and fair dealing is incapable of precise definition,"[7] but that in an *employment* contract, this requires employers to be "candid, reasonable, honest and forthright with their employees" and to "refrain from engaging in conduct that is unfair or is in bad faith by being, for example, untruthful, misleading or unduly insensitive."[8] In an insurance context, the Supreme Court of Canada, in *Sun Life Assurance Company of Canada v. Fidler* adopted the definition given by O'Connor J.A. in *702535 Ontario Inc. v. Lloyd's London Non-Marine Underwriters*:

> The duty of good faith also requires an insurer to deal with its insured's claim fairly. The duty to act fairly applies both to the manner in which the insurer investigates and assesses the claim and to the decision whether or not to pay the claim. In making a decision whether to refuse payment of a claim from its insured, an insurer must assess the merits of the claim in a balanced and reasonable manner. It must not deny coverage or delay payment in order to take advantage of the insured's economic vulnerability or to gain bargaining leverage in negotiating a settlement. A decision by an insurer to refuse payment should be based on a reasonable interpretation of its obligations under the policy. This duty of fairness, however, does not require that an insurer necessarily be correct in making a decision to dispute its obligation to pay a claim. Mere denial of a claim that ultimately succeeds is not, in itself, an act of bad faith.[9]

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7 *Wallace v. United Grain Growers Ltd. (c.o.b. Public Press)*, [1997] 3 S.C.R. 701 at para. 98 [*Wallace*].

8 *Ibid.*

9 2006 SCC 30, [2006] 2 S.C.R. 3 at para. 63 [*Fidler*], quoting O'Connor J.A. in *702535 Ontario Inc. v. Lloyd's London, Non-Marine Underwriters* (2000), 184 D.L.R. (4th) 687 at para. 29 (Ont. C.A.) [*Lloyd's*].

By way of contrast, Kelly J. in *Gateway Realty Ltd. v. Arton Holdings Ltd.* offered a more generic definition:

> The law requires that parties to a contract exercise their rights under that agreement honestly, fairly and in good faith. This standard is breached when a party acts in a bad faith manner in the performance of its rights and obligations under the contract. "Good faith" conduct is the guide to the manner in which the parties should pursue their mutual contractual objectives. Such conduct is breached when a party acts in "bad faith" - a conduct that is contrary to community standards of honesty, reasonableness or fairness.[10]

To date, there has been no overarching definition of good faith provided by the Supreme Court of Canada, nor has it offered comment on the *Gateway* definition.

While there is a line of authority coming out of New Brunswick and Newfoundland suggesting that courts will only intervene where there has been an absence of good faith "equivalent to fraud,"[11] this approach has not been followed elsewhere. Courts tend to recognize a more expansive version of good faith, frequently – though not uniformly – relying on *Gateway* and related judicial pronouncements as their guide.[12]

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[10] (1991), 106 N.S.R. (2d) 180 at para. 39 (S.C) [*Gateway*], aff'd on other grounds (1992), 112 N.S.R. (2d) 180 (C.A.).

[11] See e.g. *Zurich Insurance Co. v. Modern Marine Industries Ltd*., [1993] 111 Nfld. & P.E.I.R. 181 at para. 142 (Nfld. T.D.), aff'd (1996), 146 Nfld. & P.E.I.R. 91 (Nfld. C.A.), leave to appeal refused (1997), 161 Nfld. & P.E.I.R. 89 (S.C.C.); *Caldwell & Ross Ltd. v. New Brunswick (Minister of Transportation)* (2002), 252 N.B.R. (2d) 112 at para. 21 (Q.B.) [*Caldwell*], aff'd (2003), 256 N.B.R. (2d) 395 (C.A.); *Crawford v. New Brunswick (Agricultural Development Board)* (1997), 13 R.P.R. (3d) 215 at para. 16 (N.B.C.A.).

[12] What follows is a summary of several cases which have quoted *Gateway's* definition of good faith with approval: *Mesa Operating Ltd. Partnership v. Amoco Canada Resources Ltd.* (1992), 129 A.R. 177 (Q.B.) [*Mesa*], aff'd on other grounds by (1994), 149 A.R. 187 (C.A.), leave to appeal refused (1994), 162 A.R. 318 (S.C.C.), citing *Gateway* with approval, and finding that the defendant breached an implied term of good faith by not consulting with the plaintiff. In affirming the trial judge's decision, the Court of Appeal was clear that good faith is implied only as a matter of interpretation, at para.15; *Opron Construction Co. v. Alberta* (1994), 151 A.R. 241 (Q.B.), interpreting *Gateway*, stated at para. 618: "... the control mechanism defining the content of the doctrine of good faith in contractual relations appears to be the reasonable expectations of the parties." The Court held that the defendant owed an obligation of good faith and fair dealing to the plaintiff to disclose that it possessed material information which was inconsistent with or contradicted that which had been provided to the plaintiff in the tender documents, and that this duty was breached; *Novalta Resources Ltd. v. Ortynsky Exploration Ltd.* (1994), 151 A.R. 161 (Q.B.), quoting *Gateway* with approval,

Given that there are a great many cases that consider the good faith obligation in contractual performance, it can be challenging to understand how they all might work together. Fortunately, Professor

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emphasizing that the obligation is mutual, and finding that the plaintiff not only met but went beyond the standard required; *Erehwon Exploration Limited v. Northstar Energy Corp.* (1993), 15 Alta. L.R. (3d) 200 (Q.B.), decided while *Mesa* was under appeal at the Queen's Bench level, but quoting the *Gateway* definition with approval and finding that the defendant had neither bad faith intentions, nor acted in such a way as to substantially nullify the contractual objectives with respect to the spot price paid to the plaintiff, but finding a breach of a good faith duty to provide the plaintiff with reasonable notice that the defendant was changing its policy and exercising an option in the agreement; *Shelanu Inc. v. Print Three Franchising Corp.* (2000), 11 B.L.R. (3d) 69 (Ont. S.C.J.) [*Shelanu*], rev'd on other grounds by (2003), 64 O.R. (3d) 533 (C.A.) [*Shelanu CA*], applying the *Gateway* definition of good faith, and holding that the franchisor perpetrated four breaches of its duty of good faith towards the franchisee. The Court of Appeal reversed in part, on the finding of a breach of good faith resulting from the establishment of an alleged competitor business, and held that it was neither a breach of good faith nor a fundamental breach that allowed unilateral termination of the contract; *Machias v. Mr. Submarine Ltd.* (2002), 24 B.L.R. (3d) 228 (Ont. S.C.J.), adopting the principles from *Shelanu* and *Gateway* in finding that the franchisor was reckless in representations made to the franchisee, and that this breached the duty of good faith created by the special relationship; *George Robson Construction (Weston) Ltd. v. Hamilton-Wentworth (Regional Municipality)* (2001), 53 O.R. (3d) 337 (Ont. S.C.J.), reversed on other grounds (2003), 24 C.L.R. (3d) 82 (Ont. C.A.). The trial judge found the defendant contractor's conduct constituted bad faith, as it was contrary to community standards of honesty, reasonableness, and fairness. The Court of Appeal ordered a new trial based on the failure of the trial judge to consider the exclusion clauses in the contract, and the legal effect of the chronology of the events; *Rodaro v. Royal Bank*, [2000] O.J. No. 272 (S.C.J.), rev'd on other grounds (2002), 59 O.R. (3d) 74 (C.A.), quoting *Gateway* with approval, and finding that every contract has an implied term of good faith regarding the exercise of a discretion. The court then held that although there was no general fiduciary relationship between Rodaro and the bankers, the bank did have an implied good faith duty to review the request for an extension of repayment of the loan, which was discharged; *Lake Street Medical Centre Inc. v. Rainbows (Pembroke) Ltd.* (1995), 1995 CarswellOnt 2516 (Gen. Div.), quoting the definition with approval, and finding no conduct on the part of the plaintiffs that constituted a breach of the obligation to exercise their rights under the Lease Agreement honestly, fairly and in good faith; *947101 Ontario Ltd. v. Barrhaven Town Centre Inc.* (1995), 17 B.L.R. (2d) 186 (Ont. Gen. Div.), leave to appeal refused by (1995), 1995 CarswellOnt 4270 (Div. Ct.), citing *Gateway* with approval, but finding no breach of good faith because the plaintiff was aware of the risk of the event occurring of which it was complaining when it entered into the contract, was not misled, and accepted compensation for taking that risk; *MDS Health Group Ltd. v. King Street Medical Arts Centre Ltd.* (1994), 12 B.L.R. (2d) 209 (Ont. Gen. Div.), quoting *Gateway* with approval, and finding a breach of good faith by the defendants in allowing a competing business a lease in the building, contrary to a restrictive covenant in the plaintiff's lease with the defendant; *Valley Equipment Ltd. v. John Deere Ltd.* (2000), 4 B.L.R. (3d) 282 (N.B. Q.B.), applying the *Gateway* definition, and finding a breach of the duty of good faith and fair dealing on the part of the defendant in failing to inquire

John McCamus has identified several possibilities as to how good faith might be defined:[13]

Possibility #1: Follow the definition offered by P. Finn, a leading commentator in the area

As McCamus notes, Finn's definition of good faith requires one party to have regard for the other party's "legitimate interests," a definition cited with approval by Weiler J.A. in *Shelanu CA.* McCamus also notes that the generality of the definition means that it may not provide sufficient guidance. This point seems to be correct – an uncontextualized abstraction is difficult to apply to any given circumstance.

Possibility #2: Stitch the case law together and derive a working definition of good faith

McCamus suggests that, following this possibility, good faith might be defined in relation to:

(1) the duty to exercise discretionary powers conferred by contract reasonably and for the intended purpose;
(2) the duty to cooperate in securing performance of the main objects of the contract; and
(3) the duty to refrain from strategic behaviour designed to evade contractual obligations.

This a useful approach given that a compilation of principles derived from the common law predicts what the general duty of good faith may mean in any particular circumstance.

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into the reasons for the termination of an investor/managing partner they had specifically requested be admitted, and then using that termination as an excuse to exercise the immediate termination clause in the Dealer Agreement; *Cavendish Promotions Inc. v. Tourism Industry Assn. of Prince Edward Island*, [1998] P.E.I.J. No. 63 (S.C.), citing *Gateway* with approval, but finding no breach of the duty of good faith; *McKenna's Express Ltd. v. Air Canada* (1992), 102 Nfld. & P.E.I.R. 185 (P.E.I. S.C.), additional reasons at (1993), 110 Nfld. & P.E.I.R. 305, (P.E.I. T.D.), citing *Gateway* as authority for the imposition of a good faith duty in exercising a discretionary "satisfaction" clause in the contract, and imposing an objective, not subjective, standard of good faith pursuant to *Greenberg v. Meffert* (1985), 18 D.L.R. (4th) 548 (Ont. C.A.). leave to appeal refused (1985), 30 D.L.R. (4th) 768 (note) (S.C.C.); *Ascent Financial Services Ltd. v. Blythman*, [2006] SKQB, [2006] S.J. No. 32 (Sask. Q.B.) (QL) [*Ascent Financial Services Ltd.*], holding that there was an implied good faith duty resulting from the objectives of the agreement to act reasonably in transferring clients, including providing assistance in creating a relationship with those clients, which was breached when the defendants spoke of the plaintiffs in a derogatory fashion, and encouraged their daughter-in-law to set up a competitive business. The court also found a breach of the non-competition agreement, and a breach of a fiduciary duty independent of the contract.

13 See McCamus, *supra* note 3 at 804-05.

Possibility #3: Develop a more abstract and generalized statement of the duty, such as found in the American Uniform Commercial Code
McCamus notes the observation that such attempts do not capture the richness of the common law. But even with reliance on common law principles, problems of how to apply a general definition of good faith remain, as he observes.

Possibility #4: Regard good faith as being an "excluder" of bad faith in performance
The idea here is that it is easier to define bad faith than it is good faith and that such a focus will therefore make application of the doctrine more straightforward. This approach is in keeping with Kelly J.'s definition of good faith since he not only says what good faith requires – including honesty and fairness – he also discusses what comprises bad faith. According to Kelly J., good faith prohibits bad faith - a conduct that is "contrary to community standards of honesty, reasonableness or fairness."

This too is a promising starting point because the *Gateway* definition has been widely accepted by lower courts and found to be useful. However, given how general the *Gateway* definition is – whether focussing on good faith or bad faith – it can prove difficult to apply.

Possibility #5: Adopt the Wallace definition as a starting point
This approach is clearly viable because the definition emanates from the Supreme Court. However, given the employment context of the case, it would seem to this author that, while illustrative, the definition is not sufficiently comprehensive.

Yet another possibility is to combine the *Gateway* definition, which describes both good and bad faith, with McCamus's Possibility #2 above. This is because a broad definition, contextualized by precedent, is inherently and productively illustrative. In short, the broad definition identifies general terrain with specific cases providing instances, within that terrain, of when good faith obligations arise and why.

3. The Two Main Sources of Good Faith in Common Law Canada

While courts have discussed what good faith might entail, Canadian jurisprudence has not produced a comprehensive, authoritative account of *when* the good faith term will be implied into the relevant contract. As the Ontario Court of Appeal noted in 2003 in the case of *Transamerica Life Canada Inc. v. ING Canada Inc*:

> Unlike the situation in the United States where the duty of good faith in the performance of enforcement of commercial contracts has been broadly recognized,

> Canadian courts have not developed a comprehensive and principled approach to the implication of duties of good faith in commercial contracts.[14]

In the meantime, it is incontrovertible that good faith, like any other implied term, has two main sources in Canadian jurisprudence: first, good faith can be implied by operation of law (a term implied-in-law) and second, good faith can be implied by virtue of the parties' intentions (a term implied-in-fact).[15] It is also clear that Canadian courts have consistently rejected good faith as a *generalized* term which is automatically implied into *all* contracts, regardless of context.[16]

Throughout the balance of this paper, I will refer to contracts including good faith by operation of law as "category one contracts" and contracts including good faith based on the parties' intentions as "category two contracts."

As Professor Geoffrey England explains, "An 'implied-in-law' term is one which is made to govern the parties' relationship because the court deems it appropriate as a matter of public policy, not because it represents the unexpressed factual intentions of the parties."[17] Furthermore, according to Treitel, "The implication of a term implied in law is simply a way of specifying some of the duties which *prima facie* arise out of certain types of contracts, or, as it has been put, 'legal incidents of those...kinds of contractual relationship.'"[18] Such analysis is echoed by McLachlin J. in *Machtinger v. HOJ Industries*.[19] In her conclusion that employment contracts contain an implied-in-law term that an employer would provide reasonable notice of termination to an employee in an indeterminate contract of employment, she noted, "At

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14 (2003), 68 O.R. (3d) 457 at para. 52 (C.A.) [*Transamerica*].

15 A third, less prominent, source is a term based on custom or usage; see *ibid.* at para. 99 wherein the Court gave the following statement of law regarding when terms can be implied:

> In Canada we have well-established rules for when courts can imply a term in a contract. Terms may be implied in a contract in three situations:
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> 1.) based on custom or usage;
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> 2.) as the legal incidents of a particular class or kind of contract; or
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> 3.) based on the presumed intention of the parties where the implied term must be necessary "to give business efficacy to a contract or as otherwise meeting the 'officious bystander' test as a term which the parties would say, if questioned, that they had obviously assumed".

16 See discussion of this point, *infra* notes 32-37 and accompanying text.

17 Geoffrey England, *Employment Law in Canada*, 4th ed., vol. 2 (Markham: Butterworths, 2005) at para. 10.15.

18 G.H. Treitel, *The Law of Contracts*, 11th ed. (London: Sweet and Maxwell, 2003) at 208 [footnote omitted].

19 [1992] 1 S.C.R. 986 [*Machtinger*].

issue is not the intention of the parties, but the legal obligation of the employer, implied in law as a necessary incident of this class of contract."[20] Adopting the analysis of the House of Lords in *Liverpool City Council v. Irwin*,[21] McLachlin J. confirmed that "necessity" (the test for implying a term by operation of law) must be understood "in a practical sense to the fair functioning of the agreement, given the relationship between the parties."[22]

By way of contrast, good faith in category two contracts is an implied-in-fact term – that is, a term which the court implies because it reflects the "unstated intentions" of both contracting parties at time of formation.[23] Implied-in-fact terms can be imported via a number of doctrines including the "officious bystander" test (which identifies implied terms based on what the imagined officious bystander would say should be the case) and the "business efficacy" test (which identifies implied terms based on the assumption that parties intend to be bound by rights and duties "which facilitate the smooth operation of their contractual venture.")[24]

Under category one, courts impose the good faith standard because the kind of contract or relationship being considered brings with it an inherent and therefore a reasonably predictable vulnerability in one party. This vulnerability is present at the time of contract, and this leads the courts to ensure that good faith is implied to balance out the unequal power of the parties. Once implied, the good faith term will technically restrain both parties – but practically speaking, only the dominant party's behaviour is likely to be contested. In the Ontario Court of Appeal decision in *Shelanu Inc. v. Print Three Franchising Corp.*, for example, at issue was whether the franchisor's sharp and abusive conduct was in breach of an implied term of good faith. While the Court never used the phrase "implied in law," it clearly recognized two kinds of contracts where good faith is implied by operation of law; namely, employment contracts and franchise contracts. That is, *Shelanu CA* noted that the Supreme Court of Canada in *Wallace* imported a good faith term into the employment contract because employee vulnerability set it apart from the ordinary commercial contract.[25] *Shelanu CA* went on to reason that franchisee vulnerability would lead to the same conclusion.[26] There is

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20 *Ibid.* at para. 56.

21 [1977] A.C. 239 (H.L.).

22 *Supra* note 19 at para. 52. For more detailed discussion, see McCamus, *supra* note 3 at 743-44.

23 England, *supra* note 17 at para. 10.12.

24 *Ibid.* at para. 10.13.

25 *Shelanu CA*, *supra* note 12 at para. 64.

26 *Ibid.* at para. 66.

every argument that insurance contracts would also fall within the same category, given the "obvious power imbalance" between insurer and insured, as noted by the Supreme Court of Canada in *Whiten v. Pilot Insurance Co*.[27] In these examples, good faith is imported into these kind of contracts by operation of law (category one), not by virtue of the parties' intention (category two). In the context of McCamus's explanation outlined above,[28] the good faith term would then be used by the court (a) to limit a discretionary contractual power so that it is exercised reasonably and for the intended purpose; (b) to ensure that the parties work to secure performance of the main objects of the contract; and (c) to insist that parties not evade contractual obligations.[29]

Whether a contract falls within the second category is a more *ad hoc* matter. Cases falling into this category tend to focus on whether conduct at the time of performance was in breach of a good faith term implied on the basis of the parties' intentions as measured at the time of contract formation. In short, while certain *kinds* of contracts fit with the first category given the presence of a *predictable* vulnerability at *the time of formation*, other contracts where good faith is an issue would generally fall into the second category because of the way in which the contract in question plays out. That is, one party's power is not an inherent incident of the contract or relationship but emerges over time. In such circumstances, courts assess the parties' relationship *at the time of performance* and determine whether one party, though perhaps not dominant at the time of formation, has a contractual power which is now being exercised very much to the detriment of the other side. If this conduct is contrary to an implied term of good faith or other analogous term, it is a breach of contract. The standard of behaviour described by McCamus would also then apply to the second category. Both parties – but specifically the dominant party – are to have their conduct restrained and, like those in contracts of the first type, will (a) be forbidden from an unreasonable exercise of a discretionary contractual power; (b) will be required to work to secure performance of the main objects of the contract; and (c) will not be permitted to evade contractual obligations.[30]

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27 [2002] 1 S.C.R. 595 at para. 137 [*Whiten*].

28 *Supra* note 3 at 804-05; see too the chart *supra* at 199-200.

29 *Ibid.* at 804. Note that the Ontario Court of Appeal in *Civiclife.com Inc. v. Canada (Attorney General)*, [2006] O.J. No. 2474 [*Civiclife*] quoted McCamus' analysis with approval at para 49, and observed at para. 51 that Industry Canada's conduct breached each of the "three categories that courts recognized as giving rise to the imposition of a duty of good faith."

30 McCamus, *ibid.*

To reiterate, good faith in the first category is present largely by operation of law as measured by the test of necessity. In the second category, good faith is present on the basis of meeting the test of contractual intention to imply such a term. If this assessment is correct, then the presence of a good faith term is simply not at issue with respect to contracts falling within the first category. *All* franchise contracts, *all* employment contracts and *all* insurance contracts will contain such an implied term. There is nothing to debate on that front, though whether the good faith term has been breached or not could obviously be a point of dispute.

If it were argued that the contract in question fit within the second category, this itself would be the subject of contention since contracts in the second category are not of a type. Categorization is currently done on a case by case basis, though as the case law develops *prima facie* categories will likely start to emerge. Accordingly, and unlike established category one contracts, not all contracts of the same type will necessarily contain an implied term of good faith, and its presence or absence will be a matter of debate based on the parties' intent. In this regard, the Supreme Court of Canada in *Double N Earthmovers Ltd. v. City of Edmonton* has affirmed its 1999 admonition that

> courts must be careful not to slide into determining the intentions of reasonable parties. This is why the implication of the term must have a certain degree of obviousness to it, and why, if there is evidence of a contrary intention, on the part of either party, an implied term may not be found on this basis.[31]

In the context of category two contracts, this article has already noted how courts are often asked to assess the stronger party's dominance as it emerges *at time of performance* – as opposed to at the time of contracting. Such late-breaking domination is a trigger for the enquiry regarding good faith as an implied in-fact-term. Although circumstances subsequent to the contract's formation must therefore be considered, this is not to suggest that the parties' presumed contractual intention is also measured at that moment. In accord with foundational contract law principles, contractual intent must always be determined by the parties' presumed state of mind *at the time of the contract's formation*.

Some courts appear to reject the proposition that good faith can ever be owed by operation of law. For example, the Alberta Court of Appeal

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[31] 2007 SCC 3, [2007] 1 S.C.R. 116 at para. 31 [*Double N SCC*], quoting the judgment of Iacobucci J. in *M.J.B. Enterprises Ltd. v. Defence Construction (1951) Ltd.*, [1999] 1 S.C.R. 619 at para. 29 [*M.J.B. Enterprises*].

in *Mesa Operating Ltd. Partnership v. Amoco Canada Resources Ltd.* noted:

> [W]e should hold carefully to the distinction between the two sources of rules about contracts, the law and the contract. Sometimes a rule of law imposes a duty or a constraint upon the parties to a contract despite their agreement, as is the case of the rules about illegal contracts and unconscionable contracts. On other occasions, however, the courts impose a rule upon the parties because we conclude that this fulfils the agreement. In other words, the duty arises as a matter of interpretation of the agreement. The source of the rule is not the law but the parties. I worry that the term "good faith" in this case might blur that distinction.[32]

And the Ontario Court of Appeal in *Transamerica* made a similar comment:

> … Canadian courts have not recognized a stand-alone duty of good faith that is independent from the terms expressed in a contract or from the objectives that emerge from those provisions. The implication of a duty of good faith has not gone so far as to create new, unbargained-for, rights and obligations. Nor has it been used to alter the express terms of the contract reached by the parties. Rather, courts have implied a duty of good faith with a view to securing the performance and enforcement of the contract made by the parties, or as it is sometimes put, to ensure that parties do not act in a way that eviscerates or defeats the objectives of the agreement that they have entered into....[33]

It is unlikely, however, that either of these courts would dispute that good faith actually is owed by operation of law in certain areas such as the franchise[34] or insurance contract.[35] Yet, contrary to the Ontario Court of Appeal's admonition just above, this good faith term would be stand-alone, independent of the terms expressed in the contract, and, in this way at least, unbargained-for. Accordingly, the courts above are probably not intending to make the broad claim that good faith can *never* be owed by operation of law. It is more likely that they are simply disavowing any *generalized* duty of good faith which is owed, for example, under the Quebec *Civil*

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[32] *Mesa*, *supra* note 12 at para. 15. For a more recent pronouncement to the same effect, see *Klewchuk v. Switzer* (2003), 330 A.R. 40 (C.A.) at para. 33, leave to appeal refused [2003] S.C.C.A. No. 392 (QL).

[33] *Transamerica*, *supra* note 14 at para. 53; see also *IT/NET Inc. v. Cameron*, [2006] O.J. No. 156 at para. 30 (C.A.) (QL) [*IT/NET*].

[34] As discussed in Part 4, *infra*, good faith is owed by operation of law in the franchise contract, either by virtue of statute or the common law. As argued in Part 5, this term cannot be contracted out of.

[35] As discussed in Part 4, *infra*, insurance contracts contain an implied term of good faith. As argued in Part 5, this term cannot be contracted out of.

Code[36] or American jurisdictions governed by the *Uniform Commercial Code*.[37]

What follows is a chart which seeks to summarize the two categories of good faith contracts as well as the source of the good faith obligation:

Category of Contract	Source of Good Faith Obligation
Category One: Power imbalance between the parties is predictably evident *at the time of creation* of the contract based on the nature of the parties' relationship at that time.	Good faith is owed by operation of law (i.e. as an implied-in-law term) either by virtue of legislation or judicial *fiat* based on public policy.
Category Two: Power imbalance between the parties tends to emerge only *at time of performance*.	Good faith is owed based on the parties' presumed intentions (i.e. as an implied-in-fact term) as determined by the officious bystander or business efficacy test and as measured at time of formation. According to the Supreme Court of Canada, the term must have a "certain degree of obviousness to it."

Of course, the divide between category one and category two contracts does not always hold. As Treitel notes, there are a few examples in the case law where a term is implied by operation of law even though the contract is not of a particular type – instead, the court implies a term-in-law based on the particular transaction.[38] And, as

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[36] The Quebec *Civil Code*, S.Q. 1991, c. 64 requires a duty of good faith in all civil contracts:

> 1375. La bonne foi doit gouverner la conduite des parties, tant au moment de la naissance de l'obligation qu'à celui de son exécution ou de son extinction.
>
> 1375. 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.

[37] As the trial judge noted in *TSP-Intl*, *supra* note 4 at para. 75:

> [I]n the United States, the Uniform Commercial Code imposes an obligation of good faith on the performance of every contract or duty under its purview. The Uniform Commercial Code sets out a definition of good faith in section 1-201 as acting "honesty in fact in the conduct or transaction concerned." (sic) Similarly, Article 3 on negotiable instruments defines good faith as "honesty in fact and the observance of reasonable commercial standards of fair dealing." See the Restatement of the Law of Contracts, 2d ed. (St. Paul: American Law Institute Publishers, 1981).

[38] Treitel, *supra* note 18 at 212. As an example, Treitel cites *The Moorcock* (1889), 14 P.D. 64. Though this case is regarded as the leading decision regarding implication of terms implied-in-fact, there are, as Treitel notes at 211, passages in the

discussed in depth later in this article,[39] courts can decide – on policy grounds – to treat certain contracts as a hybrid between category one and two in order to prevent one party from exercising contractual power abusively even when contractual escape clauses appear to permit it. Yet another difficulty arises because courts do not always state whether they are implying a term in fact or in law.[40] These challenges, however, merely show that – as with any system – legal categories are not always watertight nor the lines between them identified in bright lights.

While analysis in this part of the paper is derived, in part, from the trial decision in *TSP-Intl v. Mills*, it is not fully coextensive. In *TSP-Intl*,[41] Wilson J. stated:

> It appears from the review of the caselaw that two categories of cases emerge when the duty of good faith applies in the execution [or performance] of a contract.
>
> First, the court will impose the duty of good faith as an interpretative tool regardless of the specific terms of a contract, when there is inherent vulnerability or a power imbalance in the contracting parties' relationship. Employee/employer relationships at the time of dismissal, and franchisee/franchisor of adhesion are two examples presently recognized in the cases. This power imbalance exists at the time the contract is formed, and the weaker party is characteristically not able to achieve more favourable contractual terms. The power imbalance continues to affect the contractual relationship during its execution. The presence of a power imbalance or inherent vulnerability is a factual issue that must be determined in each case.
>
> Second, in other circumstances, Weiler J.A. confirms at para. 65 of *Shelanu, supra* that "in some instances a duty of good faith may arise ordinarily out of the nature of the relationship, or the circumstances created by the other party."
>
> This second category when a duty of good faith may apply arises out of the parameters of the parties' contractual relationship and conduct, rather than the inherent power imbalance in their relationship. *Mesa Operating Ltd. v. Amoco Canada Resources Ltd*., [1994] A.J. No. 201 (C.A.) and *Gateway Realty Ltd. v. Arton Holdings Ltd*. (No. 3) (1991), 106 N.S.R. (2d) 180 (N.S.T.D.), affirmed (1992), 112 N.S.R. (2d) 180 (N.S.C.A.) reflect these principles.

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decision referring to terms implied-in-law. Treitel concludes at 212:

> To the extent that the implication was based on objective criteria of reasonableness, *The Moorcock* therefore resembles terms implied in law; but it differs from the category of terms implied in law discussed above, in that the implication related to a particular transaction rather than to a type of contract.

39 *Infra* at 223-227.

40 The Ontario Court of Appeal in *Shelanu CA* is just one example.

41 *Supra* note 4.

> This second category appears to be confirmed by the description of the duty of good faith by O'Connor A.C.J.O. in *Transamerica*, *supra* at page 468, para. 53 that:
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> > [C]ourts have implied a duty of good faith with a view to securing the performance and enforcement of the contract made by the parties, or as it is sometimes put, to ensure that parties do not act in a way that eviscerates or defeats the objectives of the agreement that they have entered into....
>
> It is the second category of cases that is more difficult to characterize clearly. O'Connor A.C.J.O. confirms that the law with respect to good faith may be described as "muddy".... [42]

The first category described by the trial judge above very much accords with the notion of good faith implied by operation of law, though it is important to emphasize that the Court never uses this precise term. There is also a difficulty. With respect, the Court is incorrect to state that in the first category, the "presence of a power imbalance or inherent vulnerability is a factual issue that must be determined in each case." This is because in the franchise contract, good faith is owed even when the franchisee is strong and the franchisor is weak.[43] The same holds true for the insurance contract[44] and, most likely, for the employment contract.[45] To this extent at least, facts going to relative power balance between the parties are not always relevant.

How the Court describes the second category also creates a few issues. First, Wilson J. never clearly states that in category two, good faith is implied based on the parties' intentions. Second, the quotation from the judgment of O'Connor A.C.J.O. in *Transamerica* – which Wilson J. seems to regard as uniquely relevant to category two contracts – actually applies equally to category one contracts, at least as understood and presented by this author.[46] Third, Weiler J.A.'s statement from *Shelanu CA* (quoted by Wilson J. above in relationship to category two contracts) is unfortunately ambiguous. It is difficult to know whether Weiler J.A. intends it to refer to category one contracts, category two contracts, or perhaps a combination

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42 *Ibid*. at paras. 60-61, 63-65.

43 As noted in Part 5, *infra*, parties to a franchise contract governed by legislation cannot contract out of the good faith term. This is also likely the case in franchise contracts governed by the common law.

44 At common law, insurance contracts are, by nature, contracts of utmost good faith though, of course, some incidents of common law good faith may have been precisely articulated by statute. For example, s. 567 of the *Insurance Act*, R.S.A. 2000, c. I-3 defines the insured's disclosure duties in relation to life insurance. These obligations are defined by the law and do not change based on the facts.

45 See discussion on contracting out of good faith in Part 5, *infra*.

46 See analysis in Part 2, above.

of both.[47] There is a good argument, however, that Weiler J.A.'s statement refers to category one contracts alone, contrary to the understanding advanced by Wilson J.; the contract at issue in *Shelanu CA* (a franchise contract) is a category one contract and moreover, the case relied on by Weiler J.A. for her general proposition (namely, *Cornell Engineering*) focussed on whether the court should mandatorily imply a good faith standard in contractual negotiation due to reliance by the weaker party on the stronger one.[48] In short, the term in *Cornell Engineering* could only be implied-in-law – if at all. To this extent then, Weiler J.A.'s statement probably describes a category one contract alone though it is impossible to resolve this issue in any definitive way. Fortunately, such indeterminacy does not impact on the basic proposition upon which this article is constructed, namely that an implied term of good faith is present either by operation of law or contractual intention. Such indeterminacy, however, is emblematic and suggests that the law of good faith in Canada is in great need of regularization.

As to when a good faith term is breached, *Shelanu CA* provides the leading test which would apply to either category of contract: "Whether or not a party under a duty of good faith has breached that duty will depend on all the circumstances of the case, including whether the party subject to a duty of good faith conducted itself fairly throughout the process."[49] To support this proposition, the Court relies on a number of insurance cases, including Laskin J.A's analysis in the Court of Appeal in *Whiten v. Pilot Insurance Co.*[50]

Before turning to an application of this simple, bifurcated model of when good faith exists as an implied term, it is important to emphasize that cases involving breach of good faith are also more likely than average to bring with them an award of punitive damages, aggravated damages, or general damages for mental distress. The defendant's relative power over the plaintiff means that it has an increased opportunity to conduct itself outrageously, egregiously, and in a manner

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[47] In "Good Faith as the New Paradigm: An Advance towards Commercial Certainty or a Decline into Ambiguity" (Canadian Bar Association Canadian Legal Conference, St. John's, Nfld., 2006), I suggested that Weiler J.A.'s sentence could be understood as referring to both sources of the good faith (i.e. in fact and in law) but I now suspect that the sentence refers to category one contracts alone. The ultimate meaning of Weiler J.A.'s sentence is irrelevant to the analysis contained in that paper, however, and the analysis still stands.

[48] In reversing the trial judge, Weiler J.A. in *Cornell Engineering*, *supra* note 4 stated at para. 39: "I respectfully disagree that [the dependent party] was justified in law in relying on [the stronger party] to bring the termination clause to his attention."

[49] *Shelanu CA*, *supra* note 12 at para. 74.

[50] (1999), 42 O.R. (3d) 641 (C.A.).

which causes justiciable distress, humiliation, or upset.[51]

4. Applying the Proposed Model

A. The First Category: Good Faith as a Term Implied-in-Law

1) Employment Contracts

The Supreme Court of Canada in *Wallace* stated that employers owe employees an obligation of good faith, at least at the time of dismissal. As already noted, the Court defined good faith as requiring employers in such a situation to be "candid, reasonable, honest and forthright with their employees" and to "refrain from engaging in conduct that is unfair or is in bad faith by being, for example, untruthful, misleading or unduly insensitive."[52] The controversial remedy offered by the Court to the ill-treated employee was a lengthening of the notice period.[53] While the Court acknowledged that the harsher the treatment received by the employee, the more likely it is to have an adverse impact on the employee's ability to find new employment, the plaintiff would not be required to prove a causal relationship. As Iacobucci J. stated:

> [I]n my view, the intangible injuries are sufficient to merit compensation in and of themselves. I recognize that bad faith conduct which affects employment prospects may be worthy of considerably more compensation than that which does not, *but in both cases damage has resulted that should be compensable*.[54]

The prescribed notice period has been closely and classically tied to the decision in *Bardal v. Globe & Mail Ltd.*[55] which identified factors

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[51] See e.g. Shannon Kathleen O'Byrne, "Damages for Mental Distress and Other Intangible Loss in a Breach of Contract Action" (2005), 28 Dal. L.J. 311; and Ronnie Cohen and Shannon O'Byrne, "Cry Me a River: Recovery of Mental Distress Damages in a Breach of Contract Action – A North American Perspective" (2005) 42 American Business Law Journal 97, cited with approval in *Fidler*, *supra* note 9, on other grounds.

[52] *Wallace*, *supra* note 7 at para. 98.

[53] *Ibid.* at para. 130.

[54] *Ibid.* at para. 104 [emphasis added].

[55] (1960), 24 D.L.R. (2d) 140 (Ont. H.C.J.) [*Bardal*]. As the Court in *Bardal* stated at 145:

> There can be no catalogue laid down as to what is reasonable notice in particular classes of cases. The reasonableness of the notice must be decided with reference to each particular case, having regard to the character of the employment, the length of service of the servant, the age of the servant, and the availability of similar employment, having regard to the experience, training and qualifications of the servant.
>
> This passage was quoted with approval in *Wallace*, *ibid.* at para. 81.

tending to affect how quickly re-employment might be secured. In this light, the analysis in the majority decision of the Supreme Court of Canada in *Wallace* is somewhat surprising. That is, the majority proposes that the employee's notice period ought to be lengthened for bad faith conduct *whether or not* such behaviour impacted on the period of time required by the employee to secure new employment. As I have argued elsewhere, the dissenting reasons by McLachlin J. provide the stronger approach, which is simply to imply into the employment contract a good faith term, breach of which is compensated according to ordinary contract law principles.[56] The length of notice would be an entirely separate matter resolved according to the approach established in *Bardal*.

Unfortunately, in *Wallace*, Iacobucci J. declined to say whether the employer's obligation in relation to conduct on dismissal was based in contract or in tort. As McLachlin J. pointed out, the majority's approach failed to honour the principle that "damages must be grounded in a cause of action."[57] That said, one is driven to conclude that such an obligation must be contractual given that the concomitant remedy is a contractual one. According to McLachlin J.:

> To assert the duty of good faith in dismissing employees as *a proposition of law*, as does my colleague [Iacobucci J.] is tantamount to saying that it is an obligation *implied by law* into the contractual relationship between employer and employee. In other words, it is an implied term of the contract.[58]

In this way, it could be said that *both* the majority and dissent found that all employment contracts contain an implied good faith term on dismissal. The difference is how to compensate the plaintiff who has suffered such a breach: Iacobucci J. favoured lengthening the notice period; McLachlin J. preferred simply to assess damages for breach according to usual contract law principles.

In the subsequent employment law decision of *McKinley v. BC Tel*,[59] Iacobucci J. appeared to validate this view that good faith is owed as a

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[56] See Shannon Kathleen O'Byrne, "Bad Faith – Contracts of Employment – *Wallace v. United Grain Growers Ltd.*" (1998) 77 Can. Bar. Rev. 492 [O'Byrne, "Bad Faith"]. For examples of other articles on point, see Nicholas Rafferty and Patricia A. Rowbotham, "Developments in Contract and Tort Law: The 1997-98 Term" (1999) 10 Sup. Ct. L. Rev. (2d) 169; M.C. Crane, "Developments in Employment Law: The 1997-98 Term" (1999) 10 Sup. Ct. L. Rev. (2d) 341; and John Swan "Damages for Wrongful Dismissal: Lessons from *Wallace v. United Grain Growers Ltd.*" (1998) 6 C.L.E.L.J. 313 [Swan, "Damages"].

[57] *Wallace*, *supra* note 7 at para. 119.

[58] *Ibid.* at para. 136 [emphasis added].

[59] [2001] 2 S.C.R. 161 [*McKinley*].

contractual term but in addition, seemed to suggest that such an obligation is owed *throughout* the employment relationship and not just at the time of termination. In this unanimous decision, Iacobucci J. stated:

> In *Wallace*, this Court recognized that the parties to an employment contract are subject to obligations of good faith and fair dealing. These obligations subsist throughout the relationship up until, and including its termination. In the context of dismissal from employment, the majority in *Wallace* described the employer's duties at para. 98 as follows:
>
> [A]t a minimum, I believe that in the course of dismissal employers ought to be candid, reasonable, honest and forthright with their employees and should refrain from engaging in conduct that is unfair or is in bad faith by being, for example, untruthful, misleading or unduly insensitive.[60]

Other courts have interpreted *Wallace* in this expansive manner. For example, in *Prinzo v. Baycrest Centre for Geriatric Care*, the Ontario Court of Appeal stated that the Supreme Court of Canada in *Wallace* "recognized that the parties to an employment contract are subject to an implied obligation of good faith and fair dealing" and that this obligation persisted "throughout the employment relationship up to and including its termination."[61] *Prinzo* also cited the *Wallace* conclusion that breach of good faith by being untruthful or unduly insensitive was insufficient to constitute an independent actionable wrong required to establish aggravated or punitive damages *in the context of an action for failure to give reasonable notice*. *Prinzo* went on to observe that the conclusion in *Wallace* is:

> … in contrast to *Whiten v. Pilot Insurance Co*., 2002 SCC 18, 209 D.L.R. (4th) 257, where, at para. 79, the Court held that an insurance company's breach of the duty of good faith in refusing to pay a claim did amount to a contractual breach, independent of the breach of contractual duty to pay the claim, and could therefore ground an award for punitive damages [which also requires a finding of an independent actionable wrong]. Although in both cases there is often an inequality of bargaining power, the Court's holding in *Whiten*, *supra*, was based on the fact that peace of mind is the very essence of an insurance contract: para 129. By contrast, in *Wallace*, ... the court held that "[a]n employment contract is not one in which peace of mind is the very matter contracted for."[62]

Through this exercise, the Ontario Court of Appeal is trying its

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60 *Ibid.* at para. 73.

61 (2002), 60 O.R. (3d) 474 at para. 34 [*Prinzo*].

62 *Ibid*. Note that *Fidler*, *supra* note 9, has reconfigured the law concerning recovery for mental distress in a contract action; see discussion, *infra* notes 98-103 and accompanying text.

utmost to abide by *Wallace*, but in doing so is forced by the conflict between *Whiten* and *Wallace* to distinguish between breaches of contract that constitute independent actionable wrongs and those that do not. Put another way, the Court is driven to the very uncomfortable conclusion that not every breach of good faith is equivalently actionable. In this way, good faith in the employment context occupies a peculiar and perplexing status which, it is hoped, the Supreme Court of Canada will choose to normalize soon.

Furthermore, the actual reach of *Wallace* remains a very contested matter. Unlike *Prinzo*, some courts have rejected the argument that the good faith obligation subsists throughout the employment relationship on the basis that *Wallace* isolated good faith as an obligation owed only in the context of dismissal. This was precisely the court's opinion in *Babcock v. Canada (A.G.)* when it stated that *McKinley* only concerned wrongful dismissal and its articulation of good faith should not be extended beyond that parameter:

> If *McKinley* was meant to extend the *Wallace* principle to the manner of conduct throughout an employment relationship, then some reference to [*Malik v. Bank of Credit and Commerce International SA*], and some discussion of policy and jurisprudence leading up to the single comment, would be expected. One would also expect the court to explicitly acknowledge it was changing the law if that was its intent. In the absence of such consideration, the single sentence of, "These obligations subsist throughout the relationship up until, and including, its termination," cannot be interpreted as signalling such a radical change in the law that would affect millions of Canadian employees and employers with no guidance on its application.[63]

But, with respect, *Babcock's* reading of *Wallace* and *McKinley* may be unduly constrained. It is true that Iacobucci J. ruled that good faith is owed on dismissal, but this must be seen in the context of the *Wallace* case. While Iacobucci J. did take pains to ensure that good faith would not be extended to the *reasons* for dismissal,[64] this is perfectly defensible

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[63] (2005), 139 A.C.W.S. (3d) 481 at para. 210 (B.C.S.C.) [*Babcock*]. *Malik v. Bank of Credit and Commerce International SA*, [1997] 3 All E.R. 1[*Malik*] is a House of Lords decision which held that all employment contracts contain a general term requiring trust and confidence between the parties; for a discussion of *Malik*, see *infra* at 215.

[64] As Justice Iacobucci stated in *Wallace*, *supra* note 7 at para. 76:

> A requirement of "good faith" *reasons* for dismissal would, in effect, contravene these principles and deprive employers of the ability to determine the composition of their workforce. In the context of the accepted theories on the employment relationship, such a law would, in my opinion, be overly intrusive and inconsistent with established principles of employment law, and more appropriately, should be left to legislative enactment rather than judicial pronouncement [emphasis added].

given the nature of the indeterminate contract of employment. To say, however, as the court in *Babcock* states, that "Iacobucci J. expressly restricted the application of the implied obligation of good faith and fair dealing on an employer to the manner of dismissal"[65] is not quite on the mark. Iacobucci J. did not say that good faith could *never* be owed in other contexts. He merely said that it would *not* be owed when the employer was deciding whether or not to terminate an employee and *would* be owed in the context of the manner of dismissal. In short, it is one thing to observe – correctly – that *Wallace* prohibits bad faith on dismissal and forbids importing a term that the employer have a good faith reason for dismissal. It is another thing to contend that *Wallace* forbids, in a blanket fashion, good faith being owed at other points in the employment context. This latter proposition has no foundation in the *Wallace* case and appears to be inconsistent with *dicta* in *McKinley*, quoted above.

Furthermore, even as Canadian courts apply good faith at the time of dismissal, constructive dismissal cases require the court to reach back in time and implicitly find good faith being owed at various junctures in the employment relationship, albeit in the ultimate context of dismissal. As Geoffrey England observes, courts have required employers to treat their employees fairly and reasonably in a number of constructive dismissal contexts by, for example:

- safeguarding the employee from bullying, intimidation and harassment from managers and other employees;
- conducting performance appraisals in a fair and sensitive manner;
- assigning work duties and work schedules in a fair and reasonable manner that ensures that the employee knows what is expected of him or her, that reasonably accommodates the employee's family life, and that does not set unattainably high performance targets;

  . . .
- conducting fair and honest investigations of serious charges of misconduct, such as theft, that are brought against an employee.[66]

Given the nature of the indeterminate contract – that the employee can be dismissed on notice or with pay in lieu thereof – Iacobucci J. wanted to be clear that there could be no requirement that an employer have good faith *reasons* to terminate an employee with notice or pay in lieu of notice. Such a requirement would undermine – indeed destroy – the very nature of the indeterminate employment contract relationship. Such would be a very unwelcome addition to Canadian employment law.

65 *Babcock*, *supra* note 63 at para. 202.

66 England, *supra* note 17 at para. 10.43 [footnotes omitted]. Cases like these

The force and number of these precedents which look at conduct well antecedent to the contract's termination may ultimately have the effect of propelling an increasing number of courts to find a more expansive good faith duty, regardless of what *McKinley* and *Wallace* may actually mean. Put another way, when the entire currency of the relationship is potentially relevant for the purposes of assessing a constructive dismissal claim, it is a small step to consider the currency of the relationship for other purposes as well. And indeed, as already argued, there is nothing in *Wallace* nor *McKinley* to prevent lower courts from choosing to do so.

The House of Lords in *Malik v. Bank of Credit and Commerce International SA*,[67] referenced in the *Babcock* quotation above, had no difficulty in concluding that *all* employment contracts contained an implied term of trust and confidence[68] – which is analogous to finding a duty of good faith and fair dealing.[69] According to the House of Lords, this obligation has its origin in the general duty of cooperation between contracting parties and as imposing an obligation that the employer shall not "... without reasonable and proper cause, conduct itself in a manner calculated and likely to destroy or seriously damage the relationship of confidence and trust between employer and employee."[70]

Gruchy J. in *Fiske v. Nova Scotia (Attorney General)*[71] cited *Malik* in the context of a constructive dismissal and breach of an implied term of good faith. In this case, the plaintiff Fiske resigned from his position as chair of the Nova Scotia Gaming Corporation two and half years into a five-year contract of employment. This was, in part, in response to a loss of status and prestige he suffered due to the conduct of his employer. According to the court:

> Fiske's relationship with the Government of Nova Scotia had been undermined. He now felt, with justification, that he could no longer trust his relationship with the Government. (See *Malik & anr v. Bank of Credit and Commerce International SA*, [1997] N.L.O.R. No. 507 (H.L.)). Mutual trust was an implied term of the contract.[72]

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validate John Swan's hope, articulated in 1998, that "as the general duty of good faith performance...is recognized, courts may find opportunities, perhaps in the law of constructive dismissal" to ensure that employees who are harassed at work "will be able to argue that their employer bears responsibility for the mental distress that they have been caused;" see Swan, "Damages," *supra* note 56.

67 *Supra*, note 63.

68 *Ibid*. at para. 53.

69 See discussion in O'Byrne, "Bad Faith," *supra* note 56 at 505-06.

70 *Malik*, *supra* note 63 at para. 54.

71 (2001), 195 N.S.R. (2d) 108 (S.C.).

72 *Ibid.* at para. 224.

See also the Ontario Court of Appeal's decision in *Spendlove v. Thorne, Ernst & Whinney* where it applied the *Malik* covenant of trust and confidence to impugn the conduct of the *employee*.[73] Thus far, only *Babcock* and *Barnard v. Testori Americas Corp*.[74] have expressly rejected *Malik.*

In *Canadian Contract Law*, John Swan expertly traces a line of cases wherein courts allude to the principles of natural justice in the employment context, though without expressly identifying those standards.[75] In this way, a good faith standard is the implicit measure and permits the court to treat as constituting unjust dismissal the employer's poor conduct in failing, for example, to investigate the question of cause.[76] Swan also notes two cases, pre-*Wallace*, in which the courts explicitly relied upon administrative law principles in the context of a simple wrongful dismissal action.[77] The concomitant result is the application of a good faith standard in another guise.

While the reach of good faith pursuant to *Wallace* and *Malik* remains uncharted in Canadian jurisprudence, what is clear is that employment contracts receive special treatment at common law due to widely-acknowledged employee vulnerability. Indeed, on several occasions, the Supreme Court of Canada has recognized the emotionally precarious position an employee occupies given that work is essential to an individual's sense of identity[78] and accordingly, that labour is not to be regarded as a commodity.[79] As the Supreme Court of Canada stated in *Wallace*:

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73 (2000), 48 C.C.E.L. (2d) 1 at para. 21 (Ont. C.A.).

74 (2001), 200 Nfld. & P.E.I.R. 29 at para. 8 (P.E.I. C.A.). See also the court's statement in *Babcock*, *supra* note 63 at para. 215, that *Malik* has "not been adopted in the Canadian jurisprudence."

75 John Swan, *Canadian Contract Law*, (Markam: LexisNexis Butterworths, 2006) at 698-704, 711-12.

76 There are several cases cited by Swan where an absence of procedural fairness appears to propel the court's finding of constructive dismissal; see *ibid.* at 703. For example, in *Kerr v. Canada Alloy Castings Ltd.* (2000), 102 A.C.W.S., the court ruled that the plaintiff had been constructively dismissed because the new owner did not give notice of what its expectations were and had not warned the plaintiff that his employment was at risk. *Kerr* is cited in Swan's note 305, *ibid*.

77 See *Davis v. United Church of Canada* (1992), 8 O.R. (3d) 75 (Gen. Div.) and *McCaw v. United Church of Canada* (1991), 4 O.R. (3d) 481 (C.A.), cited in Swan, *supra* note 75 at 703.

78 *Machtinger, supra* note 19 at para. 30.

79 See *Slaight Communications Inc. v. Davidson*, [1989] 1 S.C.R. 1038 at para. 20.

> This power imbalance [between an employer and employee] is not limited to the employment contract itself. Rather, it informs virtually all facets of the employment relationship ....
> This unequal balance of power led the majority of the Court in *Slaight Communications Inc. v. Davidson*, [1989] 1 S.C.R. 1038] to describe employees as a vulnerable group in society: see p. 1051. The vulnerability of employees is underscored by the level of importance which our society attaches to employment. As Dickson C.J. noted in *Reference Re Public Service Employee Relations Act (Alta.)*, [1987] 1 S.C.R. 313, at p. 368:
>
> Work is one of the most fundamental aspects in a person's life, providing the individual with a means of financial support and, as importantly, a contributory role in society. A person's employment is an essential component of his or her sense of identity, self-worth and emotional well-being.
>
> Thus, for most people, work is one of the defining features of their lives. Accordingly, any change in a person's employment status is bound to have far-reaching repercussions....[80]

In a similar vein and as has already been noted, the Ontario Court of Appeal in *Shelanu CA* agreed that good faith is implied in employment contracts because employee vulnerability set them outside the realm of ordinary commercial relationships.[81] One may also note the Ontario Court of Appeal's statement in *Haldane v. Shelbar Enterprises Ltd.*:[82]

> In recent years, considerable jurisprudence has developed over the extent to which terms should be *implied as a matter of law* into employment contracts...The special relationship created by employment contracts and the power imbalance between the parties renders these contracts particularly susceptible to the implication of *terms as a matter of law*.[83]

These quotations sum up why the employment contract consistently falls within category one.

2) Franchise Contracts

As I have noted elsewhere in more detail,[84] good faith is a term of every

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80 *Supra* note 7 at paras. 92-94; see also paras. 95, 98.

81 *Supra* note 12 at para. 64.

82 (1999), 46 O.R. (3d) 206.

83 *Ibid.* at para. 15 [emphasis added].

84 Shannon Kathleen O'Byrne, "Breach of Good Faith in Performance of the Franchise Contract: Punitive Damages and Damages for Intangibles" (2004) 83 Can. Bar. Rev. 431.

franchise contract governed by legislation.[85] For example, Alberta's *Franchises Act*[86] provides as follows:

> s. 7: Every franchise agreement imposes on each party a duty of fair dealing in its performance and enforcement.
>
> s. 18: Any waiver or release by a franchisee of a right given by this Act… is void.

Similarly, in Ontario, the *Arthur Wishart Act (Franchise Disclosure)*[87] states:

> s. 3 (1) Every franchise agreement imposes on each party a duty of fair dealing in its performance and enforcement.
>
> (3) For the purpose of this section, the duty of fair dealing includes the duty to act in good faith and in accordance with reasonable commercial standards.

Like Alberta's legislation, the Ontario Act also provides that any purported waiver or release by a franchisee is void.[88]

Good faith is almost certainly the standard of franchise contracts governed by common law as well. As the Ontario Superior Court of Justice observed in *Machias v. Mr. Submarine Ltd.*, the *Arthur Wishart Act (Franchise Disclosure)* functions to codify the common law requirement of good faith which attaches to franchise contracts.[89]

There are numerous examples in the case law of bad faith conduct by the franchisor including:

- abandoning the franchisee plaintiff in a failing operation while offering a franchise to a third party when it had been offered to the plaintiff and not yet refused;[90]

- failing to provide proper training and support, failing to provide timely building construction of the franchise business premises and timely provision of a liquor license, as well as pre-contractual misrepresentation;[91] and

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85 *Ibid.* at 434.

86 R.S.A. 2000, c. F-23.

87 S.O. 2000, c. 3, as am. S.O. 2001, c.9, Sched. D, s. 1.

88 *Ibid.* at s. 11.

89 *Supra* note 12 at para. 114. See also *Mr. Submarine Ltd. v. Sowdaey* (2002), 118 A.C.W.S. (3d) 373 at para. 56 (Ont. S.C.J.).

90 *Katotikidis v. Mr. Submarine Ltd.* (2002), 29 B.L.R. (3d) 258 (Ont. S.C.J.).

91 *1005633 Ontario Inc. v. Winchester Arms Ltd.* (2000), 8 B.L.R. (3d) 176 (Ont. S.C.J.), aff'd [2002] O.J. No. 4711 (C.A.) (QL).

- failing to support and collaborate with the franchisee when the franchisor decided to open a new concept of retail stores that competed directly with the existing franchisee.[92]

As with the employment context, the good faith duty in a franchise contract (whether imposed by statute or the common law) works to formalize the recognition that there is an inherent power imbalance between the franchisor and franchisee. While not uniformly the case, the franchisee is the classic "little guy"[93] who is essentially outgunned by the franchisor at every turn. As Gillian Hadfield observes:

> [T]he typical franchisee is an inexperienced businessperson, seeking to set up a small business but seeking also to reduce the risks of that enterprise. The franchisor, usually an experienced and sophisticated business entity, provides the franchisee with a package of corporate services, a product with a proven track record, and the advantages of a common trademark. As a result, the relationship is essentially a reliance relationship between unequal parties. The franchisee relies on the franchisor's superior business knowledge and perceives its obligations as following the franchisor's directives. The franchisor, in a sense burdened by its superior position in a nonetheless mutual exchange, is obligated to develop a successful system and to share its expertise with the franchisee. Even the drafting of the standard form written contract is, because of the relational imbalance, almost necessarily left to the expertise of the franchisor.[94]

The Ontario Court of Appeal in *Shelanu CA* stated that, given the characteristics of the franchise contract, "[i]t is hardly surprising...that a number of courts...have recognized that a duty of good faith exists at common law in the context of a franchisor-franchisee relationship."[95] Indeed, the Ontario Court of Appeal in *Shelanu CA* emphasized franchisee vulnerability as a reason to import such a term.

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92 *9007-7876 Quebec inc. c. Provigo inc.* (2004), 136 A.C.W.S. (3d) 1045 (Qc. C.A.).

93 See Michael Herman, "A Good Contract and Responsible Conduct: How the Franchisor Can Maximize Its Remedies Against a Defaulting Franchisee" in *Franchising: Current Issues in Financing, Leasing and Remedies in Default* (Toronto: Insight, 1985) at 2, and Rio Tzimas, "Good Faith and Obligations to Deal Fairly in the Franchise Context" in *Donuts, Pizza and Gas: Do They Always Go Together?* (Canadian Bar Association – Ontario, 1997) at 12.

94 Gillian Hadfield, "Problematic Relations: Franchising and the Law of Incomplete Contracts" (1990) 42 Stan. L. Rev. 927 at 991-92.

95 *Supra* note 12 at para. 66. To support this point, the Court cites *Imasco Retail Inc. (c.o.b. Shoppers Drug Mart) v. Blanaru* (1995), 104 Man. R. (2d) 286 (Q.B.); see also *Country Style Food Services Inc. v. 1304271 Ontario Ltd.*. (2005), 200 O.A.C. 172 (C.A.).

To reiterate, since the franchisee is, in many ways, as vulnerable as an employee, it would be consistent with the Supreme Court of Canada's pronouncement in *Wallace* that a duty of good faith also exists in the context of the franchise contract.[96] Indeed, the franchisee typically lacks equal bargaining power, cannot generally secure or negotiate for more favourable terms, and must submit to franchisor inspections and other manners of control.[97] Franchise contracts governed by the common law alone also therefore fall within what I have described as category one.

3) Insurance Contracts

In the 2006 decision of *Fidler*, the Supreme Court of Canada reaffirmed the longstanding and incontrovertible principle that good faith is owed in an insurance context.[98] This duty does not require the insurer to be correct when it decides to dispute a claim[99] but it must, for example, act promptly and fairly in the investigation and assessment process as well as attempt to resolve claims made by the insured.[100] In *Fidler*, the insurer was sued for breach of good faith by denying the plaintiff disability insurance coverage – notwithstanding medical evidence that the plaintiff was not yet capable of working. On the point of recovering general damages for mental distress, the court clarified that, unlike the case of aggravated damages, there is no requirement for an independent actionable wrong. For recovery of mental distress, the court need only be satisfied:

> (1) that an object of the contract was to secure a psychological benefit that brings mental distress upon breach within the reasonable contemplation of the parties [per *Hadley v. Baxendale*]; and (2) that the degree of mental suffering caused by the breach was of a degree sufficient to warrant compensation.[101]

By following the ordinary rules of contracts in assessing breach, the Supreme Court ended the common law's generalized ostracism of mental distress claims, going on to affirm the trial judge's award of $20,000 to compensate the plaintiff for the psychological consequences of breach.[102] The Court of Appeal's award of punitive damages was set aside, however, because the insurer's handling of the claim was

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96 *Shelanu CA*, *ibid.*

97 *Ibid.*

98 *Supra* note 9 at para. 63. For a much earlier articulation of the doctrine, see *Carter v. Boehm* (1766), 97 E.R. 1162 (K.B.).

99 *Fidler*, *ibid.*

100 *Ibid.*, citing O'Connor J.A. in *Lloyd's*, *supra* note 9.

101 *Fidler*, *ibid.* at para. 47.

102 *Ibid.* at para. 59.

"troubling, but not sufficiently so as to justify interfering with the trial judge's conclusion that there was no bad faith."[103]

It is also indisputable that the good faith duty is reciprocal – the insured also owes a duty of good faith to the insurer. As the Ontario Court of Appeal notes in *Ferme Gérald Laplante & Fils Ltée v. Grenville Patron Mutual Fire Insurance Co.*, "In an insurance contract, the law has long recognized, in addition to the express terms of the contract agreed to by the parties, a *mutual* obligation between insurer and insured to act in utmost good faith."[104]

Though most claims of bad faith are made by insured against insurer, this is not invariably the case. In *Andrusiw v. Aetna Insurance Co.*, for example, the Alberta Court of Queen's Bench ordered repayment of $260,000 in long term disability benefits by the insured as well as punitive damages of $20,000 because the insured received benefits while working and not disclosing that fact. As the Court observed:

> A great deal has been made in the case law, to which this court was referred, of the fact that insurers vis-à-vis their insureds are in a superior bargaining position and one which places the insureds in positions of dependency and vulnerability. Equally, insurers must not be looked upon as fair game. It is a two-way street founded upon the principle of utmost good faith arising from the very nature of the contract.[105]

Note also that the insured's bad faith conduct in, for example, exaggerating physical ailments, has been used by the courts as the basis for disqualifying the insured from an award for punitive damages, even in face of questions surrounding the propriety of the insurer's conduct.[106]

The invariable presence of the good faith term in the insurance contract can be directly tied to the reciprocal dependence of the parties. The insured is clearly vulnerable because, in the event of loss, the insurer makes the initial determination of whether it will even respond to the claim. The insurer is also vulnerable in multiple ways; as Professor Barbara Billingsley notes, it must rely on information provided by the insured at the time of application and beyond; it must rely in large part

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[103] *Ibid.* at para. 75.

[104] (2002), 61 O.R. (3d) 481 at para. 72 (C.A.) [emphasis added].

[105] (2001), 289 A.R. 1 at para 85 (Q.B.) [*Andrusiw*]. For another example, see *Industrial Alliance Insurance and Financial Services Inc. v. Skowron*, [2006] O.J. No. 2554 at para. 2 (S.C.J.) (where the insured was awarded $3,000 in punitive damages because the insured had made fraudulent prescription drug benefit claims).

[106] *Wachal v. Crown Life Insurance* (1999), 140 Man.R. (2d) 26 at para. 104 (Q.B.). In short, such exaggeration of ailments contributed to the insurer's decision to terminate the disability benefits.

on information provided by the insured alone when assessing a claim; and, on a related front, it must generally rely on the insured to minimize the risk of loss.[107] Given this context, the good faith term holds unfair or abusive conduct in check.

4) Standard Form Contracts or Contracts of Adhesion

The Manitoba Court of Appeal in *Mellco Developments Ltd. v. Portage La Prairie (City)* noted that principles of good faith and fairness regularly surface in a number of circumstances, including standard form contracts or contracts of adhesion.[108] For example, *Tilden Rent-A-Car Co. v. Clendenning*[109] is cited in *Mellco* as authority for the proposition that "the party in whose favour a standard form contract is made must treat the other side with good faith."[110] In *Tilden*, this meant that the car rental company in a consumer contract could not rely on an exemption clause in its favour because it had no reasonable expectation that the clause had been read by its customer nor did it take steps to make him aware of the onerous clause in question. Accordingly, the customer's signature on the document was no barrier to his recovery.[111] Note, however, that courts are less likely to be solicitous in a *commercial* contract because the customer is expected to more actively look after its own interests or suffer the consequences. In *Fraser Jewellers (1982) Ltd. v. Dominion Electric Protection Co.*,[112] for example, the Ontario Court of Appeal assessed a commercial, standard form contract containing an exemption clause in favour of the service provider. In enforcing the contract, the Court stated:

> The trial judge held that it was the defendant's responsibility to bring the clause to the "specific attention" of the plaintiff and to explain its effect. Not to have done so, he found, constituted an "unacceptable commercial practice." As I view the matter, there was no special relationship existing between these parties that imposed any such obligation on the defendant. This is an ordinary commercial contract between business people....[I]n this commercial setting, in the absence of fraud or other improper conduct inducing the plaintiff to enter the contract, the onus must rest upon the plaintiff to review the document and satisfy itself of its advantages and disadvantages before signing it. There is no justification for shifting the plaintiff's responsibility to act with elementary prudence onto the defendant.[113]

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107 Private communication with Professor Barbara Billingsley (1 February 2007).

108 (2002), 222 D.L.R. (4th) 67 at para. 86 (Man. C.A.) [*Mellco*], leave to appeal to S.C.C. refused [2002] S.C.C.A No. 502.

109 (1978), 83 D.L.R. (3d) 400 (Ont.C.A.) [*Tilden*].

110 *Mellco*, *supra* note 108 at para. 86.

111 *Tilden*, *supra* note 109 at paras. 29-39.

112 (1997), 34 O.R. (3d) 1 (C.A.) [*Fraser Jewellers*].

113 *Ibid*. at para. 32.

More recently, in *Abrams v. Sprott Securities*, the Ontario Court of Appeal has uncontroversially clarified the scope of *Fraser Jewellers* in the following way: first, the *Fraser Jewellers* proposition does not apply in face of a misrepresentation by the party seeking to rely on the contract in question; second, *Fraser Jewellers* does not apply when there is a special relationship between the parties; and finally, a party cannot raise an estoppel based on a statement induced by that party's own misrepresentation.[114]

It is clear that in this category, the presence of a good faith term is tied to customer vulnerability or other special relationship with the other side. This key factor explains why, in relation to adhesion contracts, the law provides better protection to the ordinary consumer than to his or her presumably more sophisticated commercial counterpart.

5) Other Kinds of Contracts Falling within Category One

a) Good Faith as an Incident of Contracts with a Fiduciary Over-lay

It would seem inevitable that any kind of contract whereby one or more of the parties is a fiduciary means that good faith would be an implied-in-law term of the contract. For example, in *Cancor Developments Corp. v. Cadillac Fairview*,[115] the Court implied a good faith term into the joint venture contract in question because the following section of British Columbia's partnership legislation applied:

> 22.(1) A partner shall act with the utmost fairness and good faith towards the other members of the firm in the business of the firm.[116]

In this case however, and contrary to the allegation of the defendant, the plaintiff had not breached its good faith duty in refusing to accept an offer on property held by the partnership.[117] The Court did find a breach of good faith by the defendant for failing to use its "financial strength"[118] to keep financial costs as low as possible.[119]

b) Good Faith as a Mandatory Incident of the Duty to Perform Contracts Honestly Made

Attempts to contract out of good faith in a category one contract will not

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114 (2003), 67 O.R. (3d) 368 at paras. 57-62 (C.A.).

115 [1994] B.C.J. No. 162 (S.C.) (QL).

116 *Ibid.* at para. 99.

117 *Ibid.* at para. 101.

118 *Ibid*. at para. 80.

119 *Ibid.*

necessarily succeed since, as already noted, the good faith obligation can prevail even in face of terms to the contrary. However, and as will discussed in more detail later in this paper,[120] it should generally be much easier for parties to contract out of good faith obligations in category two contracts since contractual intention drives the content in that arena, as opposed to terms imposed by law.

Not surprisingly though, there are important exceptions to the principle of freedom of contract in category two. To this extent, good faith (or its equivalent) is imposed on the parties by operation of law and such contracts therefore straddle the divide between categories one and two. Even though the parties in the subject contract are not in a relationship which brings with it the mandatory term of good faith (and thus, the contract is contained in category two), such a term is ultimately imposed by the courts by operation of law. These cases also straddle the divide between category one and category two because it is not always clear from the judgment whether the court would have permitted a more tightly drafted exclusion clause to have carried the day such that no good faith would be implied. That said, these are somewhat technical concerns. The main point to be taken from the cases discussed below is that when courts are sufficiently offended by the conduct of the stronger party, they will not render assistance no matter what the contract says.

For example, on numerous occasions in real estate transactions, courts have refused to allow one party to shelter under a "time of the essence" clause or other escape clause when to do so would be "unjust or inequitable."[121] Hence, even though real estate contracts would typically fall within category two on the basis that parties can contract as they see fit,[122] there is nonetheless a caveat. The right of one party to rely on an exclusion or other escape clause can be made subject – by judicial fiat – to an overriding good faith term. The courts are quite rightly loath to permit one party to exercise a contractual power abusively.

The leading decision in this area is the 1958 decision of the Supreme Court of Canada in *Mason v. Freedman*[123] in which the vendor covenanted to sell land to the plaintiff. The contract permitted the vendor to declare the

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120 *Infra* at Part V.

121 See Heatherington J. in *Landbank Minerals Ltd. v. Wesgeo Enterprises Ltd.*, [1981] 5 W.W.R. 524 at 535 (Alta. Q.B.) wherein the court refused to allow the vendor to rely on a "time of the essence" clause.

122 See *e.g. 921250 Alberta Ltd. v. 762910 Alberta Inc*. (2003), 334 A.R. 363 at para. 24 (Q.B.) [*921250 Alberta Ltd.*], wherein the court held that implying a good faith term in the real estate contract at bar would be contrary to its express terms. It therefore declined to do so.

123 [1958] S.C.R. 483.

agreement void should he be "unable or unwilling" to remove any valid objections to title. At a subsequent date, the vendor sought to resile from the contract on the basis that he did not have his wife's dower waiver. Because the vendor had made no *bona fide* efforts to secure the dower waiver, the purchaser sought specific performance. The Supreme Court of Canada agreed that such a remedy should be awarded, noting:

> There is a general principle to be deduced from the cases.... A vendor who seeks to take advantage of the clause must exercise his right reasonably and in good faith and not in a capricious or arbitrary manner. This measure of his duty is the minimum standard that may be expected of him...[124]

Grange J.A. invoked this analysis in the Ontario Court of Appeal decision of *LeMesurier v. Andrus*[125] to conclude that the purchaser could not rely on a small discrepancy in the property description to avoid the contract. As the Court stated:

> I think the purchaser's reliance upon this clause can be described as "capricious or arbitrary" where the vendors had removed the curb and replaced it within the lot line so that it did not encroach on the adjacent lot; and I cannot find her action to be "reasonable and in good faith." If we were to give the clause the meaning and force ascribed to it by the trial Judge, there would be very few contracts for the sale of urban land that could survive. It would be a rare case where a careful survey would not disclose some minor discrepancy. Vendors and purchasers owe a duty to each other honestly to perform a contract honestly made. As Middleton, J. put it in *Hurley v. Roy* (1921), 50 O.L.R. 281 at p. 285, 64 D.L.R. 375 at 377: "The policy of the Court ought to be in favour of the enforcement of honest bargains..."[126]

Grange J.A. went on to observe:

> The approach may be merely an example of the development of an independent doctrine of good faith in contract law at least in the performance of contracts, one explicitly set forth in the American Uniform Commercial Code and in the American Restatement and exhibited, although perhaps in disguised form, in many English and Canadian cases....[127]

The Ontario Court of Appeal has affirmed this kind of judicial approach on numerous occasions. In *Abdool v. Somerset Place Developments of Georgetown Ltd.*, for example, it noted that parties cannot rely on technical deficiencies to avoid their contractual obligations and that parties owe each other a duty to "act reasonably and

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124 *Ibid.* at para. 6.

125 (1986), 54 O.R. (2d) 1 (C.A.), leave to appeal refused [1986] 2 S.C.R. v (note).

126 *Ibid.* at para. 22.

127 *Ibid.* at para. 23.

in good faith and to perform contracts honestly made."[128] As yet another example, see *St. Thomas Subdividers Ltd. v. 639373 Ontario Ltd*,[129] wherein the Ontario appellate court concluded that the vendor in question had an obligation to act in good faith in terminating the agreement.[130] The New Brunswick Court of Appeal in *Lee v. Occo Developments Ltd*.[131] also insisted that the contractual right to repudiate the real estate contract at bar must be exercised in good faith and not for "capricious or arbitrary reasons...."[132]

Even outside the realm of real estate contracts, courts have identified an inherent jurisdiction to prevent unbridled reliance on contractual escape clauses, as set out in *Hunter Engineering Co. Inc. v. Syncrude.*[133] When the escape clause is judicially eliminated, this can have the effect of imposing a good faith term by operation of law. Wilson J. and Dickson C.J.C. stated that courts could decline to enforce exclusion or limitation clauses when the result would otherwise be "unfair or unreasonable" in the context of a fundamental breach (*per* Wilson J.) or, following the analysis of Dickson C.J.C., because the principles of "unconscionablilty" would require such a result.[134] While the approaches of these two judges are somewhat different, the Supreme Court of Canada in *Guarantee Co. of North American v. Gordon Capital Corp.*[135] has confirmed that the differences are small.[136] The point for this article is that both judges in *Hunter* agree that escape clauses do not always have to be enforced according to their terms, that some level of judicial intervention can be appropriate. As Wilson J. observes, there is "some virtue in a residual power residing in the court to withhold its assistance on policy grounds

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128 (1992), 58 O.A.C. 176 at para. 41.

129 (1996) 91 O.A.C. 193.

130 *Ibid.* at paras. 37-38.

131 (1996), 181 N.B.R. (2d) 241 at para. 31 (C.A.).

132 *Ibid.* at para. 32.

133 [1989] 1 S.C.R. 426 [*Hunter*].

134 *Ibid.*; see Wilson J. at para. 161 and Dickson C.J.C. at para. 64.

135 [1999] 3 S.C.R. 423 [*Gordon Capital*].

136 As *Shelanu CA*, *supra* note 12 summarizes the law at para. 35.

In *Guarantee Co. of North America v. Gordon Capital Corp.*, [1999] 3 S.C.R. 423 (S.C.C.), the Supreme Court of Canada "…interpreted [*Hunter v. Syncrude*] in such a way as to indicate that there was little distinction between the approaches of Dickson C.J. and Wilson J." respecting the enforceability of exclusion clauses: Rafferty, *supra*, at 143. I agree. At paragraph 52 of the reasons in *Gordon Capital Corp., supra,* Iacobucci and Bastarache JJ. stated:

The only limitation placed upon enforcing the contract as written …. would be to refuse to enforce an exclusion of liability in circumstances where to do so would be unconscionable, according to Dickson C.J., or unfair, unreasonable or otherwise contrary to public policy, according to Wilson J.

in appropriate circumstances."[137]

In *Shelanu CA*, the Ontario Court of Appeal declined to enforce an exclusion clause which otherwise would have assisted the franchisor on several grounds, including for the reasons stated by the Supreme Court of Canada in *Gordon Capital*.[138] Likewise, in *Civiclife.com v. Canada (Attorney General)*, the court refused to enforce an "entire agreement clause" because, *inter alia*, it would be "unconscionable, unfair, unreasonable or otherwise contrary to public policy."[139] Accordingly, the Court was able to imply a good faith term into the subject contract, unimpeded.

c) Predicting Whether Category One Will Grow

Whether the number of contracts fitting within category one will grow remains an open question. For example, a British Columbia court has held that the duty to act in good faith is an implied-in-law term for every construction contract[140] but this so far remains a minority view. There is at least one reason why the number of cases contained in category one may not see large expansion. In contracts where good faith can be implied on the basis of the facts of the case, courts are much more inclined to follow that path because it is much less controversial. In *Ascent Financial Services Ltd. v., Blythman*, for example, the Saskatchewan Court of Appeal declined to decide whether, in the contract at bar, a good faith term also existed by operation of law – noting that it was not necessary to do so.[141] Instead, it implied such a term on the facts alone.[142] A similar approach was followed in *Markakis v. Yuck* by the Alberta Court of Queen's Bench.[143]

B. The Second Category: Good Faith as a Term Implied-in-Fact

As already noted, under this second category, good faith is typically implied in light of one party gaining the upper hand at a time subsequent to the contract's creation. Good faith is implied-in-fact, either via the business efficacy or officious bystander test. Accordingly, courts assess

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137 *Supra* note 133 at para. 171.

138 *Supra* note 135 at para. 59.

139 *Supra* note 29 at para. 52.

140 *Golden Hill Ventures Ltd. v. Kemess Mines Inc.* (2002), 7 B.C.L.R. (4th) 1 at para. 665 (S.C.).

141 *Supra* note 12 at para. 51.

142 *Ibid.*

143 (2003), 32 B.L.R. (3d) 82 (Alta. Q.B.). The Court found a good faith term implied on the facts and in the alternative, found the term to be present by operation of law, at paras 31-32.

the parties' ostensible intentions at time of contract as triggered by one party's emerging domination at time of performance. As O'Connor A.C.J.O stated in *Transamerica*, "courts have implied a duty of good faith with a view to securing the performance and enforcement of the contract made by the parties, or as it is sometimes put, to ensure that parties do not act in a way that eviscerates or defeats the objectives of the agreement that they have entered into...."[144]

The existence of a good faith term will be strongly pressed in contracts where performance is rendered over time. In such 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.

It is category two which poses the greatest challenge to practitioners as to when good faith is or is not owed. This is clearly acknowledged when Wilson J. of the Ontario Superior Court stated in *TSP-Intl* that "the second category of cases is more difficult to characterize clearly" and quoted O'Connor A.C.J.O's. view that the law on good faith is "muddy."[145]

Category two is challenging, partly because it is difficult to interpret a contractual silence. Put another way, when should the court conclude that the absence of a good faith or analogous clause means that no such term is actually intended and when should that absence be seen as non-determinative? On the one hand, it could be argued that good faith should be implied in such circumstances because it is intended as a device for filling in "contractual gaps."[146] As Gillian Hadfield notes, "Often, contracts are necessarily and intentionally incomplete because mutual desires for flexible, but bounded, responses to uncertain future conditions limit the scope and precision of verifiable terms."[147] On the other hand, it could be argued that the very absence of a good faith clause means that no good faith is owed, on a plain reading of the contract.

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144 *Transamerica*, *supra* note 14 at para. 53, quoted with approval in *TSP-Intl*, *supra* note 4 at para 65.

145 *TSP-Intl*, *ibid*. at para. 66 of the trial decision, quoting *Transamerica*, *supra* note 14 at para. 39.

146 For a discussion of this function of good faith see David Stack, "The Two Standards of Good Faith in Canadian Contract Law" (1999) 62 Sask. L.R. 201 and Hadfield, *supra* note 94.

147 Hadfield, *ibid*. at 927-28.

By way of contrast, contractual silence in category one contracts concerning a good faith clause is not ambiguous by definition since the good faith obligation is owed regardless of what parties think or intend.

What follows is a short account of certain category two contracts. This section, is not, of course, offered as being an exhaustive treatment of the law in any given area nor of all the contracts which ostensibly fit within category two. Rather, my purpose is to select some of the more telling and illustrative instances of category two contracts.

It will also be seen that these cases are united by four constant factors:

- the contract at bar gives the parties obligations which cannot be instantaneously performed;
- subsequent to creation of the contract, one of the parties finds itself in a position to exercise a contractual power – typically a discretion of some sort – in a manner that severely disadvantages the other side;
- the party exercising its contractual power does so unfairly and unreasonably; and
- at issue is whether this harsh exercise of a contractual power is at odds with the bargained-for standard of conduct governing the contract.

The central idea is that, based upon the parties' intention, courts will use the good faith term to restrain one party from unmitigated free reign.

What follows are examples of when the court has been willing to regard good faith as an implied- in-fact term.

1) Tendering Contracts

As is well known, the Supreme Court of Canada in *Ron Engineering and Construction Eastern Ltd. v. Ontario*[148] determined that submission of a tender amounts to an acceptance of the owner's offer of unilateral Contract "A"[149] though creation of Contract "A" is not invariably the case. As the Supreme Court later confirmed in *M.J.B. Enterprises Ltd. v. Defence Construction (1951) Ltd*., formation of Contract "A" – including whether

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148 [1981] 1 S.C.R. 111 [*Ron Engineering*].

149 For discussion of the Contract "A" being formed as a result of the tenderer accepting the owner's offer of same, see McCamus, *supra* note 3 at 44-45.

it is formed at all – depends on the intentions of the parties.[150] When created, Contract "A" governs the rights and obligations of the parties in relation to the creation of Contract "B" or the main contract for which the tenderer hopes to be selected. Because the content of Contract "A" technically can be negotiated between the parties – with no mandatory terms to be implied-by-law – such contracts must, by definition, be considered category two contracts. However, most Contract "A"'s will contain an implied good faith or fairness term, given the centrally important principle that is always at risk, namely the integrity of the tendering system.[151]

According to the Manitoba Court of Appeal in *Mellco*,[152] the possible good faith obligations in relation to negotiating Contract "B" run along a continuum:

> At one end are the formal tender cases invoking the principles of *Ron Engineering & Construction (Eastern) Ltd*. At the other end are cases where, for example, an owner requests a simple quote. There is obviously a lot of territory between these two extremes. The fact situation before us falls somewhere in between the two extremes. One the one hand, there is a detailed request for proposals mandating that they must contain a security deposit and remain open for a length of time. Conversely, the RFP [Request for Proposals] does not create Contracts A or B and envisions continuing negotiations with the "lead proponent" that submits the most attractive proposal.[153]

But even in cases which do not constitute a formal tendering situation – as in *Mellco* where the owner requests proposals merely to open up a process of negotiation – good faith *can* be owed. As the court in *Mellco* noted:

> Within the continuum, in the instant case, there was, in my opinion, an obligation on the part of the city *to conduct itself fairly and in good faith*. Without some fairness in the system proponents could incur significant expenses in preparing futile bids which could ultimately lead to a negation of the process. In circumstances such as those

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[150] *Supra* note 31 at 632. As the court in *Tercon Contractors Ltd. v. British Columbia (Ministry of Transportation and Highways)*, [2006] B.C.J. No. 657 (S.C.) (QL) [*Tercon*] notes at para. 82, "[t]he label or name of the tender document is not a determinative factor...[nor] is the requirement for a security deposit or the existence of established time lines."

[151] As the Alberta Court of Appeal observes in *Double N Earthmovers Ltd. v. Edmonton (City)* (2005), 263 A.R. 201 at para. 52 [*Double N CA*]: "The Supreme Court of Canada has repeatedly stressed that a central principle in all tender decisions is the need to preserve the integrity of the tendering process." The Supreme Court of Canada emphasized this same point in its decision in *Double N SCC*, *supra* note 31; see *infra* notes 172-74 and accompanying text.

[152] *Supra* note 108.

[153] *Ibid.* at para. 80.

> before us, there must be enough fairness and equality in the procedures to ensure its integrity and openness.[154]

On this basis, the court implied a good faith obligation but also found that this term had seen compliance.[155]

Though not entirely clear, it seems that the court in *Mellco* placed a duty of fairness on the city as an exception to the general principle that there is no obligation to conduct contractual negotiations in good faith.[156]

In the tendering context of *Martel Building Ltd. v. Canada*,[157] the Supreme Court of Canada implied a term in Contract "A" that owners must treat all bidders "fairly and equally." Put another way, the owner's discretion as to who should be selected for Contract "B" was not unfettered, despite a broadly worded privilege clause.[158] According to the Court:

> In the circumstances of this case, we believe that implying a term to be fair and consistent in the assessment of the tender bids is justified based on the presumed intentions of the parties. Such implication is necessary to give business efficacy to the tendering process. As discussed above, this Court agreed to imply a term in *M.J.B. Enterprises Ltd.* that only compliant bids would be accepted since it believed that it would make little sense to expose oneself to the risks associated with the tendering process if the tender calling authority was "allowed, in effect, to circumscribe this process and accept a non-compliant bid" (para. 41). Similarly, in light of the costs and effort associated with preparing and submitting a bid, we find it difficult to believe that the respondent in this case, or any of the other three tenderers, would have submitted a bid unless it was understood by those involved that all bidders would be treated fairly and equally. This implication has a certain degree of obviousness to it to the extent that the parties, if questioned, would clearly agree that this obligation had been assumed. Implying an obligation to treat all bidders fairly and equally is consistent with the goal of protecting and promoting the integrity of the bidding process, and benefits all participants involved. Without this implied term, tenderers, whose fate could be predetermined by some undisclosed standards, would either incur

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154 *Ibid.* at para. 81 [emphasis added]. For a very helpful and recent review of good faith in the tendering context, see Ellen Stenshot, "The Doctrine of Good Faith in Contract Law" in the National Civil Litigation Conference "Hot Topics in Litigation" (Toronto: Canadian Bar Association, 2005) at Tab 9.

155 *Mellco*, *ibid.* at para. 84.

156 *Ibid.* at para. 86.

157 *Supra* note 4.

158 *Ibid*. at para. 82. The privilege clause in *Martel* stated that the lowest or any tender would not necessarily be accepted.

> significant expenses in preparing futile bids or ultimately avoid participating in the tender process.[159]

Other courts have found a term of good faith to cover similar terrain and treat it as parallel to the term of fairness articulated by the Supreme Court of Canada above. According to the Saskatchewan Court of Appeal, for example, the owner's obligation to consider a tender "in good faith" requires it to "assess the tender fairly and equally."[160]

Whether there is a difference between a good faith term and a term going to fairness and equality as articulated by the Supreme Court of Canada will generally not make a difference. Put another way, these terms would impeach the same conduct – such as intentionally awarding to a non-compliant bidder. However, there is an argument that the Supreme Court of Canada's fairness term captures a wider range of conduct, including the situation where the owner simply misunderstands the situation and inadvertently awards to a non-compliant bidder. According to McCamus, this conduct might not be impeachable under a good faith term (because there was no bad faith) but would be actionable under a term to treat all bidders "fairly and equally."[161] The other perspective is to note that good faith as defined by *Gateway* forbids unreasonable or unfair conduct. On this footing, it would be unreasonable to award a tender to a non-compliant bidder despite the owner being without *mala fides* in doing so. That is, such conduct is unreasonable even though it was inadvertent. If this analysis is correct, then the two terms – fairness and good faith – are synonymous.

While good faith or fairness terms are open-ended and capture a variety of breaches, the British Columbia Supreme Court in *Tercon Contractors Ltd. v. British Columbia*[162] provided a useful summary of what it means to date:

> The integrity of the tendering process depends upon no competitive advantage being given to any tenderer. As a result, there is an implied duty of fairness upon those calling for tenders in relation to their dealings with tenderers which calls for the reasonable expectation of the parties involved in the bidding process to be respected (*Martel* at para. 88; *Stanco* at paras. 84-85; *Fred Welsh Ltd. v. B.G.M. Construction Ltd.* (1996), 24 B.C.L.R. (3d) 52, [1996] 10 W.W.R. 400 (S.C.)). The scope of the duty is defined in consideration of the terms of contract A so that the fate of proponents is not determined by undisclosed standards (*Martel* at paras. 88-89; *Elite Bailiff* at para. 2). Fairness means consistent application of the tender rules without "... any

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159 *Ibid.* at para. 88.

160 *West Central Air Ltd. v. Saskatchewan* (2004), 249 Sask R. 1 at para. 15 (C.A.).

161 *Supra* note 3 at 151.

162 *Supra* note 150.

> colourable attempt ... to achieve a desired result ..." (*Martel* at paras. 95 and 100). There can be no special treatment (*Martel* at para. 96). Requirements cannot be ignored (*Martel* at para. 98).[163]

Likewise, it is a breach of fairness or good faith for the recipient of tenders to engage in bid-shopping, even in the face of a privilege clause.[164]

Regardless of the outcome in any given case, a judicial emphasis on preserving the integrity of the tendering system shines through the jurisprudence. This emphasis can also be understood as a wish to protect the tenderer from circumstances which have come into play since the formation of Contract "A." The court seeks to prevent the owner from unfairly choosing a non-compliant bid, for example, because this conduct would, applying McCamus's general analysis to the tendering context, (a) be an unreasonable exercise of a discretionary contractual power; (b) would be an attempt to avoid the main objects of Contract "A;" and (c) would amount to an evasion of contractual obligations.[165]

Of course, not every failed tender is judicially attributed to bad faith by the owner. In the 2007 decision of *Double N SCC*, for example, the Supreme Court of Canada ruled that the City of Edmonton did not treat Double N Earthmovers unfairly when it selected the competing Sureway bid.[166] In this case, Double N was an unsuccessful bidder in a tender call for four pieces of heavy equipment to move garbage for the City. As noted by the Court of Appeal, Double N sued the City for breach of Contract "A" on two fronts: first, that the City was in breach when it accepted Sureway's tender without investigating allegations that Sureway's bid was non-compliant and second, when it failed to re-tender the job upon learning that Sureway's bid was deceitful.[167] The trial judge found no breach of Contract "A,"[168] and this decision was upheld on appeal.[169] The Supreme Court of Canada, by a slim majority (LeBel, Deschamps, Fish, Abella, and Rothstein JJ.) also dismissed Double N's

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[163] *Ibid*. at para. 127. See *Caldwell*, *supra* note 11, for a much more restrictive view of what good faith requires. As noted earlier, this view is not the position taken by courts in other Canadian jurisdictions.

[164] See e.g. *Thompson Bros. (Const.) Ltd. v. Wetaskiwin (City)* (1997), 34 C.L.R. (2d) 197 at para 51-52 (Alta. Q.B.). This case was cited with approval by the SCC in *M.J.B. Enterprises*, *supra* note 31 at para. 50.

[165] See discussion of McCamus's analysis at 199, above.

[166] *Supra* note 31.

[167] See the Alberta Court of Appeal's summary in *Double N CA*, *supra* note 151 at para. 1.

[168] [1998] 6 W.W.R. 486 at para. 56 (Q.B.).

[169] *Supra* note 151.

appeal. Though there were some deficiencies and deceitful misdescriptions in the Sureway bid, the majority determined that the bid was nonetheless compliant and capable of being accepted.[170] As for Sureway's deceit in the information it provided regarding one of the pieces of equipment, the majority was unalarmed:

> The City was not aware of Sureway's deceit until after it had accepted Sureway's bid, nor did it collude with Sureway during the bidding process to perpetrate an unfairness against other bidders. Once the City accepted the offer of compliant units, Sureway's failure to supply as promised became a matter between the City and Sureway alone. The City was entitled to deal with Sureway's obligations as it saw fit.[171]

Part of the majority's reasoning relied on the conclusion that Contract "A" is fully performed (and there can be no further obligations to the unsuccessful tenderers) upon formation of Contract "B" with Sureway.[172] Motivating this somewhat technical analysis was Russell J.A.'s concern that "parties to contract B might be subject to constant surveillance and scrutiny of other bidders, challenging any deviation from the original terms of contract A, thereby ultimately frustrating the tendering industry generally, and introducing an element of uncertainty to contract B."[173]

A strong dissent (Charron J. with McLachlin C.J.C. and Bastarache and Binnie JJ. concurring) suggests that the kind of legal issues at play in *Double N SCC* may well see future litigation as Canada's highest court is not of one mind. In rebuttal to the analysis quoted above, Charron J. in dissent persuasively stated:

> The [owner's] right to insist on compliance [from the successful bidder] cannot turn what is on its face a non-compliant bid into a compliant one. Furthermore, I fail to see how the integrity of the bidding process is protected by allowing a bidder to get rid of the competition unfairly and then hash it out with the owner after it has been awarded the contract. Approaching the tendering process in this manner encourages precisely the sort of duplicity seen in the present appeal. A bidder can submit a bid that is either ambiguous or deliberately misleading but compliant on its face in some respects, secure in the knowledge that if it is awarded Contract B it will be in a strong position to renegotiate essential terms of the contract. And an owner can reason that it may be best not to resolve any ambiguity before awarding Contract B, since at that time all Contract A obligations towards other bidders will terminate and it can then enter into

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170 *Double N SCC*, *supra* note 31 at para. 74.

171 *Ibid.*

172 *Ibid.* at para. 71.

173 *Ibid.* at para 73.

> renegotiations with the successful bidder without fear of liability. This approach is not consistent with a fair and open process.[174]

The dissenting analysis has particular resonance given the acknowledged deceit surrounding Sureway's bid. How can it be in the best interests of the tendering system for such poor conduct to ultimately carry the day?

2) Leasing Contracts

The leading good faith case in Canada – *Gateway* – is also a case involving a real estate lease. In *Gateway*, the plaintiff applied to terminate the defendant's leasehold rights in the plaintiff's mall. The defendant was a competitor of the plaintiff who secured the anchor tenant's premises by assignment. The plaintiff and defendant then entered into a contract whereby the defendant covenanted to use "best efforts" to find a replacement tenant but it did not take any serious steps to do so nor would it approve the prospective tenants brought to it by the plaintiff. In this case, the court held that the defendant was in breach of the best efforts clause *and* of an implied covenant of good faith and fair dealing.[175]

What *Gateway* defines as the reach of good faith is not entirely clear since the court sometimes seems to imply that *every* contract (including a leasing contract) contains such a term and then at other times indicates that all is a matter of interpretation. For example, Kelly J. states that "courts are more and more requiring both parties not to act in an 'unreasonable' manner in the performance of a contract"[176] (which points to the term being implied-by-law) and then adds "unless the lease explicitly provides that party can act in such a manner."[177] On this basis, it would ultimately seem that Kelly J. regards good faith in the circumstances of a lease as a default standard out of which parties must expressly contract.

As already noted, *Gateway* has been cited in numerous subsequent decisions across the country.[178]

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[174] *Ibid.* at para. 123.

[175] *Supra* note 10 at para. 108.

[176] *Ibid.* at para. 56.

[177] *Ibid.* Note that the trial judge in *TSP-Intl*, *supra* note 4, regarded the contract in *Gateway* as falling within category two, at para. 64.

[178] For cases citing *Gateway*'s definition of good faith with approval, see *supra* note 12.

A recent decision from the Manitoba Court of Appeal in *Nickel Developments Ltd. v. Canada Safeway Ltd.*[179] appears to follow *Gateway* though, ironically, without ever mentioning the case nor the term "good faith." In this case, Canada Safeway Ltd. became the anchor tenant in a mall, pursuant to a long-term lease with Nickel Developments Ltd. Safeway occupied the premises continually for 30 years. In 1999, Safeway exercised its final renewal option on the lease and promptly ceased operations at the mall. Of course, the landlord objected to this course of action, particularly given how devastating the loss of an anchor tenant's presence generally is to the health of a mall. While not arguing expressly for the imposition of a good faith term, the landlord took an analogous position, saying that the tenant's act of leaving the premises unoccupied would, in the court's words, "frustrate the undisputed intention expressed in the lease."[180] The tenant saw the matter otherwise, arguing that the contract in question had no continuous occupation clause and on that basis, none should be implied.

The Court of Appeal affirmed the trial judge's decision that Safeway was in breach of contract. This finding was influenced by the fact that, at time of renewal, Safeway had no intention to occupy. On the contrary, it wanted to focus its efforts on another store not far away from the mall in question. It renewed only to maintain control over the space and ensure that a competitor could not take up occupation. As well, the Court did not accept Safeway's argument that it was still attempting to sublet the premises.[181] The Court agreed with Nickel's submission that "if the lease is read as a whole while keeping in mind its undisputed commercial purpose, one is bound to find an intention that there be continuous occupation."[182] This is equivalent to finding a good faith term as implied-in-fact based on one party's emerging vulnerability during the course of a contractual relationship. In short, the defendant's right to renew did not give it the unbridled power to occupy or leave the premises dark. Based on business efficacy – which the Manitoba Court of Appeal seems to call the contract's commercial purpose – the contract contained an implied-in-fact term of good faith.

3) Independent Contractor Contracts

In *TSP-Intl*,[183] a case already mentioned above, an independent contractor (Mills) was hired to service TSP's major client (Scepter

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179 (2001), 156 Man. R. (2d) 170 (C.A.).

180 *Ibid.* at para. 16.

181 *Ibid.* at para. 15.

182 *Ibid.* at para. 17.

183 *TSP-Intl*, *supra* note 4 (Ont. S.C.J.).

Corporation). This arrangement continued for four years at which point Mills – abruptly and without consultation with TSP – agreed to work for Scepter directly. The Court ruled that, as there was no power imbalance between the parties at time of contracting,[184] a good faith obligation could only be owed if the contract fell within what it called category two (which also parallels the categorization system being used in this article). According to Wilson J., this contract did so because Mills exercised his discretionary power in a way that "unilaterally eviscerates the contract."[185] Furthermore, the defendants' actions

> caused significant harm to the plaintiffs, contrary to the parties' original expectations. It does not accord with objective community standards of reasonableness, and fairness. I do not impute dishonesty to the defendants. It is not necessary to do so. Mills [the defendant] did not adequately have regard to the legitimate interests of the plaintiffs and did not deal fairly or reasonably with them.[186]

On this basis, the defendants were found liable, *inter alia*, for the plaintiff's loss of profit during the contract's one year notice period.[187]

The Court of Appeal reversed the trial judge's decision in its entirety, however, on the procedural grounds that it was impermissible to find liability for breach of good faith obligation and unconscionable conduct where pleadings did not raise such matters.[188]

5. Contracting Out of Good Faith in Category One and Category Two Contracts

A. Category One Contracts

The general default rule is that parties can contract out of good faith, regardless of the kind of contract at issue. As Kelly J. observed in *Gateway*:

> Because of their respect for the competency of most parties to negotiate their own bargains, and their reluctance to impose "moral" principles on legal transactions, courts properly tread with great care and interfere with reluctance in this type of exercise. Therefore, court-imposed "moral" standards are rarely imposed in a manner that would override express contractual provisions.[189]

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184 *Ibid.* at para. 62.
185 *Ibid.* at para. 85.
186 *Ibid.*
187 *Ibid.* at para. 106.
188 *TSP-Intl*, *supra* note 4 at para. 29 (Ont. C.A.).
189 *Gateway*, *supra* note 10 at para. 63.

With respect to category one contracts, it is a general rule that a term implied-by-law can be displaced by express agreement.[190] However, given the exceptional policy concerns at play in the kinds of contracts contained in category one, good faith is likely an obligation out of which the parties cannot easily contract[191] – if at all. This is because good faith is implied (by virtue of statute law or case law precedent) as a corrective or counter-balance to an inherently unbalanced contractual relationship. To permit contracting out of those obligations would arguably defeat the premise for applying the good faith standard in the first place.

Certainly, the franchisee cannot contract out of being owed a good faith duty in the franchise contract in light of unequivocally clear legislative prohibitions from doing so. These prohibitions would probably be echoed in those jurisdictions which do not have franchise legislation but rely exclusively on the common law. This conclusion is derived from the judicial view that franchise legislation merely codifies the common law, as discussed above.[192] Likewise, in the fiduciary context, it is clear that contracting out would not be permissible.

Given the state of uncertainly regarding the reach of good faith in the employment context, this is a more difficult matter to survey. Though a debatable proposition, it would seem contrary to public policy to permit parties to contract out of this obligation such that the employee could be treated with derision and dishonesty on dismissal or during the currency of the employment relationship. The power imbalance between the parties at the time of contract would incline the court against enforcing such a term. Even if such imbalance were not evident on its face, the fact that the employee would purportedly agree to such treatment strongly suggests a power imbalance notwithstanding appearances. To reiterate, there would be tremendous public policy reasons against enforcing such a clause.

There is at least one case that would militate against this conclusion, however. In *Lane v. School District 68 (Nanaimo-Ladysmith),*[193] the British Columbia Supreme Court declined to award *Wallace* damages for

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[190] See *Machtinger*, *supra* note 19 at para. 56, McLachlin J. concurring in the result.

[191] As noted, courts can decline to enforce "entire agreement" or other exclusion-type clauses on the basis that the clause is unconscionable, unfair, unreasonable or otherwise contrary to public policy. See discussion at note 139 and accompanying text. Note that in some jurisdictions, contracting out of good faith in a franchise context is forbidden by law; see the statutory provisions cited in notes 86 and 88 and accompanying text.

[192] *Supra*, note 89 and surrounding text..

[193] (2006), 47 C.C.E.L. (3d) 219 (B.C.S.C.).

a number of reasons, including that they are only available in a wrongful dismissal action. Because the employer School Board fully complied with a term in the plaintiff-superintendent's employment contract – permitting dismissal without cause provided that she was offered another position or provided with 12 months' notice of termination or was paid her salary for 12 months – nothing actionable had transpired.[194] There was no wrongful dismissal and therefore nothing to which *Wallace* damages could attach. The Court went on to add that, even if the School Board had acted with bad faith in how it terminated the plaintiff's employment (which the court found on the facts it had not), damages were contractually capped at the equivalent of 12 months' salary and benefits.[195]

Though arguably consistent with a strict reading of *Wallace*, this decision can be criticized for giving employers in contracts containing severance clauses free rein to act in any way they see fit. Indeed, there are strong policy reasons to require that *all* employees be treated honestly, fairly, and in good faith at the end of their contract, however it comes to be terminated. It seems peculiar to require that wrongfully terminated plaintiffs be treated in good faith while legally terminated plaintiffs have lesser protection, especially given the Supreme Court of Canada's repeated pronouncements regarding the generalized vulnerability of employees and the importance of work to one's self-esteem, quoted earlier in this article.

A more palatable approach, which I would argue is consistent with both *Wallace* and *McKinley*, would be to imply a good faith term requiring the School Board to treat the plaintiff in a candid, reasonable, honest, and forthright way (to rely on Iacobucci J's words in *Wallace*) when invoking the termination clause but to affirm, based on its readings of the facts, that this obligation had not been breached.

Where parties deal with good faith matters ineffectively in their contract – through, for example, an overly-broad covenant of non-solicitation and non-competition – at least one court has ruled that good faith cannot be invoked to fill in the newly-created gap in the contract. In *IT/NET Inc. v. Cameron*,[196] the Ontario Court of Appeal struck the impugned restrictive covenant and ruled that the former employee had not breached a confidentiality clause. In response to an argument, in the alternative, that the former employee had breached an implied term of good faith, the Court of Appeal stated that there is "no room to import a

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194 *Ibid*. at para. 187.

195 *Ibid.* at para. 188.

196 *Supra* note 33.

separate duty of good faith where both express clauses have been complied with."[197] This decision can also be rationalized on the basis that courts are not generally inclined to backstop poorly conceived contracts by redrafting them.

B. Category Two Contracts

As for category two contracts, contracting out of good faith should be permissible as a general proposition, based on the *Gateway* pronouncement quoted earlier.[198] For example and as already noted, the Alberta Court of Queen's Bench in *921250 Alberta Ltd. v. 769210 Alberta Ltd.* ruled that where the terms of the contract excluded implied or collateral agreements, it was not possible to imply good faith on the facts.[199] In short, the Court permitted parties to exclude good faith terms from their relationship.

Contracting out of good faith in the tendering context is possibly a more controversial question. This is because, while technically within category two, such contracts can very closely approach being category one contracts where policy concerns regarding the integrity of the tendering system are triggered. In such circumstances, a court may well rely on its residual power to forbid one party from relying on escape clauses in its favour, thereby functionally placing certain tendering contacts into category one.[200] For example, in *Tercon*,[201] the British Columbia Supreme Court noted as follows:

> From *Elite Bailiff*, *supra* at paras. 31-35, it is apparent that an owner may limit its liability for breach of contract A by an appropriately drafted clause. However, this case does not stand for the proposition that exclusion clauses are necessarily enforceable in the tendering context.[202]

The court went on to cite cases holding that a discretion clause could not be used to bring a non-compliant bid into existence; an exclusion clause could not be used to accept a non-compliant bid; and a privilege clause could not be used to treat a bidder unfairly.[203] The court also invoked the power to intervene in a bargain between parties with equal bargaining power pursuant to the Supreme Court of Canada's decision in

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197 *Ibid.* at para. 30.
198 *Supra* note 189.
199 *Supra* note 122.
200 See argument in Part 4, above.
201 *Supra* note 150.
202 *Ibid.* at para. 141.
203 *Ibid.*

Gordon Capital,[204] as well as that same court's analysis in *Hunter*[205] regarding the power of a party to rely on an exclusion clause. In short, while freedom of contract means that owners can include clauses to limit or exclude their obligations, courts may resist being persuaded that such terms have hit their mark.

Another possible route for avoiding good faith obligations is for the owner to prevent Contract "A" from coming into existence altogether. That is, the absence of Contract "A" would oust the implied good faith term since there is no contract to which the term can attach. In *Maple Ridge Towing (1981) Ltd. v. Maple Ridge (Corp. of)*,[206] for example, the British Columbia Supreme Court determined, *inter alia*, that an exemption clause in a Request for Proposals (RFP) meant that Contract "A" was never formed.[207] The clause in question read: "The District of Maple Ridge and the District of Pitt Meadows shall not be obligated in any manner to any Proponent whatsoever until a written agreement has been duly executed relating to an approved proposal."[208] The Court concluded that the exemption clause was "a complete answer to the breach of contract question."[209] In short, since there was no contract between the parties, there could be no obligations either.

A competing line of authority suggests, however, that the lack of a Contract "A" is not necessarily fatal to the argument that good faith obligations are owed. As already noted, the court in *Mellco* concluded that – though the facts did not give rise to a Contract "A" – circumstances of the case at bar demanded that "there must be enough fairness and equality in the procedures to ensure its integrity and openness."[210] This meant that the owner was bound to a standard of behaviour even absent a contract mandating that conduct. However, to the extent that the request for proposal simply opens up negotiations and contains broad wording in favour of the owner, an actionable breach of the good faith obligation will presumably be rare.

As already noted,[211] whether Contract "A" is formed is a question of intention. Dean David Percy notes that courts have identified several

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204 *Supra* note 135 at para. 56, cited in *Tercon*, *ibid*. at para. 142.

205 *Supra* note 133.

206 (2001), 22 M.P.L.R. (3d) 297 [*Maple Ridge*]. See also *Buttcon Ltd. v. Toronto Electric Commissioners* (2003), 65 O.R. (3d) 601 (S.C.J.) and *Leeds Transit Sales Ltd. v. Ottawa (City)*, [2004] O.T.C. 840 (S.C.J.) where no Contract "A" was formed.

207 *Maple Ridge*, *ibid.* at paras. 17-18.

208 *Ibid.* at para.16.

209 *Ibid.*

210 *Supra* note 108 at para. 81.

211 See note 150 and surrounding text.

factors indicating the presence or absence of that intention in a construction context,[212] giving two examples. He notes that in *Wind Power Inc. v. Saskatchewan Power Corp.*,[213] the Saskatchewan Court of Appeal rejected the owner's argument that its RFP should be treated differently from an Invitation to Tender governed by *Ron Engineering*. The RFP made proposals irrevocable for a certain period of time and required the successful proponent to enter into a contract whose terms were made known in advance and which were non-negotiable. The court's view was that the RFP should be treated according to the law governing tenders, observing:

> SaskPower offered to consider bids for contract B. They did so by inviting tenders through a formal tendering process involving complex documentation and terms. In submitting its tender, the appellants accepted this offer. The submission of the tender was good consideration for SaskPower's promise, as the tender was a benefit to it and prepared at a considerable cost of money and time to the appellants.[214]

Accordingly, Sask Power did have contractual obligations to those submitting proposals though, on the facts, there was no liability because Cabinet approval was required before the project could proceed and such approval was not forthcoming.[215]

As a contrasting example, Percy cites the Manitoba Court of Appeal in *Mellco*,[216] discussed just above, which found no Contract "A" to exist, particularly in light of a clause stating that proposals were not considered to be tenders and that the ultimate development agreement between the parties would have to be negotiated. But as Percy notes in relation to *Mellco*:

> [T]he RFP contained a number of other signs that could have been taken to create Contract A. These included the fact that the proponents had to pay the cost of receiving the bid documents, they had to submit security with the proposals, and all proposals were subject to specified evaluation criteria. These factors brought the RFP to the verge of creating Contract A.[217]

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[212] David Percy, "Formation of Contracts" in *Law and the Construction Industry* (n.p.: Alberta Construction Industry, 2007) at A-31.

[213] (2002), 15 C.L.R. (3d) 291 [*Wind Power*], application for leave to appeal dismissed [2002] S.C.C.A. No. 283.

[214] *Ibid.* at para. 46.

[215] *Ibid.* at para. 71.

[216] *Supra* note 108.

[217] *Supra* note 211 at A-32.

And finally, the British Columbia Supreme Court gives a very helpful summary in *Tercon*[218] as to when Contract "A" is formed:

> The courts have recognized several factors or terms indicative of an intent to form contract A. The irrevocability of the bid is one such factor... Other factors include the formality of the procurement process, whether tenders are solicited from selected parties, whether there was anonymity of tenders, whether there is a deadline for submissions and for performance of the work, whether there is a requirement for security deposit, whether evaluation criteria are specified, whether there was a right to reject proposals, whether there was a statement that this was not a tender call, whether there was a commitment to build, whether compliance with specifications was a condition of the tender bid, whether there is a duty to award contract B, and whether contract B had specific conditions not open to negotiation....
>
> The label or name of the tender document is not a determinative factor... Neither is the requirement for a security deposit or the existence of established timelines.....
>
> An offer to negotiate is generally not considered to give rise to contractual relations. This is because a bare agreement to negotiate has no legal content... However, new breeds of procurement model, called "hybrids", have both an element of negotiation and competition (see *Brindle*, supra). This was recognized by Tysoe J. in Powder Mountain SC at para. 107 when he said that "a tender giving rise to contract A may allow for a limited form of negotiation, but the final form of contract must be substantially non-negotiable in the form specified in the tender." [219]

Hence, owners seeking to avoid good faith obligations by avoiding creation of Contract "A" face two main hurdles. First, they must ensure that their RFP or other originating document does not contain the hallmarks of a Call for Tenders. As Percy notes, owner should avoid trying "to take all the advantages of Contract A without incurring any of its obligations. If they wish to avoid Contract A, in principle, they should ensure that neither side has any obligations until a tender is accepted."[220] Second, the owner must overcome the proposition put in place by *Mellco* whereby good faith obligations can adhere even absent Contract "A."

Notwithstanding the court's possible reluctance in the context of a tendering contract, contracting out of good faith in category two cases is generally likely to succeed provided that there is absolutely no fiduciary overlay to the relationship and provided it is not unconscionable or otherwise contrary to public policy.[221] For example, in *921250 Alberta*

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218 *Supra* note 150.

219 *Ibid.* at paras. 81-83.

220 Percy, *supra* note 211 at A-33.

221 See Shannon Kathleen O'Byrne, "Good Faith in Contractual Performance:

Ltd., the Alberta Court of Queen's Bench held that implying a good faith term in the parties' written contract for the purchase and sale of real estate would be contrary to its express terms.[222] It therefore declined to do so.[223] As W. Grover comments from a more general perspective:

> With some common sense and some sensitivity to his client's plight, a careful solicitor can normally rely on the enforceability of a properly drafted clause. The courts are not ready to read down freedom of contract explicitly if you can avoid the illegality and public policy arguments and your client does not have the status of a fiduciary. A clear clause will embarrass the judiciary into submission, for the courts are aware that any loss of freedom to contract will herald a partial return to a status society, where judges determine the status of all. In my view, most judges are reluctant to go that far.[224]

6. Conclusion

There is no doubt that the area of good faith in contractual performance is challenging in part because it seems to arise in so many different contexts. Going back to contractual basics is therefore helpful since it isolates the two main sources of good faith in contract law: terms implied-in-law and terms implied-in-fact.

Accompanying the structure discussed in this article are acknowledged and persistent difficulties in predicting when a category two contract contains an implied term of good faith. As I have argued elsewhere, such a problem is most easily and reasonably solved by the recognition of a new common law rule which would provide that good faith is the governing, default standard out of which parties must expressly contract, as appropriate.[225] Such a solution has also been identified by Morrison and Afarian:

> Treating the duty of good faith as an inherent part of every contract unless the parties have expressly and clearly contracted out of the duty will create certainty while honouring the intent of the parties. Apart from an ever-expanding patchwork of statutes seeking to impose good faith duties, a Supreme Court of Canada decision outlining the nature of the duty, its legal basis and its scope would give the doctrine the formal status it deserves while achieving a measure of much-coveted clarity.[226]

Recent Developments" (1995) 74 Can. Bar Rev. 70 [O'Byrne, "Good Faith"].

[222] *Supra* note 122.

[223] *Ibid.* at para. 24.

[224] W. Grover, "A Solicitor Looks at Good Faith in Commercial Transactions" in *Commercial Law: Recent Developments and Emerging Trends (Special Lectures of the Law Society of Upper Canada, 1985)* (Don Mills: De Boo, 1985) at 106-07.

[225] O'Byrne, "Good Faith," *supra* note 221.

[226] *Supra* note 3 at 224. Note the caveat that this recommendation is particularly suitable for arm's length commercial agreements and that other considerations may apply

When one considers what good faith in contractual performance means – that one party cannot, for example, use a power to eviscerate the contract, evade contractual obligations, nullify contractual objectives, cause significant harm to the other party, or exercise a discretionary power unreasonably – it becomes genuinely hard to see this as a radical suggestion. Indeed, such terms would routinely be implied on the basis of principles relating to business efficacy alone. As Richard Potter observes in 1990:

> ...explicit recognition by Canadian Courts of a good faith doctrine would be a helpful step forward in ensuring that clients' reasonable expectations are fulfilled and are not frustrated by our inability to categorize their activity into watertight compartments.[227]

Such suggested reform would simply remove all doubt that good faith governs the contract as a starting position. The onus would then be placed on the party who wants a lower operative standard to put his or her cards on the table during contractual negotiations and secure that reduction by an express term. Such an approach would eliminate the needlessly *ad hoc* nature of category two and help infuse the law with greater certainty and effectiveness.

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for contracts of adhesion; *ibid*. at 224, note 121.

[227] Richard Potter, "Case Comment: *McKinlay Motors Ltd. v. Honda Canada Inc.*" (1990) 46 B.L.R. 111 at 116, quoted with approval in *Elite*, *supra* note 2 at para. 89.