

# GOOD FAITH IN CONTRACTUAL PERFORMANCE: RECENT DEVELOPMENTS

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Alberta

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*This paper considers recent case law on the obligation of contractual parties to perform in good faith and in particular, seeks to determine whether a good faith obligation is imposed by operation of law or merely as a matter of interpretation. The paper also identifies some of the more common scenarios in which a good faith standard is applied by the courts and addresses the matter of contracting out of the obligation to perform in good faith.*

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*Cet article examine la jurisprudence récente portant sur l'obligation des parties d'une entente contractuelle d'exécuter le contrat de bonne foi et en particulier, il cherche à déterminer si une obligation d'agir de bonne foi est imposée par la loi ou si elle est une question en matière d'interprétation. Cet article identifie également certains scénarios communs auxquels un standard de bonne foi est appliqué par les tribunaux et discute de la question de savoir si une partie peut être exemptée par la convention, de l'obligation d'agir de bonne foi.*

Introduction	71
I. Locating the good faith requirement relative to other standards	72
II. Defining good faith	73
III. Questions raised by Gateway	75
A. <i>Is the good faith doctrine simply about uncertainty and judicial moralism?</i>	75
B. <i>Is the good faith doctrine at odds with neo-classical contract law theory?</i>	76
C. <i>Is the good faith doctrine a rule of law or a rule of interpretation?</i>	77
D. <i>Is state of mind important in an action based on breach of good faith?</i>	78
IV. Judicial treatment of good faith in Ontario and Alberta	79
A. Ontario	79
B. Alberta	80
V. Situations in which a good faith requirement is implied	85
A. <i>Good faith obligations arising from the nature of the relationship</i>	86
B. <i>Good faith obligations arising as an ordinary incident of the kind of contract involved</i>	87
(i) Real estate contracts	87
(ii) Employment contracts	89
(iii) Contracts containing exclusion clauses	90
(iv) Contracts of adhesion	91
(v) Tendering contracts	92
C. <i>Good faith obligations arising from the terms of the contract</i>	93
D. <i>Commentary</i>	94
VI. Contracting out of good faith?	94

### Introduction

Though it is much in the case law lately, good faith is by no means a novel legal concept. A recent computer search reveals that the phrase "good faith" appears 426 times in the Revised Statutes of Ontario; 162 times in the Revised Statutes of Alberta; and 170 times in the Revised Statutes of Canada.<sup>1</sup>

Similarly, many common law principles are grounded in the notion of good faith. Within the contractual arena, unconscionability, various kinds of estoppel, illegality, forbearance, capacity, and the enforceability of exculpatory clauses — to name a few examples — are all linked to good faith considerations.<sup>2</sup> The newer trend, however, is a judicial willingness to enforce a duty to negotiate and perform contracts in good faith.

The purpose of this paper is to focus on the obligation of contractual parties to perform in good faith. Given that, at the date of writing, there is no Supreme Court of Canada decision on point, this article is necessarily circumscribed. Part I provides some general orientation by locating good faith performance relative to other measures of conduct in consensual relationships. Part II discusses *Gateway v. Arton Holdings Ltd.* (hereinafter "*Gateway*"),<sup>3</sup> an important starting

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<sup>1</sup> Computer search conducted by University of Alberta Law Librarian Caron Rollins on 29 April 1994. Ms. Rollins's search for Ontario is complete as at 1 July 1993; for Canada as at 31 October 1991; and for Alberta as at 1 October 1990. The Law Reform Commission of Ontario has conducted a similar search the results of which are reported in Law Reform Commission of Ontario, *Report on Amendment of the Law of Contract* (Ottawa: Ministry of the Attorney General, 1987) at 166 and accompanying notes.

<sup>2</sup> For a recent treatment of some of these principles in English law, see J.F. O'Connor, *Good Faith in English Law* (Aldershot: Dartmouth, 1990) at 17-49. The good faith components of important Canadian common law rules are identified by E. Belobaba, "Good Faith in Canadian Contract Law" in *Commercial Law: Recent Developments and Emerging Trends (Special Lectures of the Law Society of Upper Canada, 1985)* (Don Mills: De Boo, 1985) 73 at 80-87. See also B.J. Reiter, "Good Faith in Contracts" (1983) 17 Val. Univ. L.R. 705.

<sup>3</sup> *Gateway Realty Ltd. v. Arton Holdings Ltd.* (1991), 106 N.S.R. (2d) 180 (S.C.); aff'd (1992), 112 N.S.R. (2d) 180 (C.A.). The number of decisions reveal the bitterness of the fight. *Arton Holdings Ltd. v. Gateway Realty Ltd.* (25 October 1989), No. 69679; *Gateway Realty Ltd. v. Arton Holdings Ltd.* (1990), 96 N.S.R. (2d) 82 (C.A.); *Gateway Realty Ltd. v. Arton Holdings Ltd.* (1990), 98 N.S.R. (2d) 39 (S.C.T.D.); *Gateway Realty Ltd. v. Arton Holdings Ltd.* (1991), 106 N.S.R. (2d) 163 (S.C.T.D.); *Gateway Realty Ltd. v. Arton Holdings Ltd.* (1991), 108 N.S.R. (2d) 387 (S.C.T.D.).

point in any account of good faith. Part III considers several questions raised by *Gateway*, including whether the requirement of good faith is imposed by operation of law or merely as a matter of interpretation. Part IV looks at how subsequent courts have treated *Gateway* and the extent to which judicial assumptions concerning its scope are well founded. In a series of cautionary tales, part V identifies some of the more common scenarios in which a good faith standard is applied. Finally, part VI considers the matter of contracting out of good faith and offers some tentative, practice-based conclusions.

### I. Locating the good faith requirement relative to other standards

Finn, in his article "The Fiduciary Principle"<sup>4</sup> provides a useful treatment of the good faith standard regulating consensual relationships relative to both unconscionability and the obligations of a fiduciary.<sup>5</sup> What follows are certain highlights from Finn's analysis:

<b>THE FIDUCIARY STANDARD</b>	<ul style="list-style-type: none"> <li>✕ requires the fiduciary "to act selflessly and with undivided loyalty" to the other party.<sup>6</sup></li> </ul>
<b>THE GOOD FAITH STANDARD</b>	<ul style="list-style-type: none"> <li>✕ requires the parties to have regard for each other's "legitimate interests."<sup>7</sup></li> <li>✕ applies even though the purpose of the contract is for each party to promote its own interests.<sup>8</sup></li> <li>✕ means that the parties have only a qualified entitlement to act self-interestedly.<sup>9</sup></li> <li>✕ arises in arms-length transactions.</li> </ul>
<b>THE UNCONSCIONABILITY STANDARD<sup>10</sup></b>	<ul style="list-style-type: none"> <li>✕ prohibits the parties from being "excessively self-interested or exploitative."<sup>11</sup></li> <li>✕ means that the parties have a virtually absolute entitlement to act self-interestedly<sup>12</sup> and with minimum regard for the other party.</li> <li>✕ arises, generally, where one party is vulnerable or weaker than the other.</li> </ul>

<sup>4</sup> P.D. Finn, "The Fiduciary Principle" in T.G. Youdan, ed., *Equity, Fiduciaries and Trusts* (Toronto: Carswell, 1989) at 1.

<sup>5</sup> As noted by Mr. Donald Neeland of Field & Field Perraton, if one defines good faith narrowly, a strong argument can be made for yet another standard — namely commercial reasonableness — which would be located between the good faith and fiduciary standard.

<sup>6</sup> Finn, *supra* footnote 4 at 4.

<sup>7</sup> *Ibid.*

<sup>8</sup> *Ibid.* at 11.

<sup>9</sup> *Ibid.* at 4.

<sup>10</sup> R. Flannigan notes in "Hunter Engineering: The Judicial Regulation of Exculpatory Clauses" (1990) 69 Can. Bar Rev. 514 at 529ff, that there is both a wide and narrow version of unconscionability applied by Canadian courts. He concludes that the Court's failure in *Hunter Engineering v. Syncrude*, [1989] 1 S.C.R. 426 to explore more fully the doctrine of unconscionability "makes the judgment an entirely unsatisfactory foundation for the subsequent application of the standard" at 529.

<sup>11</sup> *Supra* footnote 4 at 4.

<sup>12</sup> *Ibid.*

These foregoing standards force each party to acknowledge and respect the interests of the other,<sup>13</sup> thereby putting a relative brake on self-promotion.<sup>14</sup> Parties are not free to do exactly as they please: their conduct must meet the threshold standard governing the relationship in question.

As will become clear in subsequent sections of this paper, good faith can have no absolute meaning: it assumes its content from the facts of each particular case.<sup>15</sup> Good faith as a general concept can only be understood relative to higher and lower standards governing consensual relationships.<sup>16</sup> Put another way, the standards of unconscionability, good faith, and the fiduciary are not distinct but represent the more obvious and “dominant shades on a spectrum.”<sup>17</sup>

## II. Defining good faith

Finn notes that, of the three standards referred to in part I above, “good faith” is the most contentious.<sup>18</sup> As an overriding principle, it has been largely rejected in England<sup>19</sup> but thoroughly entrenched in other jurisdictions, including Australia and the United States.<sup>20</sup> In Canada, it is enjoying increasing judicial treatment, particularly since the decision of *Gateway*.

*Gateway Realty Ltd.* (“Gateway”) owned a shopping mall in which Zellers was the anchor tenant. The lease permitted Zellers to occupy the premises, leave them vacant, or assign to a third party without any obligation to secure the

<sup>13</sup> *Ibid.*

<sup>14</sup> *Ibid.*

<sup>15</sup> As Belobaba notes, *supra* footnote 2 at 79: “Good faith cannot be defined with any meaningful precision. The only definitional guidance that can be provided is via modern examples of bad faith behaviour.”

<sup>16</sup> See Finn’s account of each of these standards, *supra* footnote 4 at 3-54.

<sup>17</sup> *Ibid.* at 3.

<sup>18</sup> *Ibid.* at 4.

<sup>19</sup> See the Law Reform Commission of Ontario, *supra* footnote 1 at 165. As the court states in *Interfoto Picture Library Ltd. v. Stilleto Visual Programmes Ltd.*, [1989] 1 Q.B. 433 at 439 (C.A.), while civil law systems recognize a general principle of good faith, “English law has, characteristically, committed itself to no such overriding principle but has developed solutions in response to demonstrated problems of unfairness.”

<sup>20</sup> The American Uniform Commercial Code (U.C.C.) section 1-203 provides: “Every contract or duty within this Act imposes an obligation of good faith in its performance or enforcement.” Good faith, defined as “honesty in fact in the conduct or transaction concerned” in U.C.C. section 1-201(19), is an obligation which cannot be disclaimed by agreement of the parties per U.C.C. section 1-102(3). For a recent appellate decision regarding the implied covenant of good faith and fair dealing, see *Racine & Laramie v. Dept. of Parks*, 14 Cal.Rptr.2d 335 (Cal. App. 4 Dist. 1992).

For a recent review of Australian jurisprudence regarding good faith, see *Renard Constructions (ME) v. Minister* (1992), 3 N.S.W.L.R. 234 at 263-269 (C.A.). Finally, see the Symposium on the Law of Bad Faith in Contract and Insurance (1994) 72 Texas L.R. 1203ff.

consent of the Landlord.<sup>21</sup> After being approached by the defendant Arton Holdings Ltd. (“Arton”) — a competitor of Gateway’s — Zellers agreed to locate in Arton’s mall. As part of this arrangement, the defendant agreed to take an assignment of the remaining 17 years of Zellers’s lease with Gateway. The upshot was that 60,000 square feet of Gateway’s mall had been assigned to its largest competitor. Pursuant to a subsequent agreement between Gateway and Arton, the companies agreed to “use their best efforts” to lease the space formerly occupied by Zellers. According to the court, this agreement bound Arton’s exercise of its tenancy rights “either as a clarification of its tenancy obligations, as an amendment to the lease clause allowing it to ‘go dark’, or as a collateral agreement to the same effect.”<sup>22</sup> When Arton continued to reject prospective tenants which it thought would strengthen Gateway’s mall at the expense of its own operation, Gateway brought an action claiming, *inter alia*, that Arton had breached an obligation of good faith by not taking reasonable steps to sublet and had failed to discharge its obligation to use “best efforts.”

Kelly J. found for Gateway on both grounds and therefore terminated the assignment.<sup>23</sup> Not only was Arton in breach of its obligation to use “best efforts,” it had failed to discharge its more generalized duty to perform in good faith. According to the court:

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.<sup>24</sup>

This notion of honesty or reasonableness is not necessarily as broad as it may seem at first glance. Put another way, what good faith generally prohibits is bad faith.<sup>25</sup> According to the *Gateway*:

in most cases, bad faith can be said to occur when one party, without reasonable justification, acts in relation to the contract in a manner where the result would be to substantially nullify the bargained objective or benefit contracted for by the other, or

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<sup>21</sup> The generosity of these clauses is explained by the trial judge when he notes that the leasing of department store space in the 1960’s was “pretty much a one-sided venture” in favour of the tenant, *supra* footnote 3 at 190.

<sup>22</sup> *Ibid.* at 202.

<sup>23</sup> *Ibid.* at 212.

<sup>24</sup> *Ibid.* at 191-192.

<sup>25</sup> As R. Summers notes in “‘Good Faith’ in General Contract Law and the Sales Provision of the Uniform Commercial Code” (1968) 54 Va. L.R. 195 at 201:

In contract law, taken as a whole, good faith is an “excluder.” It is a phrase without general meaning (or meanings) of its own and serves to exclude a wide range of heterogeneous forms of bad faith [footnotes deleted].

This passage is quoted with approval in *Gateway*, *ibid.* at 197.

to cause significant harm to the other, contrary to the original purpose and expectation of the parties.<sup>26</sup>

Obviously, this second account of good faith is less controversial than the first. Forbidding one party to cause significant harm to the other would invariably be consistent with contractual intention. A common law rule requiring the parties to meet a standard of fairness and reasonableness is less clearly so.

It would seem that the court in *Gateway* comes to a largely unremarkable conclusion<sup>27</sup> through remarkable means. Kelly J. uncontroversially holds that because Arton agreed to use its "best efforts" to find a subtenant, it became bound to conduct itself in good faith vis à vis Gateway. To this extent, the court is doing no more than holding Arton to its own bargain. But at the same time, the court makes the broader claim, namely, that Arton owed a duty to perform in good faith quite apart from any obligations expressly assumed by contract.

### III. Questions raised by *Gateway*

The court's treatment of good faith in *Gateway* raises several questions, three of which are treated below.

#### A. *Is the good faith doctrine simply about uncertainty and judicial moralism?*

*Gateway* is somewhat unsettling because it seems to inject uncertainty into the law. Good faith requires conduct above unconscionability but one cannot define in advance precisely what conduct will meet and what will fall short of the good faith standard.<sup>28</sup> This is a criticism which Kelly J. seeks to address directly:

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<sup>26</sup> *Gateway*, *ibid.* This approach to good faith is the flip-side to the following pronouncement in *Butt v. M'Donald* (1896), 7 Q.L.J. 68 at 70-71:

It is a general rule applicable to every contract that each party agrees, by implication, to do all such things as are necessary on his part to enable the other party to have the benefit of the contract.

*Butt* is quoted by D.W.M. Waters in his comment "*Lac Minerals v. International Corona Resources Ltd.*" (1990) 69 Can. Bar Rev. 455, his footnote 77.

<sup>27</sup> A very narrow reading of the case is that Arton was simply in breach of an express covenant to use its "best efforts." There was no need to imply good faith because Arton had already expressly committed itself to that standard.

<sup>28</sup> See a similar comment by Kerans J.A. in *Mesa Operating Limited Partnership v. Amoco Canada Resources Ltd.* (1994), 19 Alta. L.R. (3d) 38 (C.A.) (hereinafter "*Mesa*") at 44 (with a minor corrigendum released April 8, 1994) and quoted below:

The argument the other way is that "good faith" is too vague a term. It might be said that it would encourage judges to wander unnecessarily far into the thicket of extra-contractual rules of conduct.

See also Fraser C.J., "Searching for Fairness" (Address given to the 20/20 Anniversary Celebration, University of Alberta Faculty of Law, 18 September 1992) at 19.

Surely it is of commercial value to the business community to have their commercial relationships, their contractual drafting, and their contractual performance guided by some good faith requirement. They can then rely on such a legal principle rather than incur costs in an attempt to protect themselves from bad faith....A climate of law where counsel are urging their clients to act fairly, or at least not in 'bad faith', is a climate where business disputes will more likely be resolved, and such disputes and the costs arising from them likely avoided.<sup>29</sup>

*B. Is the good faith doctrine at odds with neo-classical contract law theory?*

A second, related question concerns the extent to which the good faith requirement collides with the free market expectations of neo-classical contract law theory. As Collins notes, contract law is traditionally regarded as a

facility for individuals to pursue their voluntary choices. Its latent social ideal embodies a liberal state in which the law maximizes the liberty of individual citizens, encourages self-reliance, and adopts a more or less neutral stance with regard to permissible patterns in social life. It secures these goals by facilitating the creation of legal obligations on any terms which individuals freely choose.<sup>30</sup>

Neo-classical contract law theory regards the individual as a rational self-maximizer whose right to enter into freely chosen trades should remain largely unfettered. Viewed from this perspective:

Good faith ... is an imperfect translation of an ethical standard into legal ideology and legal rules. However much it might stimulate research or encourage inquiry into theories underlying contract law, its appropriate home is the university where it can perform these functions without wreaking practical mischief.<sup>31</sup>

To the extent that good faith performance is a requirement of every contract — regardless of contractual intent — is the extent to which freedom of contract is mandatorily reduced.

According to Kelly J., however, such an assessment of the good faith doctrine would be entirely misguided. Quoting Edward Belobaba, the court emphasizes that a good faith requirement is

not about transactional or 'commercial good samaritanism.' It has nothing to do with 'judicial moralism.' Indeed, the explicit adoption of a good faith doctrine today would not impose any new contractual obligations or responsibilities. It would simply consolidate existing doctrinal approaches and provide a more precise remedial vocabulary.<sup>32</sup>

<sup>29</sup> *Supra* footnote 3 at 198. See also the comment by S. Burton in "Breach of Contract and the Common Law Duty to Perform in Good Faith" (1980) 94 Harv. L.R. 369 at 393: The good faith performance doctrine may be said to enhance economic efficiency by reducing the costs of contracting. The costs of exchange include the costs of gathering information with which to choose one's contract partners, negotiating and drafting contracts, and risk taking with respect to the future. The good faith performance doctrine reduces all three kinds of costs by allowing parties to rely on the law in place of incurring some of these costs [footnotes deleted].

<sup>30</sup> H. Collins, *The Law of Contract* (London: Weidenfeld and Nicolson, 1986) at 1.

<sup>31</sup> M. Bridge, "Does Anglo-Canadian Contract Law Need a Doctrine of Good Faith?" (1984) 9 Can. Bus. L.J. 385 at 412

<sup>32</sup> *Gateway*, *supra* footnote 3 at 197, quoting Belobaba, *supra* footnote 2 at 78.

Note too the court's assurance that:

[b]ecause 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.<sup>33</sup>

In this way, Kelly J. — with some success— locates good faith within the overarching context of curial deference, freedom of contract, and certainty.

C. *Is the good faith doctrine a rule of law or a rule of interpretation?*

It is not entirely clear from *Gateway* whether a covenant of good faith is to be implied in every contract or whether such a term will only be implied if consistent with the parties' contractual intention.<sup>34</sup>

*Gateway* goes in both directions on this question. Kelly J. states, on the one hand, that "courts are more and more requiring both parties not to act in an 'unreasonable manner' in the performance of a contract" but then goes on to add this proviso: "unless the lease explicitly provides the party can act in such a manner."<sup>35</sup> Similarly as the last quotation immediately above reveals, the court claims, on the one hand, to respect the bargain which the parties have struck but, on the other hand, to say that the courts will — albeit rarely — override express contractual provisions.<sup>36</sup> To complicate matters even further, some of the court's statements regarding good faith are completely unqualified. For example, Kelly J. states that: "[t]he insistence on a good faith requirement in discretionary conduct in contractual formation, performance, and enforcement is only the fulfilment of the obligation of the courts to do justice in the resolution of disputes between contending parties."<sup>37</sup>

Notwithstanding a lack of definitiveness, Kelly J.'s position appears to be this: the overwhelming majority of contracts contain an implied covenant of good faith and this is the standard to which the parties are accordingly held.

<sup>33</sup> *Gateway, ibid.* at 198.

<sup>34</sup> As D. Clark asks, is good faith to be seen as operating *within the parameters of the parties' express allocation of rights and responsibilities*, subjecting them in the interest of reasonableness to implied qualifications not inconsistent therewith? Or is the doctrine rather a further recognition of the *paramountcy of objective, tort-like norms* that in an appropriate case will trump express contractual rights the exercise of which a court views as too unfair? "Some Recent Developments in the Canadian Law of Contracts" (1993) 14 *Adv. Q.* 435 at 438.

<sup>35</sup> *Supra* footnote 3 at 196.

<sup>36</sup> *Ibid.* at 198

<sup>37</sup> *Ibid.* at 192.



D. *Is state of mind important in an action based on breach of good faith?*

It is Kelly J. who provides one of the few accounts of the state of mind required in the discretion-exercising party when breach of good faith is being alleged. In the recent decision of *Dudka v. Smilestone*, he agreed that state of mind is important and concluded that the court's duty is to conduct an objective inquiry into the discretion-exercising party's state of mind.<sup>38</sup> According to Professor G.H.L. Fridman, however, this ruling fails to resolve whether subjective honesty is sufficient to meet the good faith standard or whether the court should rely only on an objective assessment.<sup>39</sup> Certainly, as Kelly J. notes, the court would be unwilling to interfere with the exercise of discretion absent improper motive or purpose by the party in question.<sup>40</sup> But even this statement at bottom imports a largely objective standard of state of mind given that what appears to the third party to be an unreasonable exercise of a discretion would also lead to the conclusion that the discretion-exercising party has acted with an improper motive. If this is true, then does the subjective standard have no role to play at all? *Greenberg v. Meffert*<sup>41</sup> provides significant guidance in this area and may prove to be the bellwether in future good faith cases.

The Ontario Court of Appeal in *Greenberg* was seeking to determine whether one party had exercised its discretion properly. According to Robins J.A.:

[in] contracts in which the matter to be decided or approved is not readily susceptible of objective measurement — matters involving taste, sensibility, or personal compatibility or judgment of the party for whose benefit the authority was given — such provisions are more likely construed as imposing only a subjective standard. On the other hand, in contracts relating to such matters as operative fitness, structural completion, mechanical utility or marketability, these provisions are generally construed as imposing an objective standard of reasonableness.<sup>42</sup>

Applying this central distinction to good faith cases, the courts ought to invoke a functionally subjective measure of state of mind when the matter at issue relevantly concerns "taste, sensibility, or personal compatibility." Conversely, an objective inquiry into state of mind should be conducted where the matter can properly be assessed by a third party. To use an example based on the *Gateway* case, a court is more than competent to consider whether the discretion-exercising party has legitimately exercised its contractual right to reject a proposed subtenant.

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<sup>38</sup> (1994), 131 N.S.R. (2d) 81 (S.C.) at 90.

<sup>39</sup> *The Lawyers Weekly*, 14:04 (May 27, 1994) 31.

<sup>40</sup> *Supra* footnote 3 at 199, quoting with approval S. Burton, *supra* footnote 29.

<sup>41</sup> (1985), 37 R.P.R. 74 (C.A.), leave to appeal to the S.C.C. refused (1985), 64 N.R. 156.

<sup>42</sup> *Ibid.* at 81.

#### IV. Judicial treatment of good faith in Ontario and Alberta

##### A. Ontario

The obligation to perform contracts in good faith has recently been considered in Ontario in *MDS Health Group Ltd. v. King Street Medical Arts Centre Ltd.* (“*MDS Health Group*”).<sup>43</sup> Haley J. found that King Street Medical Arts Centre Ltd. (“King Street”) had breached a duty of good faith by establishing a medical laboratory service, contrary to the interests of MDS Health Group Limited (“MDS”) which operated a medical lab in the same building. To fully understand the court’s analysis of good faith, it is necessary to review the facts of *MDS Health Group* in some detail.

The shareholders in King Street were doctors, dentists, and MDS. They were also tenants in a building owned by King Street. As summarized by the court, the King Street Shareholders’ Agreement restricted shareholders to practising medicine or dentistry or “carrying on health care related activities.”<sup>44</sup> It also recited that, *inter alia*, a medical laboratory could not be admitted as a common shareholder without the written consent of MDS.<sup>45</sup> The lease between MDS and King Street contained a restrictive covenant which provided that the Landlord would not allow the building to be occupied or used by any business the function of which was to take medical specimens or operate a medical laboratory service.<sup>46</sup>

Shortly after MDS refused to pay quadruple rent, the respondent doctors entered into a lease with King Street and set up a “Physicians’s Lab,” which duplicated most of MDS’s functions. This lease provided that the Physicians’s Lab space was to be used “only for the practice of medicine” and further, that “the Tenant shall not carry on or permit be (sic) carried on therein any other trade or business.” The respondent Canadian Medical Laboratories Ltd. (“CML”), which was neither a party to the Shareholders’ Agreement nor to the lease, stepped in and provided personnel, supplies and furniture to run the Physicians’ Lab. In response, MDS brought an application for a declaration that the relevant respondents were in breach of a restrictive covenant in a lease in favour of MDS and in breach of the Shareholders’ Agreement.

Two related aspects of the court’s reasoning in this case are important. First, the court rejected the respondent doctors’ position that the Shareholders’ Agreement was irrelevant to construing the restrictive covenant in MDS’s lease with King Street. The court ruled that while the Shareholders’ Agreement “may not be available to explain the lease itself,” the lease was “necessary to put the issue in its business or commercial context.”<sup>47</sup> Second, the court found that the

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<sup>43</sup> (1994), 12 B.L.R. (2d) 209 (Ont. Gen. Div.).

<sup>44</sup> *Ibid.* at 216.

<sup>45</sup> *Ibid.* at 217.

<sup>46</sup> *Ibid.* at 221.

<sup>47</sup> *Ibid.* at 216.

lease allowing the Physicians' Lab to occupy space in the King Street building was a breach by the respondent doctors (as directors) and King Street (as landlord) "of the good faith required of the law of parties to a contract."<sup>48</sup> The court relied extensively on Kelly J.'s decision in *Gateway* and concluded that the doctor directors

whether out of pique with MDS or in an effort to pressure it into paying more rent have knowingly allowed King Street to enter into the lease for...[the Physicians' Lab] to create competition with MDS and to nullify the restrictive covenant on which MDS was entitled to rely when it entered into its own lease with King Street. They have done so in bad faith.<sup>49</sup>

The court therefore issued an injunction, enjoining the respondents from continuing to breach the restrictive covenant in the lease.<sup>50</sup> The injunction extended to CML — even though it did no more than to "take advantage of an economic opportunity"<sup>51</sup> — because it would be "unfair to allow it to continue to take advantage of the situation now that the court has found that the respondent doctors and King Street are acting in bad faith."<sup>52</sup>

It would appear that an application of *Gateway* was appropriate in *MDS Health Group*. The "Physicians' Lab" was a large operation, the effect of which was to reduce MDS's business from an average of 693 requisitions to 228 a week.<sup>53</sup> The lab accordingly destroyed "the whole premise upon which MDS's original participation in the building was based,"<sup>54</sup> and to apply the *Gateway* principle, substantially and without reasonable justification, nullified the object or benefit contracted for by MDS.

The case of *Gateway* has not yet been considered by the Ontario Court of Appeal.

## B. Alberta

Kelly J.'s analysis in *Gateway* has been expressly endorsed by the Alberta Court of Queen's Bench in several recent cases, including: *Opron Construction Co. v. Alberta*<sup>55</sup> (hereinafter "*Opron*") and *Mesa Operating Ltd. Partnership v. Amoco Canada Resources Ltd.*<sup>56</sup> The latter has also been considered by the Court of Appeal.<sup>57</sup>

<sup>48</sup> *Ibid.* at 223.

<sup>49</sup> *Ibid.* at 225.

<sup>50</sup> The court also stated that MDS was entitled to damages and ordered a trial of that issue.

<sup>51</sup> *Ibid.* at 224.

<sup>52</sup> *Ibid.* It should be noted that, like *Gateway*, the decision in *MDS Health Group* can be justified on the narrower ground that the respondents had breached an express contractual term.

<sup>53</sup> *Ibid.* at 219.

<sup>54</sup> *Ibid.* at 222-223.

<sup>55</sup> (1994), 151 A.R. 241 (Q.B.).

<sup>56</sup> (1992), 129 A.R. 177 (Q.B.).

<sup>57</sup> *Supra* footnote 28.

In 1979, Mesa Operating Ltd. ("Mesa") sold all its Canadian oil and gas properties to Dome Petroleum which was succeeded by Amoco Canada Resources Ltd. ("Amoco"). Mesa retained a 12.5% "overriding royalty" in part consideration for the sale of its nonproducing properties.<sup>58</sup> Under the agreement, Amoco was granted discretion to pool properties. Amoco drilled a successful gas well and purported to pool it with an adjoining property which it owned. The effect of this particular pooling arrangement was to reduce Mesa's royalty by half. Mesa therefore brought an action against Amoco for lost royalties.

The Court of Queen's Bench held that Amoco had breached its duty of good faith:

[The pooling] clause does not purport to dictate to Dome [Amoco] the method of pooling to be employed or the allocation of the revenues resulting therefrom. Therefore, in my view, Dome [Amoco] has the discretion to proceed as it sees fit but it is not unfettered discretion, because it is obliged to act in good faith vis-à-vis the royalty holder. Such a term exists by implication.<sup>59</sup>

Quoting extensively from *Gateway* in this section of the judgment, the court agreed that the common law duty to perform in good faith is breached "when one party acts in a manner that substantially nullifies the contractual objectives or causes significant harm to the other, contrary to the original purposes or expectations of the parties."<sup>60</sup>

The court concluded that Amoco's failure to consult with Mesa regarding pooling was just such a breach,<sup>61</sup> particularly because Mesa was in a position of dependence and was "relying on Dome for fair treatment."<sup>62</sup>

The Alberta Court of Appeal agreed with the trial judge's conclusion that Amoco was in breach of its agreement, but on much narrower grounds. Kerans J.A. (Irving J.A. and Moore J.A. concurring) emphasized two distinct sources of rules governing a 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* [emphasis added in the last two sentences].<sup>63</sup>

The Court of Appeal ultimately went on to hold Amoco to a good faith standard though not expressly calling it so:

The rule that governs here can, therefore, be expressed much more narrowly than to speak of good faith, although I suspect it is in reality the sort of thing some judges have in mind when they speak of good faith. As the trial judge said, a party cannot exercise

<sup>58</sup> *Mesa*, *supra* footnote 56 at 179.

<sup>59</sup> *Ibid.* at 214.

<sup>60</sup> *Ibid.* at 218.

<sup>61</sup> *Ibid.* at 221.

<sup>62</sup> *Ibid.* at 217.

<sup>63</sup> *Supra* footnote 28 at 43.

a power granted in a contract in a way that 'substantially nullifies the contractual objectives or causes significant harm to the other contrary to the original purposes or expectations of the parties.'<sup>64</sup>

After citing numerous cases where one party is granted a discretion by the other party, the court confirmed that Amoco had a duty to act "in accord with settled expectations about pooling" and hence with a reasonable expectation *created by the contract*. As the court notes: "the modern view is to look for, *and if found*, enforce an expectation that [such a party]...will act reasonably and responsibly" [emphasis added].<sup>65</sup>

The position of the Alberta Court of Appeal in *Mesa* is clear: any requirement for good faith performance will be judicially imposed as a matter of contractual interpretation consistent with the parties' intentions, not by operation of law.<sup>66</sup>

Two days after the Court of Appeal's judgment in *Mesa*, Feehan J., for the Court of Queen's Bench, gave his judgment in *Opron*.

Briefly stated, the facts of *Opron* are these. Opron Construction Co. Ltd. was a successful tenderer in the Paddle River Dam project, being managed by the Department of Environment, Government of Alberta. As Opron began work, it discovered that the conditions were much more difficult than had been represented in the tender documents. Accordingly, Opron brought an action, arguing, *inter alia*, that the government — by not advising of the errors it was aware of in the tender documents — breached an implied covenant of good faith and fair dealing. Feehan J. agreed: "Alberta Environment owed an obligation of good faith and fair dealing to the plaintiff to disclose that it possessed material geotechnical information which was inconsistent with or which contradicted the information which had been provided to the plaintiff in the tender documents."<sup>67</sup>

Though Feehan J. had to consider the good faith requirement without the benefit of the Court of Appeal's deliberations on the matter, his analysis is nonetheless a very useful one.

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<sup>64</sup> *Ibid.* at 45.

<sup>65</sup> *Ibid.*

<sup>66</sup> This is also the approach taken by Master Funduk in a decision pre-dating *Mesa*. Like the Court of Appeal, he finds *Gateway*'s pronouncements on good faith to be overly broad:

[The comments in *Gateway* are] all very nice, in Utopia. It is those kind [sic] of grand sweeping statements which help to keep lots of courts and lots of lawyers in lots of work.

...In some cases good faith may be relevant, but relevancy is determined in the context of each particular contract....The foundation must always be the particular contract, not some generalization.

See *Sahim Woodwork Ltd. v. Edmonton*, [1993] A.J. No. 570 (29 July 1993) (Alta. Q.B.) (QL).

<sup>67</sup> *Opron*, *supra* footnote 55 at 349.

Not only does Feehan J. rely on *Gateway* and the Court of Queen's Bench analysis of good faith in *Mesa*, he also references *National Bank of Canada v. Soucisse*<sup>68</sup> (hereinafter "*Soucisse*") and *Canadian National Bank v. Houle*<sup>69</sup> (hereinafter "*Houle*") which both provide that "good faith is an implicit, necessary obligation in all contractual relationships."<sup>70</sup> These two Supreme Court of Canada cases involved Article 1024 of the Québec *Civil Code* (as it then was) which stated:

The obligation of a contract extends not only to what is expressed in it, but also to all the consequences which, by equity, usage or law, are incident to the contract, according to its nature.<sup>71</sup>

*Soucisse* and *Houle* are relevant to Alberta, according Feehan J., because Article 1024 is coextensive with the common law rule that contractual terms can be implied as required by "established custom or usage, business efficacy or necessity as legal incidents of the contract..."<sup>72</sup>

For reasons which will follow, it is my view that Feehan J. correctly assesses the applicability of these civil law cases to common law Canada and correctly identifies the trend to recognition of an independent doctrine of good faith. Though he never expressly identifies a common law rule to this effect, Feehan J. quotes with approval several cases which do. On this basis, his conclusion appears to be that, as a starting point, every contract contains a good faith obligation. What the parties must do to meet this obligation will depend on the surrounding circumstances, including the norms governing the commercial sector in question. As the court notes: "the control mechanism defining the content of the doctrine of good faith in contractual relations appears to be the reasonable expectations of the parties."<sup>73</sup> In short, the standard of good faith can be wide, narrow and perhaps excluded entirely.<sup>74</sup> However, it is presumptively present and subject only to express contractual terms or other circumstances affecting its scope.<sup>75</sup> In this way, Feehan J.'s analysis of good faith is subtly — but significantly — different from that offered by the Alberta Court of Appeal in *Mesa*. While the Court of Appeal elevates freedom of contract and therefore rules against any presumption of good faith, Feehan J. appears to find a common law presumption of good faith which standard is subject to modification by the parties.

Is Feehan J. correct in contending that *Houle* and *Soucisse* have application to common law Canada? In support of his conclusion, it should be emphasized

<sup>68</sup> [1981] 2 S.C.R. 339.

<sup>69</sup> [1990] 3 S.C.R. 122, 74 D.L.R. (4th) 577.

<sup>70</sup> *Opron*, *supra* footnote 55 at 346.

<sup>71</sup> Quoted in *Opron*, *ibid*.

<sup>72</sup> *Ibid*.

<sup>73</sup> *Ibid*. at 349.

<sup>74</sup> For further discussion on this point, see Part VI *infra*.

<sup>75</sup> Having given this expansive reading to *Opron*, I should also note that the decision itself can be justified on the very narrow ground that good faith governed the relationship in question because this is what the parties had implicitly agreed.

that the Supreme Court in *Soucisse* held the parties to a good faith standard even though Article 1024 of the then Québec *Civil Code* contained no such express requirement. To reach its conclusion, the court quoted with approval the following from the French scholar Dormat:

[Translation] There is no species of agreement in which it is not implied that one party owed good faith to the other party, with all the consequences which equity may demand, in the manner of stating that agreement as well as in the performance of what is agreed upon and all that follows therefrom.<sup>76</sup>

It should be noted, however, that the Supreme Court does not comment on the applicability of its reasoning to common law Canada.

In *Houle*, the Supreme Court of Canada confirms that good faith is a requirement of at least *Civil Code* contracts. In interpreting what implied standards are contained in Article 1024 of the *Code*, the court stated: "Good faith has been regarded as one such implicit, necessary obligation in all contractual relationships."<sup>77</sup> But the court appears to limit the doctrine to Québec civil law in the following passage:

At a general level, it seems indisputable that an implicit obligation of good faith exists in every contract in Québec civil law. This obligation is derived from a long civil law tradition formulated in art. 1024 C.C.L.C.; it mandates that rights be exercised in a spirit of fair play [emphasis added].<sup>78</sup>

Hence, until the matter of good faith is litigated from a common law perspective before Canada's highest court, it is simply uncertain whether the good faith doctrine will be imposed by operation of law or by virtue of contractual interpretation only. One can, of course, speculate. Courts are, as already noted, showing an increasing inclination to impose standards of good faith and fair dealing on contractual parties.<sup>79</sup> This, combined with the fact that Article 1024 does bear considerable resemblance to the common law rule identified by Feehan J., argues in favour of *Soucisse* and *Houle* having an influence beyond the Québec borders. Further, Fraser C.J. has recently acknowledged the potential relevance to Alberta of these Supreme Court of Canada decisions when she stated: "although both *Houle* and *Soucisse* considered Québec civil law, their impact is potentially much greater since they both recognize a general good faith requirement even in the absence of express codification of the concept under the *Civil Code* then in effect."<sup>80</sup>

Finally, and as noted by Feehan J., the Supreme Court of Canada has expressly recognized in common law Canada a duty to *bargain* in good faith where it accords with expectations of the parties.<sup>81</sup> If any of these reasons portend the future, Feehan J.'s analysis in *Opron* ought to carry the day.

<sup>76</sup> *Soucisse*, *supra* footnote 68 at 356-357.

<sup>77</sup> *Houle*, *supra* footnote 69 at 599.

<sup>78</sup> *Ibid.* at 601.

<sup>79</sup> For further analysis of this trend, see Clark, *supra* footnote 34.

<sup>80</sup> *Supra* footnote 28 at 20.

<sup>81</sup> *Lac Minerals v. International Corona Resources Ltd.* (1989), 61 D.L.R. (4th) 14 at 47 (S.C.C.) referred to with approval in *Opron*, *supra* footnote 55 at 195-196.

It will be recalled that for the Alberta Court of Appeal, good faith is entirely a matter of interpretation. This formulation, however, does not acknowledge cases where courts have declined to enforce a contractual term because it would be unfair or inequitable to do so<sup>82</sup> and further, it may be a naive dismissal of the applicability of certain civil law principles to common law Canada. What I take to be Feehan J.'s formulation of good faith is preferable. It forges an attractive compromise between the principle of freedom of contract and the principle of fair dealing. It does this by importing a contractual good faith standard which, by and large, can be modified by the parties should they so choose. If this formulation is correct, it means that the courts will *generally* respect the bargain struck by the parties but will "put the burden of careful contract planning on the discretion-exercising promisor who wishes to depart from the [good faith] norm, because such a promisor is in the best position to secure the expectations of both parties."<sup>83</sup>

Thus far, I have dealt with the narrow definition of good faith referred to in *Gateway*, namely that one party cannot exercise a contractual power so as to nullify substantially the negotiated objectives of the contract. What should be done about the broader definition of good faith which holds parties to a standard of fair dealing? *Lac Minerals*, *Gateway* and *Mesa* (at the Court of Queen's Bench level) can be read as keeping this broader definition in check by linking acceptable conduct to that which is consistent with the parties reasonable expectations as determined by the commercial sector in question, or if none applies, by the general circumstances of the case.

#### V. *Situations in which a good faith requirement is implied*

This section provides illustrations from the plethora of case law in which good faith obligations are judicially enforced. While no scheme is fully defensible, there are certain categories of cases in which the good faith requirement is traditionally found.<sup>84</sup> Because my purpose in this part is merely to alert the practitioner to some recent cases which invoke good faith language, it is beyond the scope of this paper to give a definitive account of the law in the various areas which follow.<sup>85</sup>

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<sup>82</sup> See discussion, in Part V, *infra*.

<sup>83</sup> Burton, *supra* footnote 29 at 403.

<sup>84</sup> If this is true, the Court of Appeal's distinction in *Mesa* — between a rule which is imposed despite the parties' agreement and a rule imposed because it fulfils the parties' agreement — may begin to collapse. Where good faith is an ordinary incident of certain categories of contracts, the standard of good faith is imposed functionally by operation of law.

<sup>85</sup> Aside from this paper's earlier analysis of *Opron*, above, it is also beyond the scope of this paper to consider rules relating to disclosure as an incident of good faith. For further discussion of this area, see Finn, *supra* footnote 4 at 16-24 and P. Girard, "'Good Faith' in Contract Performance: Principle or Placebo?" (1983) 5 Supreme Court L.R. 309 at 325ff.



As this paper has already shown, one common category in which courts find a duty of good faith is when one party has “the power or capacity unfairly to prejudice the other’s interests.”<sup>86</sup> This power can arise due to: the circumstances of the relationship; as an ordinary incident of the *kind* of contract in question; or by virtue of the contract itself.<sup>87</sup>

Though entitled to pursue his own self-interest in a relationship, one party’s decision or action may bear so directly upon the interests of the other that basic fairness may require that in some circumstances he should have regard to those interests in addition to his own.<sup>88</sup>

“Reasonable expectations” becomes the watchword here, both as “the *formal* justification for, and the measure of, the responsibility we would wish to impose on one party for the protection of the other.”<sup>89</sup>

#### A. *Good faith obligations arising from the nature of the relationship*

The British Columbia Supreme Court, in a decision of last year, imports good faith to a contract due to the nature of the relationship between its parties: they were partners. In *Cancor Development Corp. v. Cadillac Fairview*,<sup>90</sup> the court determined that the subject contract could not be interpreted inconsistently with the general principle of partnership law that partners shall act with utmost fairness and good faith.<sup>91</sup> A similar but more broadly worded observation is

<sup>86</sup> Finn, *ibid.* at 4, footnotes deleted. This was basically the problem which Mesa faced when Amoco exercised its pooling discretion in a disadvantageous way.

<sup>87</sup> As LeDain J. notes in *CP Hotels v. Bank of Montréal*, [1987] 1 S.C.R. 711 at 764, quoting Lord Tucker with approval:

Some contractual terms may be implied by general rules of law. These general rules, some of which are now statutory, for example, Sale of Goods Act, Bills of Exchange Act, etc., derive in the main from the common law by which they have become attached in the course of time to certain classes of contractual relationships, for example, landlord and tenant, innkeeper and guest, contracts of guarantee and contracts of personal service. Contrasted with such cases as these are those in which from their particular circumstances it is necessary to imply a term to give efficacy to the contract and make it a workable agreement in such manner as the parties would clearly have done if they had applied their minds to the contingency which has arisen. These are the “officious bystander” type of case, to use Mackinnon L.J.’s well-known words. According to Finn:

<sup>88</sup> Finn, *supra* footnote 4 at 13, footnotes deleted.

<sup>89</sup> *Ibid.* at 14, footnotes deleted.

<sup>90</sup> [1994] B.C.J. No. 162 (B.C.S.C.) (QL). Though the good faith analysis in this case is founded on the *Partnership Act*, R.S.B.C. 1979, c. 312, s. 22(1) (which recites that partners shall act with utmost fairness and good faith towards each other), it is also a general principle of law that partners are fiduciaries. For discussion of this point, see M. Ellis, “Fiduciary Duty and Joint Business Relations” in *Special Lectures of the Law Society of Upper Canada*, 1990: *Fiduciary Duties* (Scarborough: Thomson, 1991) 89 at 90-93. See too the general pronouncement in Dubin C.J.’s dissenting judgment in *PWA Corp. v. Gemini Group Automated Distribution Systems Inc.* (1993), 64 O.A.C. 274 at 284: “The essence of a partnership is that of mutual confidence and trust in one another, and it is of the essence of that relationship that mutual confidence be maintained.”

<sup>91</sup> *Ibid.*

made in *Litwin Construction (1973) Ltd. v. Pan, Nicolson and Nicolson*.<sup>92</sup> According to the court, in certain commercial relationships, a

special duty may arise, over and above the universal duty of honesty....[I]t is important to recognize first, that the duty may arise only in relation to particular circumstances, and not generally, and second, that there are graduated standards of extra honesty....The higher standard of honesty may be a duty not to act unconscionably, or a duty to deal fairly, or a duty to act in good faith, or in utmost good faith; all of which may still fall short of the fiduciary standard of selflessness and loyalty [emphasis added].<sup>93</sup>

Examples of business relationships which carry fiduciary obligations with them include partnerships, joint ventures<sup>94</sup> and enterprise contracts.<sup>95</sup> It is beyond the scope of this paper to give an account of how fiduciary law principles become imported into the commercial sector. For an important discussion of this concept, however, see *inter alia*, the minority judgment of La Forest J. in *La C Minerals*.<sup>96</sup> In fact, some academic commentators have argued that Canadian courts deploy fiduciary law as an indirect method of enforcing a good faith standard in contractual relationships.<sup>97</sup>

#### B. *Good faith obligations arising as an ordinary incident of the kind of contract involved*

What follows is a non-exhaustive list of the *kinds* of contracts which courts have found to contain a good faith requirement.

##### (i) *Real estate contracts*

In *Leung v. Leung*,<sup>98</sup> the agreement of purchase and sale contained a "time of the essence" clause. One of the documents presented by the purchaser on the appointed day was not in registrable form. Because the defect was discovered late in the business day, the defect could not be cured before the Toronto Registry Office closed. However, the corrected documents were tendered to the vendors by approximately 18:00 hours that same day. The court found first, that tendering at this time was sufficient to meet the terms on the contract.<sup>99</sup> Second, the court found that even if the plaintiff had been in breach, the vendors could

<sup>92</sup> (1988), 29 B.C.L.R. (2d) 88 (C.A.).

<sup>93</sup> *Ibid.* at 105 and quoted with approval by Shannon J. in *Trimac Ltd. v. C-I-L* (1989), 99 A.R. 30 at 55 (Q.B.).

<sup>94</sup> See Ellis, *supra* footnote 90 at 96-99.

<sup>95</sup> For a recent discussion of this kind of civil code contract, see *Bank of Montréal v. Bail Liée*, [1992] 2 S.C.R. 554. It brings with it a duty to inform.

<sup>96</sup> Though a majority of the court found no fiduciary relationship to exist on the facts, La Forest J. in a minority judgment discusses at length the concept of a fiduciary in a commercial context, *supra* footnote 81 at 25ff.

<sup>97</sup> See Waters' observation on this point, *supra* footnote 26 at 456 as well as his footnote 4.

<sup>98</sup> (1990), 75 O.R. (2d) 786 (Gen. Div.).

<sup>99</sup> *Ibid.* at 796.

not rely on the “time of the essence” clause.<sup>100</sup> In coming to this conclusion, the court relied on a number of legal propositions, including:

- i. the exercise of a rescission power by the vendor of land must not be “arbitrary, capricious or unreasonable;”<sup>101</sup>
- ii. the vendor is under a duty to “act in good faith and to take all reasonable steps to complete the contract;”<sup>102</sup> and
- iii. where a vendor does not act in good faith, the law “precludes him from relying on the ‘time of the essence’ provision to terminate the contract.”<sup>103</sup>

Similar reasoning is at work in *Le Mesurier v. Andrus*, a decision of the Ontario Court of Appeal.<sup>104</sup> Here, the vendor could not convey title to the entire parcel of land which was subject to the agreement of purchase and sale. On the basis of the shortfall — which amounted to .16% of the total property — the purchaser purported to repudiate.<sup>105</sup> The court did not, however, permit repudiation. Relying on considerable case law, the court insisted that contractual rights be exercised “reasonably and in good faith and not in a capricious or arbitrary manner.”<sup>106</sup> After noting that “vendors and purchasers owe a duty to each other to perform a contract honestly,”<sup>107</sup> the Ontario Court of Appeal went on to comment that such a duty “may be merely an example of an independent doctrine of good faith in contract law at least in the performance of contracts.”<sup>108</sup>

*Le Mesurier* has recently been quoted with approval in *Abdool v. Somerset Place Developments of Georgetown Ltd.*,<sup>109</sup> where it is stated that “[a]greements should not be rendered unenforceable by technical deficiencies....Contracting parties...owe one another a duty to act reasonably and in good faith and to perform contracts honestly made.”<sup>110</sup>

Alberta courts have made similar determinations. In considering a “time of the essence” clause, Hetherington J. noted in *Landbank Minerals Ltd. v. Wesgeo Enterprises Ltd.*:<sup>111</sup> “If there are circumstances which make it unjust or inequitable for a party to insist that time is of the essence, the court may refuse to give effect to this provision in the agreement.”<sup>112</sup>

<sup>100</sup> *Ibid.* at 799.

<sup>101</sup> *Ibid.* at 797, references deleted.

<sup>102</sup> *Ibid.*, references deleted.

<sup>103</sup> *Ibid.*, references deleted.

<sup>104</sup> (1986), 54 O.R. (2d) 1 (C.A.), leave to appeal refused (1986), 74 N.R. 239 (S.C.C.).

<sup>105</sup> *Ibid.* at 4.

<sup>106</sup> *Ibid.* at 7, quoting the Supreme Court of Canada in *Mason v. Freedman*, [1958] S.C.R. 483 at 497.

<sup>107</sup> *Ibid.*

<sup>108</sup> *Ibid.*

<sup>109</sup> (1992), 58 O.A.C. 176.

<sup>110</sup> *Ibid.* at 190.

<sup>111</sup> [1981] 5 W.W.R. 524 (Q.B.).

<sup>112</sup> *Ibid.* at 535. (One such circumstance is when a deadline has been extended, at 535). This passage was quoted with approval in *Salama Enterprises (1988) Inc. v. Grewal* (1992), 90 D.L.R. (4th) 146 at 158 (B.C.C.A.), *supp. reasons unreported* (28 August 1992).

As a final example in this category, consider *Salama Enterprises (1988) Inc. v. Grewal*<sup>113</sup> [hereinafter “*Salama*”] which adopts Hetherington J.’s analysis quoted above. In *Salama*, the court refused to allow the vendor to terminate an agreement for the purchase and sale of land because his conduct — in not granting the purchaser a further time extension — was “unjust and inequitable.”<sup>114</sup> In short the vendor was prohibited from relying on an express “time of essence” clause in the contract. The dissent is worth noting for its rejection of any principle that “a person may not exercise his contractual right of termination or resist a claim for equitable relief, if in the opinion of the court his conduct was unfair or unkind.”<sup>115</sup>

Regardless of the terminology used, these cases all show that courts will not automatically allow a party to rely on an expressly contracted-for right. They illustrate that a good faith standard inures in contracts concerning the sale of land and that the price for failing to meet that standard is unenforceability of express clauses allowing repudiation.

#### (ii) *Employment contracts*

In *Clare v. Canada*,<sup>116</sup> the Federal Court of Appeal held that the federal government had a duty to warn a longstanding public service employee of unsatisfactory performance. Such an employee could not be dismissed summarily but had to first be given an opportunity to correct deficient performance.<sup>117</sup> *Clare* thus imposes a requirement on the employer to treat an unravelling employee with good faith even to the extent that ordinary common law rules — such as the employer’s right to terminate without notice for incompetence — are displaced for being inconsistent with that standard.

Good faith is also owed by the employee to the employer. To cite a recent example, in *Murray (Tony) & Associates v. Law*,<sup>118</sup> the plaintiff employed the defendant as a real estate agent. Though she agreed to remain with the plaintiff for two years, she left after a few months, unscrupulously taking a listing with her. According to the court:

The defendant’s direct, deliberate and wrongful intervention...is clearly in breach of the defendant’s obligations of good faith and diligence with respect to the interests of the plaintiff, provisions implied by contract law in the contract here in the absence of any express stipulation to the contrary.<sup>119</sup>

<sup>113</sup> *Ibid.*

<sup>114</sup> *Ibid.* at 161.

<sup>115</sup> *Ibid.* at 154.

<sup>116</sup> (1993), 100 D.L.R. (4th) 400 (F.C.A.).

<sup>117</sup> *Ibid.* at 412.

<sup>118</sup> (1991), 292 A.P.R. 292 (Nfld. S.C.T.D.).

<sup>119</sup> *Ibid.* at 321.

(iii) *Contracts containing exclusion clauses*<sup>120</sup>

The leading decision regarding the enforceability of exclusion clauses is *Hunter Engineering Company Inc. v. Syncrude Canada Ltd.*<sup>121</sup> Dickson C.J.C., (La Forest J. concurring) stated that whether an exemption clause would exclude liability for a given occurrence was simply a question of interpretation. Even harsh exemption clauses are enforceable provided they do not run afoul of rules regarding unconscionability.<sup>122</sup>

More relevant for our purposes is the judgment of Wilson J. (L'Heureux-Dubé J. concurring). According to Wilson J., when a fundamental breach occurs,<sup>123</sup> the court must decide “*in the context of the particular breach which has occurred,...* [whether it is] fair to enforce the clause” in favour of the culpable party.<sup>124</sup> This, she notes, would “require an extension of the principle of unconscionability beyond its traditional bounds of inequality of bargaining power.”<sup>125</sup> Put another way, there is “some virtue in a residual power residing in the court to withhold its assistance on policy grounds in appropriate circumstances.”<sup>126</sup>

For Wilson J. then, an otherwise effectively drafted exemption clause excluding liability for fundamental breach should not be enforced if, under the circumstances, it would be “unfair or unreasonable”<sup>127</sup> to do so. Concerned that the court not overreach its bounds however, Dickson C.J.C. expressly rejects Wilson J.’s analysis on this point:

I do not favour, as suggested by Wilson J., requiring the court to assess the reasonableness of enforcing the contract terms after the court has already determined the meaning of the contract based on ordinary principles of contract interpretation. In my view, the courts should not disturb the bargain the parties have struck, and I am inclined to replace the doctrine of fundamental breach with a rule that holds the parties to the terms of their agreement provided the agreement is not unconscionable.<sup>128</sup>

In referencing fairness and reasonableness and the “boundaries of tolerable conduct,”<sup>129</sup> Wilson J. shows a willingness to reassess contractual rights in light of subsequent events. Her judgment is an important, though less express example, of the courts enforcing a good faith standard and this despite an

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<sup>120</sup> I am grateful for the assistance of J. Kristin Bryson, a student at the Faculty of Law, University of Alberta in the drafting of this sub-section.

<sup>121</sup> *Supra* footnote 10.

<sup>122</sup> *Ibid.* at 462.

<sup>123</sup> For Wilson J., *ibid.* at 499, a fundamental breach is one which deprives the innocent party of “substantially the whole benefit which it was the intention of the parties that he should obtain from the contract.”

<sup>124</sup> *Ibid.* at 510.

<sup>125</sup> *Ibid.* at 516.

<sup>126</sup> *Ibid.* at 517.

<sup>127</sup> *Ibid.* at 510.

<sup>128</sup> *Ibid.* at 455-456.

<sup>129</sup> *Ibid.* at 516.

agreement between the parties that such a standard would not govern all aspects of their relationship.<sup>130</sup>

(iv) *Contracts of adhesion*

The case law involving “take it or leave it” contracts suggests that the party in whose favour a standard form contract is made must treat the other side with good faith.<sup>131</sup> In the classic decision of *Tilden-Rent-A-Car v. Clendenning*,<sup>132</sup> the court refused to apply an onerous clause in a standard form contract — even though the contract had been signed — because that clause had not been drawn to the attention of the other party.<sup>133</sup> What seemed to motivate the court’s analysis in *Tilden* are notions of fairness and reasonableness concerning enforcement of buried, unexpected, and onerous clauses in a lengthy standard form contract.

Clark argues that a recent Ontario Court of Appeal decision extends the principle in *Tilden*.<sup>134</sup> In *Trigg v. MI Movers International Transport Services Ltd.*,<sup>135</sup> [hereinafter “*Trigg*”] the court held that it is not enough simply to draw the customer’s attention to the exclusion clause. The court endorsed a higher standard when it stated that “the general rule is that a limitation or exemption clause is not imported into a contract unless it is brought home to the other party so prominently that he or she must be taken to have known it and agreed to it.”<sup>136</sup>

The case constitutes yet another example of a court obliquely assessing one party’s conduct against a good faith referent. Such an assessment means that should one party’s conduct be found wanting, the courts are liable to refuse to permit reliance on strict contractual rights.

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<sup>130</sup> *Hunter* has been considered by the Alberta Court of Appeal in *Catre Industries Ltd. v. Alberta* (1989), 36 C.L.R. 169 (Alta. C.A.), leave to appeal denied (1990), 105 A.R. 254n (S.C.C.) but according to Stratton J.A. at 193, it was unnecessary to decide between the competing analyses offered Wilson J. and Dickson C.J.C. in *Hunter*. The court in *Canadian Fracmaster Ltd. v. Grand Prix Natural Gas Ltd.* (1990), 109 A.R. 173 (Q.B.) at 189-190 was put to an election, however, and relied on the judgment of Dickson C.J.

<sup>131</sup> W. Grover, “A Solicitor Looks at Good Faith in Commercial Transactions” in *Commercial Law: Recent Developments and Emerging Trends*, *supra* footnote 2 at 102-106.

<sup>132</sup> (1978), 83 D.L.R. (3d) 400 (Ont.C.A.).

<sup>133</sup> *Ibid.* at 408-409.

<sup>134</sup> Clark, *supra* footnote 34 at 448.

<sup>135</sup> (1991), 84 D.L.R. (4th) 504 (Ont. C.A.), leave to appeal to S.C.C. refused 88 D.L.R. (4th) vii.

<sup>136</sup> *Ibid.* at 507. Clark adds, *supra* footnote 34 at 450, that if the customer signed but failed to read the contract “in circumstances free of external constraints,” this should not render the exemption clause unenforceable. Any other outcome would be inconsistent with the S.C.C.’s analysis of *non est factum* in *Marvco Color Research Ltd. v. Harris*, [1982] 2 S.C.R. 774.

(v) *Tendering contracts*

There are several Canadian cases which hold government to a duty of fairness in the tendering context.<sup>137</sup> This duty bears close relationship to the good faith doctrine and involves importing a public law standard into the private law regime of state contracts. For example, the court in *Thomas Assaly Corp. v. Canada* asserts that the governmental decisions to accept or reject a tender

directly affect the interests of the persons invited to bid...There is therefore attached a duty of fairness which Courts can enforce by certiorari, [see eg. *Martineau v. Matsqui Institution Disciplinary Board*, [1980] 1 S.C.R. 602 at 628] a public law remedy to control the proper exercise of governmental powers.<sup>138</sup>

Similarly, the Federal Court in *Glenview Corp. v. Canada* (Min. of Public Works) states: "The Court must be vigilant in assuring itself that the Crown is acting in utmost good faith and not actually attempting to obviate the tendering process."<sup>139</sup> And the Supreme Court of the Northwest Territories in *Martselos Services Ltd. v. Arctic College* is very direct in its pronouncement that: "[a]s a public body operating with public funds, the defendant was required to conduct its operations in a manner worthy of the high trust placed in it by the public."<sup>140</sup>

More specifically, in fully accepting the following submission made by counsel for *Martselos Services*, the court in *Martselos* acknowledged that holding government to a standard of fairness in the tendering process is directly consonant with the doctrine of good faith:

The obligation of the...government to maintain the integrity of the tendering process was implied...in the tendering contract entered into between the parties when the plaintiff submitted its tender. This was an obligation to contract in good faith: *Gateway Realty Ltd. v. Arton Holdings Ltd.*, (1991) N.S.J. No.362.<sup>141</sup>

The Northwest Territories Court of Appeal's decision in *Martselos* acknowledges the good faith doctrine but less expansively. According to the court:

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<sup>137</sup> It should be noted that there is some authority for the proposition that government does not owe a duty of fairness when involved in purely commercial matters which do not have a public interest overlay. See, for example, *St. Lawrence Cement v. Ontario (Minister of Transportation)* (1991), 3 O.R. (3d) 30 (Gen. Div.) which involved the reconstruction of a public highway. Given the Supreme Court of Canada's decision in *R. v. Dywidag Systems International* (1990), 40 C.L.R. 1 at 4 (S.C.C.) which implicitly determined that a contract for the construction of a wharf in Nova Scotia was not a purely commercial matter, the reasoning in *St. Lawrence Cement* is suspect. For more discussion on this point, see my analysis in "Public Power and Private Obligation: An Analysis of the Government Contract" (1992) 14 Dal. L.J. 485.

<sup>138</sup> (1990), 34 F.T.R. 156 (T.D.) at 158. According to the court, fairness in the case at bar would require, at 159, that "the party whose interests are to be affected by a decision be aware of the issues he must address to have a chance of succeeding."

<sup>139</sup> (1990), 34 F.T.R. 292 (T.D.) at 296.

<sup>140</sup> *Martselos Services Ltd. v. Arctic College* (1992), 5 B.L.R. (2d) 204 (N.W.T.S.C.); rev'd on other grounds, [1994] N.W.T.R. 36 (C.A.).

<sup>141</sup> *Ibid.*

In the area of contract tendering, the doctrine of good faith found some expression in the Supreme Court of Canada judgment in *R. v. Ron Engineering & Construction (Eastern) Ltd.*, [1981] 1 S.C.R. 111....Estey J. stated that the 'integrity of the bidding system must be protected where under the law of contracts it is possible so to do' (p. 121). In my opinion this should be considered as a duty to treat all bidders equally but still with due regard for the contractual terms incorporated into the tender call.<sup>142</sup>

Regardless of whether a wider or narrower version of good faith in tendering is adopted, David Percy's observation that good faith cases have arguably superseded earlier tendering decisions like *Thomas Assaly Corp.* is nonetheless germane.<sup>143</sup> To the extent that courts become concerned with "more general questions of policy in the administration of tenderers,"<sup>144</sup> is the extent to which even non-governmental persons must perform in good faith. From this perspective, *Martselos* may simply be understood as an application of the *Gateway* good faith principle in the specific context of tendering.

### C. Good faith obligations arising from the terms of the contract

Courts will generally impose good faith standards on the exercise of discretion by one party. In fact, Hunt J. in *Consolidated Oil & Gas v. Suncor Inc.*,<sup>145</sup> suggests that *Gateway's* good faith principle "has been applied primarily where one contracting party has been in a position to exercise a discretion in a fashion contrary to the interests of the other."<sup>146</sup>

There are numerous examples in the case law of courts limiting how a discretion can be exercised. For example, where one party in a contract is given a "sole discretion" power, the courts have implied a term that this power is to be exercised honestly and in good faith.<sup>147</sup>

A similar but more stringent view is taken of "best efforts" clauses.<sup>148</sup> In

<sup>142</sup> *Supra* footnote 140 at 41. This assessment is consistent with the Alberta Court of Appeal's analysis in *Mesa* because, first and foremost, it links the good faith doctrine to freedom of contract.

<sup>143</sup> "Never Ending Developments in the Law of Tenders," Preliminary draft, (29 January 1994), quoted with permission.

<sup>144</sup> *Ibid.*

<sup>145</sup> (1993), 140 A.R. 188 (Q.B.).

<sup>146</sup> *Ibid.* at 213.

<sup>147</sup> See *Moir v. J.P. Porter Co.* (1979), 57 A.P.R. 674 (N.S.C.A.), quoted with approval by Kelly J. in *Gateway*. See too *Julian v. Christopher*, 575 A.2d 735 (Md. 1990). At issue in *Julian* was a clause which permitted the landlord to withhold consent to an assignment. According to the Court at 739 and quoted in *Gateway* at 196:

When the lease gives the landlord the right to exercise discretion, the discretion should be exercised in good faith, and in accordance with fair dealing; if the lease does not spell out any standard for withholding consent then the implied covenant of good faith and fair dealing should imply a reasonableness standard.

The Court in *Gateway* finds that the law is similar in Canada: "When the landlord or the tenant are [sic] authorized by the lease document to exercise a discretion, it should be exercised in a reasonable way in accordance with an obligation to act in good faith," *supra* footnote at 196.



*Atmospheric Diving Systems Inc. v. International Hard Suits Inc.*,<sup>149</sup> for example, the court agreed that where one party agrees to use “best efforts,” that party’s efforts must be “subject to such overriding obligations as honesty and fair dealing.”<sup>150</sup> In summarizing the law in the area, the court concluded that “best efforts” means, *inter alia*, “taking, in good faith, all reasonable steps to achieve the objective, carrying the process to its logical conclusion and leaving no stone unturned.”<sup>151</sup>

#### D. *Commentary*

The case law cited in this part of the paper shows the good faith standard in a variety of contexts. Significantly, this standard is applied even when the person being regulated is “not, as a rule, in a relationship in which his function and purpose is to act in the other’s interests.”<sup>152</sup> To this extent, good faith puts a presumptive fence around freedom of contract.

By invoking good faith, the court seeks to avoid “untoward consequences”<sup>153</sup> and to do justice between the parties. For this reason, some commentators have suggested that in emphasizing good faith, the courts are more concerned with individual justice than certainty.<sup>154</sup> But this is to exaggerate the swath of good faith and to locate it outside of the sphere of reasonable expectations. As noted earlier, good faith is tied to reasonable expectations created by the nature of the relationship between the parties (such as a partnership), the nature of the contract in question (such as a real estate agreement) or by a contractual term, whether express or implied based on the circumstances of the case.

### VI. *Contracting out of good faith?*

Earlier in this paper, I indicated that Feehan J.’s approach to good faith is preferable to that taken by the Alberta Court of Appeal in *Mesa*. Feehan J. in *Opron* held that all contracts are subject to a standard of good faith which standard can in most cases be modified by agreement. This formulation is useful because first, it takes into account the very real possibility that *Houle* and *Soucisse* have Canada-wide application; second, its generality nicely absorbs the vast array of common law rules which use good faith as their foundation and thereby provides some certainty to the law;<sup>155</sup> and third, it is consistent with the expectations of an overwhelming majority of contracting parties. It would be

<sup>148</sup> See *Gateway, ibid.*

<sup>149</sup> (1994), 89 B.C.L.R. (2d) 356 (S.C.).

<sup>150</sup> *Ibid.* at 372, quoting *Bruce v. Region of Waterloo Swim Club* (1990), 73 O.R. (2d) 709 (H.C.J.).

<sup>151</sup> *Ibid.*

<sup>152</sup> Finn, *supra* footnote 4 at 13.

<sup>153</sup> *Ibid.*

<sup>154</sup> See Clark’s pronouncement on this point, *supra* footnote 34 at 440.

<sup>155</sup> See *supra* Part IV of this paper.

truly unusual for a person to confer a contractual discretion on another expecting it to be used "to recapture foregone opportunities"<sup>156</sup> or otherwise to do one harm.

Until the matter of good faith in common law Canada is litigated before the Supreme Court, practitioners should err on the side of caution and assume that a good faith standard inures in all contracts. Until there is the highest authority to the contrary, practitioners should assume, for example, that the valid exercise of a bare discretion granted by contract is not unfettered. Take, for instance, a clause in a lease which simply requires the landlord's "consent" to an assignment. Even though the landlord has not covenanted to act reasonably, the good faith requirement imports this standard.<sup>157</sup> Support for this kind of conclusion is found in the recent Federal Court of Appeal case *Shibamoto & Co. v. Western Fish Producers*<sup>158</sup> in its consideration of a "sole discretion" clause. The court concluded that though the discretion was broadly stated, "even the broadest form of contractual discretion must be exercised within well recognized limits."<sup>159</sup> It then noted with approval *Greenberg's* assertion that the exercise of a discretion "whether measured by subjective or objective standards, is subject to a requirement of honesty and good faith"<sup>160</sup> and quoted with approval *Greenberg's* pronouncement that "in the absence of explicit language or a clear indication from the tenor of the contract or the nature of the subject-matter, the tendency of the cases is to require the discretion or dissatisfaction to be reasonable."<sup>161</sup>

It follows that if the landlord wishes the opportunity to withhold consent *unreasonably*, his or her lawyer should secure an express covenant to that effect. Absent such a clause, a reasonableness standard will almost certainly be implied.

This leads to the next question: assuming one can secure an "unreasonableness" clause, can one enforce it or is a good faith standard mandatory? Lower court decisions which conclude that a good faith standard adheres in virtually all contracts, tacitly acknowledge the enforceability of such clauses. As Kelly J. notes in *Gateway*, courts rarely impose "moral" standards like good faith "in a manner that would override express contractual provisions."<sup>162</sup> In the same vein, he remarks upon a judicial trend which requires "both parties to a lease not to act in an 'unreasonable' manner...*unless the lease explicitly*

<sup>156</sup> Burton, *supra* footnote 29 at 387.

<sup>157</sup> For further analysis on this point, see R. Fraser, J. Gose and N. Nellis, "Commercial Real Estate Leasing" (Seminar presented to the American Law Institute-American Bar Association and the Continuing Legal Education Society of British Columbia, 10-12 July 1986).

<sup>158</sup> (1992), 145 N.R. 91.

<sup>159</sup> *Ibid.* at 102.

<sup>160</sup> *Ibid.* at 103.

<sup>161</sup> *Ibid.*

<sup>162</sup> *Gateway*, *supra* footnote 3 at 198.

*provides the party can act in such a manner*" [emphasis added].<sup>163</sup> And the Courts of Appeal in *Martselos* and *Mesa* clearly elevate freedom of contract as an overarching norm in the contractual arena.<sup>164</sup>

Provided then that the "opting out" clause in question is precise, specific, not antithetical to the entire purpose or intent of the remainder of the contract, and is not unconscionable or contrary to public policy, it ought to be enforceable.<sup>165</sup> It has tentatively been suggested, for example, that such a clause clearly state that the discretionary right in question is not subject to the expectations, "reasonable or otherwise," of the parties to the contract and that any action taken pursuant to the provision is "deemed to be exercised in good faith."<sup>166</sup> On the other hand, a clause which generally disclaimed absolutely any obligation of good faith or permitted one party to be dishonest or wantonly destructive would be vulnerable on the grounds of public policy and, depending on the facts, unconscionability. But as Grover comments:

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 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 the judges determine the status of all. In my view, most judges are reluctant to go that far.<sup>167</sup>

There is a final caveat to the foregoing analysis. This paper has identified several cases where one party has not been entitled to rely on an express contractual right because, as in *Salama Enterprises*,<sup>168</sup> for example, his or her conduct was in some way unjust. Noting such a trend with alarm, Clark states: "[w]hereas doctrines such as unconscionability, economic duress and promissory estoppel have criteria and areas of operation that are relatively circumscribed, there is no knowing where what might be called the "new equity" may next manifest itself."<sup>169</sup>

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<sup>163</sup> *Ibid.* at 196. Accord Grover, *supra* footnote 131 at 107 who states: "It is my belief that 'good faith' normally remains within the contract and can be avoided by proper drafting."

<sup>164</sup> *Mesa*, *supra* footnote 28.

<sup>165</sup> I am grateful for the assistance herein of Professor M. Litman of the Faculty of Law, University of Alberta.

<sup>166</sup> See J. Tyrell's analysis in "Freedom of Contract Dies Again?" (Seminar presented to the Advanced Business Law Series, Legal Education Society of Alberta 15 June 94) at 15.

<sup>167</sup> *Supra* footnote 131 at 106-07.

<sup>168</sup> *Supra* footnote 112. Similarly, it will be recalled that Wilson J. (L'Heureux Dubé J. concurring) in *Hunter*, *supra* footnote 10, has shown a preference for circumstantial reasonableness as being the measure of whether an exclusion clause should be enforced or not. If this kind of reasonableness standard achieves a solid foothold in the case law regarding the exercise of discretion — on the theory that an unreasonableness clause is like an exclusion clause — even properly drafted "unreasonableness" clauses are at risk of being unenforceable in the right circumstances. If the lower standard of unconscionability is adopted, then such clauses, of course, stand a much better chance of survival.

<sup>169</sup> Clark, *supra* footnote 34 at 440.