

# Honesty is the best policy: The Supreme Court of Canada seeks to clarify the duty of honest contractual performance

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Don't mislead your contracting counterparties about matters linked to the performance of a contract. That is the apparently simple message from the Supreme Court of Canada in *CM Callow Inc v Zollinger*. Applying the organizing principle of good faith and, specifically, the duty of honest contractual performance (recognized in *Bhasin v Hrynew*) to a case involving a right to terminate an agreement on notice for convenience, *Callow* seeks to clarify the circumstances in which the duty of honest performance may require a contracting party to provide information to its counterparty about a matter involving the performance of a right under the contract. The Court held:

- All contractual rights and obligations – even apparently absolute ones – must be exercised in line with the duty of honest performance, which cannot be expressly or implicitly excluded under the contract.
- Even if a party complies with the letter of a contract, the way it exercises a right or performs an obligation may still breach the duty of honest performance.
- Although there is no positive obligation of disclosure, a contracting party cannot engage in “active deception” and, where the facts disclose dishonest conduct, may be required to correct a false impression created by its own actions.
- A breach of the duty of honest performance may give rise to a claim for expectation damages to put the innocent party in the same position as if the contract had been performed.

Much of this should come as no surprise to contracting parties, as these principles already arose from the Court's reasons in *Bhasin*. What *Callow* adds to *Bhasin* primarily relates to the application of the duty of honest contractual performance where one contracting party knows that the other party is under a false impression about rights under the contract. At the same time, *Callow* provides important confirmation that the Court has not changed its prior view that the duty of honest performance does not impose a fiduciary-like duty of disclosure, nor does it entitle the counterparty to benefits it did not bargain for, nor does it generally preclude contracting parties from acting in their own interests.

*Callow* still leaves unanswered questions about the exact circumstances in which a party's failure to provide information to a counterparty will breach the duty of honest performance. Moreover, the concurring and dissenting reasons expressly declined to address how the organizing principle of good faith applies (if at all) to constrain the exercise of contractual discretionary powers. The Court's forthcoming judgment in *Wastech Services Ltd v Greater Vancouver Sewerage and Drainage District*, which was heard together with *Callow* and which remains under reserve, will likely address this question.

## Facts

In 2012, Baycrest entered into two sets of maintenance contracts with Callow: a two-year winter contract and a summer contract. Pursuant to the winter contract if for any reason, Callow's services were no longer required, Baycrest could terminate the contract upon giving 10 days' written notice.

In early 2013, Baycrest decided to terminate the winter contract but chose not to inform Callow of its decision at that time. In the interim, Callow had discussions with Baycrest regarding the renewal of the winter contract. As a result of those discussions, Callow formed the mistaken impression that its winter contract was likely to be renewed. Baycrest was aware of Callow's misapprehension but did not correct it. During the summer of 2013, Callow performed work at no charge, which it hoped would induce Baycrest to renew the winter contract. Baycrest accepted the free work but nonetheless terminated the winter contract by giving the required notice in September.

Callow sued for breach of contract, alleging that Baycrest exercised the termination clause contrary to the requirements of good faith.

At trial, the court found that Baycrest had breached its duty of honest contractual performance by knowingly causing Callow to believe that the winter contract would be renewed until after Callow had performed its services under the summer contract. The Court of Appeal set aside the trial judgment, ruling that Callow had only bargained for 10 days' notice of early termination, and that was what Baycrest had provided. Callow appealed to the Supreme Court of Canada.

## The duty of honest performance underpins all contractual rights and obligations

Eight of nine judges of the Supreme Court (Côté J. dissenting) allowed the appeal and found in favour of Callow. Baycrest breached its duty of honest performance by deliberately misleading Callow about Baycrest's decision to terminate the winter contract. Kasirer J. wrote for a five-judge majority, while Brown J. gained the support of two of his colleagues in his concurring reasons.

Kasirer J. reiterated the Court's earlier reasons in *Bhasin* which held that the duty of honest contractual performance underpins all contractual rights and obligations and cannot be expressly or implicitly excluded under the contract. Still, Kasirer J. observed that the scope of this duty is not unbounded: it relates only to matters regarding the *performance* of the contract, and not simply to any matter that arises between the contracting parties.

The duty of honest performance imposes an obligation not to deliberately mislead a contracting counterparty about the matters arising under contract. This principle had been recognized by the Court in *Bhasin*. In this case, Baycrest breached this obligation by deliberately failing to correct Callow's mistaken belief, created by Baycrest, that Baycrest intended to renew. It was not Baycrest's exercise of its termination right, but the way Baycrest exercised this right, that constituted a breach of the duty. Even if a party complies with all the terms of a contract, therefore, it is still possible to breach the duty of honest contractual performance.

Furthermore, Kasirer J. disagreed with Baycrest's position, which had been accepted by the Court of Appeal, that the termination in this case related not to the performance of the existing winter contract, but to the renewal of a future contract not yet in existence. Properly

understood, Baycrest's deception was directly linked to the current contract, because its exercise of the termination clause in the current contract was dishonest.

## Baycrest failed to correct Callow's misapprehensions

Kasirer J. acknowledged that requiring a party to disclose information over and above the requirements of the contract could confer an unbargained-for benefit on a counterparty. The majority therefore did not purport to expand the duty of honest performance to require such disclosure. However, Kasirer J. noted that in certain circumstances, a failure to speak can amount to active dishonesty directly related to the performance of the contract. In such a case, liability flows from the "active deception" of the innocent party and not from the breach of a positive duty to disclose, or a requirement to put the interests of the other contracting party first.

Whether conduct rises to the level of knowingly misleading another party is a fact-specific exercise and can include (but is not limited to) outright lies, half-truths, and even omissions, depending on the context. In the absence of any palpable and overriding error, Kasirer J. was obliged to defer to the factual findings of the trial judge that Baycrest had acted in a manner that was deliberately dishonest in exercising its right to terminate.

Thus, Baycrest did not have a positive duty to disclose immediately that it intended to terminate the winter contract once it had resolved to do so in the spring. However, Baycrest was also not entitled to deliberately mislead Callow, to its detriment, about Baycrest's intentions. Baycrest deliberately withheld information in anticipation of exercising its termination rights, knowing that such silence, when combined with active communications assuring Callow that all was well, had deceived Callow. In light of Baycrest's other conduct and representations, Baycrest's failure to correct Callow's misapprehension constituted "active deception" and breached its duty of honest contractual performance.

The trial judge would have required Baycrest to address certain alleged performance issues, provide prompt notice of its intention to terminate the contract, or refrain from any representations in anticipation of the notice period in order to comply with the duty of good faith. The majority of the Supreme Court did not go this far, indicating that Baycrest should either have refrained from making false representations during the notice period, or corrected the misapprehension caused by representations it did make.

Kasirer J.'s reasons stopped short of addressing whether Baycrest would have a duty to correct misapprehensions that it did not cause or materially contribute to, or whether the party who formed the misapprehension must have had a reasonable basis for doing so. The concurring judges would have framed the test based on a "material" contribution to the misapprehension by the counterparty.

## Calculating damages: expectation or reliance?

The appropriate methodology for calculating the damages flowing from Baycrest's breach is a key distinction between the majority judgment and Brown J.'s concurring reasons. Kasirer J. held that Callow was entitled to "expectation damages" which are typical in contract law and which place a plaintiff in the position it would have been in if the defendant had fulfilled its contractual obligations. Brown J. disagreed, writing that Callow should receive "reliance damages", which compensate a plaintiff for losses resulting from its reliance on the defendant's performance.

Despite this difference in approach, both Kasirer and Brown JJ. calculated Callow's damages

on the basis of Baycrest's failure to correct the misapprehension that his contract would be renewed, which deprived him of an opportunity to obtain alternate work to replace the winter contract.

In other cases, expectation damages and reliance damages may produce drastically different results. As Brown J. reasoned, a defendant may fulfil its contractual obligations to the letter but breach the duty of honest performance, causing loss to the plaintiff as a result of its reliance on the dishonest conduct. In such circumstances, reliance damages may be more appropriate.

Given this debate, contracting parties may wish to consider revisiting liquidated damages and limitation of liability clauses in their contracts to ensure that they are sufficiently broad to encompass breaches of the duty of honest contractual performance, as well as the duty of good faith more generally.

## Role of Québec civil law

A further distinction between the reasons of Kasirer J. and Brown J. reflects a division in the Court over the use of Québec civil law. Kasirer J. drew on the civil law concept of "abuse of rights" and held that authorities from Québec may be useful and helpful to interpret the scope of the common law duty of honest contractual performance – particularly, the need for a connection between the conduct at issue and rights or obligations under the contract. The Québec law concept of "abuse of rights" provides that no discretionary right in a contract may be exercised in an excessive or unreasonable way. This concept is foreign to the common law.

Brown J. wholeheartedly rejected this approach, contending that the application of the duty in this case could and should be resolved by resort only to common law authorities. Although regard may be had to civil law in situations where there is a gap left by the common law or for comparative purposes, there is no such gap here. In Brown J.'s view, the introduction of civil law concepts into the common law can only create confusion and further difficulty for common law lawyers and judges in interpreting the applicable standards.

It is not wholly clear from the reasons in *Callow* how far the Court intends to apply the civil law concept of "abuse of rights" to the common law. Whether this aspect of Kasirer J.'s reasons is truly a mere "dialogue" engaged in to provide helpful context remains to be seen. It is also uncertain whether the reliance on the civil law by the majority in *Callow* will carry over into future cases on unrelated topics.