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The Duty of Honesty in Commercial Contracts: What You Now Need to Know

By Marco P. Falco

In 2014, the Supreme Court of Canada recognized that all parties to a contract have a duty to act honestly: *Bhasin v. Hrynew*, 2014 SCC 71. This includes the obligation that parties must not lie or otherwise knowingly mislead each other about matters directly linked to the performance of the contract.

Legal abstractions aside, however, does the duty of honest contractual performance prevent parties from actively deceiving each other? Is there now a duty to look out for the opposing parties' interest in a commercial contract? And would a party's silence or failure to disclose a material fact to the other side of a commercial contract meet the threshold for "dishonesty"?

At the end of 2020, the Supreme Court of Canada issued its much-anticipated decision, *C.M. Callow Inc. v. Zollinger*, 2020 SCC 45. *Zollinger* grapples with the questions above and establishes that determining what constitutes dishonest contractual performance is a fact-dependent exercise. The case also expands the scope of dishonest conduct to include active deception.

The Winter's Tale

The facts of *Zollinger* are not complex.

The plaintiff provided winter maintenance services to the defendant condominium corporations, including snow removal.

To that end, the parties entered into a winter maintenance agreement, which included a two-year term from November 1, 2012 to April 30, 2014 (the "Agreement").

Under the Agreement, the defendant corporations had a unilateral, unfettered right to terminate the contract for convenience:

...if for any other reason [the plaintiff's] services are no longer required for the whole or part of the property covered by this Agreement, then the [defendants] may terminate this contract upon giving ten (10) days' notice in writing to [the plaintiff].

In the first year of the Agreement, the defendant's property manager advised the condominium Board to terminate due to the plaintiff's poor workmanship during the winter. The Board voted to terminate shortly thereafter, but the defendants did not inform the plaintiff of that decision.

Over the course of the Agreement, the plaintiff had discussions with various Board members about the Agreement's renewal. On the basis of these discussions, the plaintiff thought it was likely the Agreement would be renewed for a further two years.

In the meantime, the plaintiff continued to fulfill his duties under the Agreement and even performed "freebie" work as an incentive for the defendant to renew the Agreement. In correspondence, a Board member advised that, in conversations with the plaintiff, the plaintiff expressed the belief that the Agreement would be renewed. The Board member said nothing as he did not want to "get involved".

It was not until the end of the Agreement, in September, 2013, that the defendant finally advised the plaintiff about its decision to terminate the Agreement. The defendant did so on the belief that all that was required was that it provide the plaintiff with ten days' notice of non-renewal under the Agreement.

The plaintiff started an action against the defendant for, amongst other things, breach of contract. The plaintiff alleged that the defendant had acted in bad faith and contrary to its obligation of honest contractual performance, as set out in the Supreme Court of Canada's *Bhasin* decision, *supra*.

In particular, the plaintiff argued that the defendant had accepted the plaintiff's free services knowing they were being offered to maintain their future contractual relationship, that the defendant exercised the termination clause dishonestly by withholding information that the contract was in danger of termination, and that the plaintiff had not pursued other maintenance contracts on the belief that the Agreement would have been renewed.

The trial judge granted the plaintiff's action. The lower Court held that the duty of honest contractual performance had been breached by the defendant by "actively deceiving" the plaintiff from the time the termination decision was made to the time the plaintiff was notified of the termination in 2013. The Court awarded damages representing the value of the winter maintenance agreement for one year, \$64,306.96, in addition to the value of a one-year equipment lease for the equipment the plaintiff would have leased had the Agreement been renewed, in the amount of \$14,835.14.

The Court of Appeal reversed, holding that the defendant was free to terminate the Agreement provided it informed the plaintiff of its intention to do so and gave the required 10-days' notice. In the Court of Appeal's view, the defendant's conduct did not rise to the necessary level of dishonesty required to establish a breach of contract.

The majority of the Supreme Court of Canada restored the trial judge's original decision.

The Court held that the duty of honest contractual performance now precludes active deception. The defendant breached this duty by knowingly misleading the plaintiff into believing that the Agreement would not be terminated and, accordingly, exercised the termination clause dishonestly.

The Scope of Honest Contractual Performance

Zollinger establishes and reaffirms four important points about the duty of honest contractual performance:

1. The duty of honest contractual performance is contract law doctrine.

Reiterating the theme from *Bhasin*, the Court emphasized that the doctrine of honest contractual performance is a free-standing, contract law doctrine. Its existence and application does not depend on the intentions of the contracting parties, nor is it an implied term in any given contract. It is imposed, like

other contractual doctrines such as unconscionability or *non est factum*, on every agreement at common law.

The duty applies even where, as in the *Zollinger* case, “the parties have expressly provided for...termination” in their agreement. The Court affirmed that no “contractual right, including a termination right, can be exercised dishonestly and, as such, contrary to the requirements of good faith”.

2. Dishonesty Includes More Than Outright Lies.

The Court revisited its decision in *Bhasin*, observing that the duty of honest contractual performance most certainly precludes outright lies and half-truths by the parties to the agreement.

However, expanding upon this definition, the Court noted that the issue of whether a party has “knowingly misled” its counterparty to the contract is a “highly fact-specific determination” which can include “lies, half-truths, omissions, and even silence, depending on the circumstances”.

The list of dishonest acts “is not closed” and, in the Court’s view, “merely exemplifies that dishonesty or misleading conduct is not confined to direct lies”.

In expanding the definition of dishonesty in this way, the Court was careful to note that this did not mean a contractual party had a general duty to subordinate its interests to that of the other party or a duty to disclose. This caveat addresses the concern that an overly-expansive view of honest contractual performance would lead to commercial uncertainty and confer unbargained-for benefits on the aggrieved party. On the other hand, recognizing that honest contractual performance includes more than direct lies promotes the idea of “contractual justice”:

...Yet where the failure to speak out amounts to active dishonesty in a manner directly related to the performance of the contract, a wrong has been committed and correcting it does not serve to confer a benefit on the party who has been wronged.

The Court also noted that the duty to act honestly is a negative obligation, i.e. the parties have a duty not to act dishonestly. Accordingly, the doctrine is sufficiently narrow in this regard to protect the principles of freedom of contract, contractual autonomy and corrective justice.

In *Zollinger*, the fact that the defendant condominium corporation had an unfettered right to terminate the contract did not mean that its conduct was unrestricted by the duty of honest contractual performance. The contractual right to terminate could not be exercised “in a manner that transgresses the core expectations of honesty required by good faith in the performance of contracts”.

The defendant had deceived the plaintiff with its “active communications”. The defendant also accepted the “freebies” from the plaintiff knowing it had no intention of renewing the Agreement. Overall, the defendant intentionally withheld information in anticipation of exercising the termination clause, knowing that its silence and active communications had misled the plaintiff. The defendant was liable for breach of honest contractual performance and therefore breach of contract.

3. The Dishonesty Must be Directly Linked to the Contract.

The Court further noted that the nature of the dishonesty by the defendant could not be assessed in the abstract. There must be a nexus between the defendant’s dishonesty and its rights or obligations under the contract. The question is whether the defendant exercised its contractual rights in a dishonest manner: “[d]ishonesty is directly linked to the performance of a given contract where it can be said that the exercise of a right or the performance of an obligation under that contract has been dishonest”.

4. Damages for Dishonesty are Ordinary Expectation Damages

When calculating damages for a breach of contract arising from dishonest contractual performance, the ordinary measure of expectation damages is applied. That is, the damages must put the plaintiff in the same position it would have been in had the duty been performed. This approach stands in contrast to

what are known as “reliance damages”, where the injured party is placed in the position it would have been in had the contract not been entered into at all.

The duty of honest performance protects expectation, not reliance interests. Moreover, damages were to be measured against the defendant’s least onerous means of performance.

Applying these principles, the Court held that the least onerous means of performance in *Zollinger* would have been to correct the misrepresentation once the defendant knew the plaintiff had drawn a false inference about the renewal. If the defendant had in fact done so, the plaintiff could have secured a new contract for the upcoming winter.

Accordingly, the Court upheld the trial judge’s ruling that the plaintiff was entitled to compensation for both the opportunity to bid on other maintenance contracts and the cost of leasing winter maintenance equipment for one year.

A Brave New Contractual World?

While much of *Zollinger* is devoted to reaffirming or clarifying principles established in *Bhasin*, the Court did make some bold legal gestures.

The expansion of the definition of dishonesty in the performance of the contract, coupled with the Court’s view that the list of dishonest acts is both contextual and “not closed”, means that the boundaries of dishonest conduct will be tested in the years to come. The extent to which a defendant’s omissions or half-truths amount to active deception will inevitably vary from case-to-case, granting significant discretion to the lower Courts.

Moreover, defendants will no doubt also argue that if the doctrine is applied to the individual facts of its case, the Court will have promoted a form of commercial uncertainty that is unacceptable and contrary to the principle of freedom of contract. From a policy perspective, this argument in any individual case may have merit. If *Bhasin* represented a modest, incremental change to the law of contract, then the Courts will likely be hesitant to view *Zollinger* as a revolution.

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