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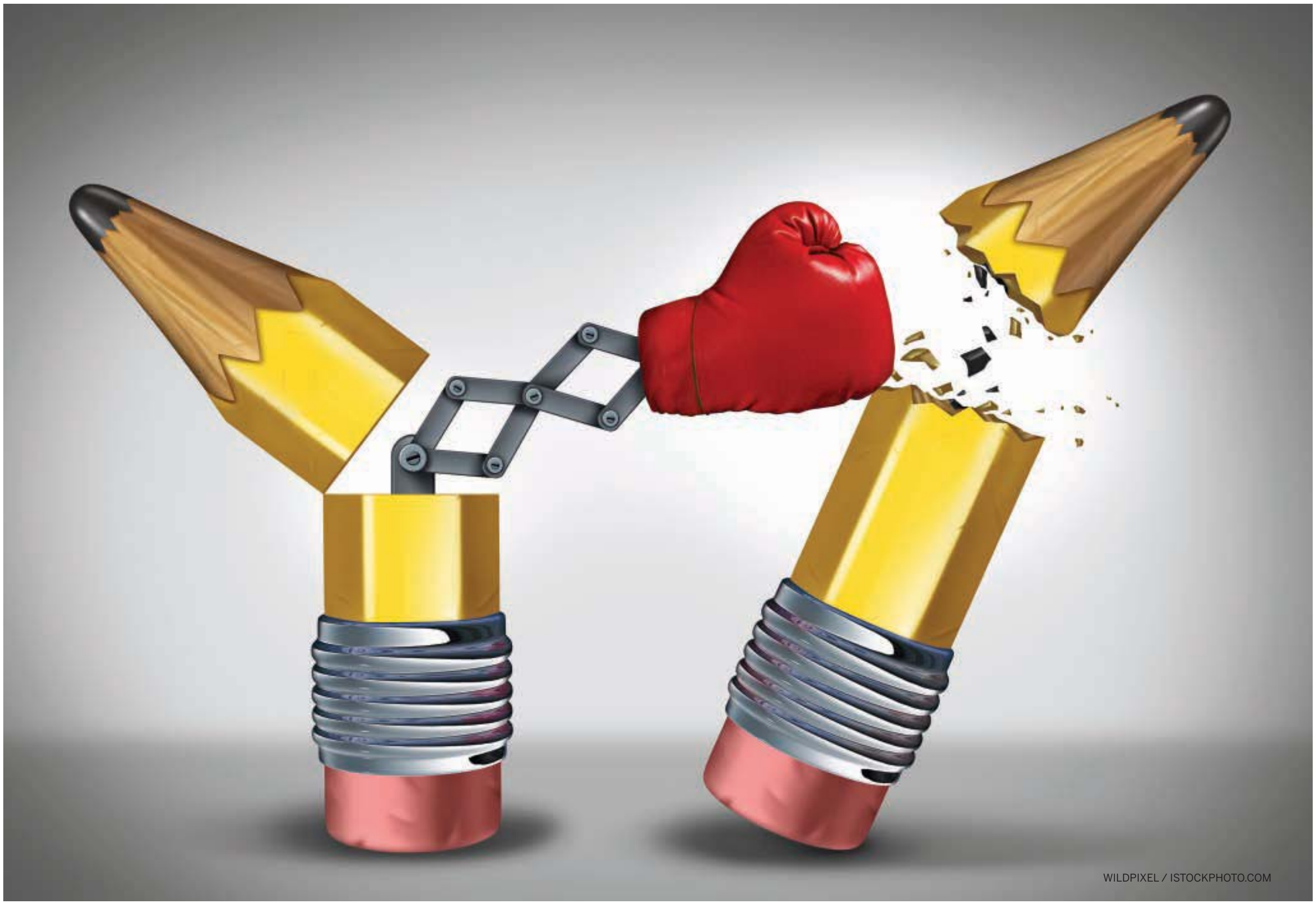

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Expanding the duty of good faith

SCC has blown wide open the grounds for a contractual dispute

Eli Lederman

The Supreme Court of Canada's landmark decision in *Bhasin v. Hrynew* [2014] S.C.J. No. 71, makes it clear that there is now a common law duty to act honestly in the performance of all contractual obligations. Previously, duties of good faith had been recognized in particular types of contracts (for example, in employment, insurance and franchise agreements), with respect to particular types of contractual provisions (as in contractual clauses which provide for the exercise of discretionary powers) and in particular types of contractual relationships.

The court found that this approach to good faith performance of contracts was piecemeal, unsettled and unclear. As a result, the court recognized a "general organizing principle" of the common law of contract that parties expect that contractual obligations will be performed in good faith. It recognized and affirmed existing lower-court good faith jurisprudence, but did so ambiguously. On the one hand, the court left the door open to extending the concept of good faith where the existing law is "found to be wanting." On the other hand, the court recognized that in commercial contractual relationships, a party "may sometimes cause loss to another — even intentionally — in the legitimate pursuit of economic self-interest and that the principle of good faith must not veer into a form of ad hoc judicial moralism or 'palm tree' justice."

In spite of this cautionary language, the decision in *Bhasin* is groundbreaking in two respects. First, the court explained the "organizing principle" of good faith in terms that transform good faith from being a gap-filling doctrine into a positive obligation to pay "appropriate regard" to the other party's interests in the exercise of a contractual right. Unfortunately, the Supreme Court did not define "appropriate regard" and instead held that it will vary depending on the context of the contractual relationship. As a result, the grounds for a contractual dispute have been blown wide open as strict compliance with a contractual term is now no longer the end of a contractual dispute.

Second, in addition to consolidating and extending previous good faith jurisprudence, the court went on to impose, on all contracts, a duty to act honestly in the performance of all contractual obligations.

At first blush, this does not appear to be a drastic change in the law. What contracting party does not expect the other party to perform their contractual obligations honestly and in good faith? The difficulty lies in its application, as a breach of contract may now be asserted even when the terms of a contract have been fully complied with.

The Supreme Court further held that parties are not free to contract out of the

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Debtors selling U.S. property should know the rules


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A debtor's ability to sell assets free and clear of creditor claims, including claims against property located in foreign jurisdictions, is of paramount importance to the success of any insolvency proceeding. United States courts, however, will not enforce foreign sale orders with respect to assets located within the U.S. without a debtor's adherence to U.S. recognition and sale procedures.

A foreign debtor seeking to sell assets located in the U.S. must fulfil two requirements. A debtor, through its "foreign representative," must first seek recognition of its "foreign proceeding" in the U.S. by filing a petition for recognition under chapter 15 of the U.S. *Bankruptcy Code*. Chapter 15 allows recognition of a debtor that is engaged in "a collective… proceeding in a foreign country… in which proceeding the assets and affairs of the debtor are subject to control or supervision by a foreign court…." *Companies' Creditors Arrangement Act* and the *Bankruptcy and Insolvency Act* proceedings are routinely recognized by U.S. courts.

A debtor should also demonstrate that its foreign proceeding is a foreign main proceeding. A foreign main proceeding is an insolvency proceeding located in the country where the debtor's "centre of main interests" is located. A debtor that demonstrates that its proceeding is a main proceeding is automatically entitled access to the sale provisions in the *Bankruptcy Code*. U.S. courts will also recognize insolvency proceedings commenced where a debtor merely has an "establishment" as foreign non-main proceedings. A foreign representative in a non-main proceeding, however, may only utilize the sale provisions of the *Bankruptcy Code* at the court's discretion and, as such, must somehow justify the sale of assets separate from the assets located in the debtor's centre of main interests.

After receiving chapter 15 recognition, a foreign representative must then seek court approval of a sale of assets located in the U.S. under section 363 of the *Bankruptcy Code* [See s.1520 (a)(2), applying section 363 to property located in territorial U.S.]. Section 363 permits a debtor "after notice and a hearing, [to] use, sell, or lease, other than in the ordinary course of business, property of the estate…" Critically, section 363(f) provides that, if the debtor follows the procedures and requirements of section 363, a debtor can sell and a buyer of assets may buy a debtor's property free and clear of all other interests in the property, including successor liability claims. [*In re Chrysler LLC*, 576 F.3d 108, 125 (2d Cir. 2009)].

Case law interpreting section 363 provides a debtor must demonstrate a "good business reason" to make a sale outside the ordinary course of business [*Comm. of Equity Security Holders v. Lionel Corp.* (*In re Lionel Corp.*), 722 F.3d 1063, 1071 (2d Cir. 1983)]. A court will usually determine that "a good business reason" exists if a debtor demonstrates that a sale: is in the "best interests" of the estate; has a legitimate business justification; and was negotiated in good faith and at arm's length.

There is no requirement that a debtor follow a specific process to satisfy the factors enumerated above. Rather, bankruptcy courts will generally follow the deferential "business judgment rule" and approve an asset sale if the debtor can demonstrate that it engaged in a sale process that was calculated to obtain the highest sale price for the assets and was free of inside or self-dealing. It is usually sufficient for a debtor to show that the assets were sufficiently marketed by a professional with experience marketing similar assets. Chapter 15 also does not require that this process happen under the supervision of the U.S. courts. A foreign debtor may conduct the marketing and auction process under the supervision of the foreign court.

Whether the marketing and auction process is conducted in a foreign or U.S. court, section 363 and the Federal Rules of Bankruptcy Procedures require that notice of the sale be given to all parties-in-interest [See Fed. R. Bankr. Pro. 2002(b)(2)]. Further, under the bankruptcy rules, a debtor is required to give this notice at least 21 days prior to the sale unless the time for the notice is shortened by the court for "cause." Recent case law suggests that asset buyers should demand that debtors immediately commence this notice process. In *Krys v. Farnum Place, LLC (In re Fairfield Sentry)*, the U.S. Court of Appeals for the Second Circuit held that bankruptcy courts must evaluate sale motions at the time of the motion rather than when the sale agreement was executed. Accordingly, courts may begin to reject sale motions if the subject assets appreciate significantly in value before the motion is heard.

In sum, in order to enforce free and clear asset sales conducted in foreign courts of property located in the U.S., a debtor must both seek recognition of its foreign proceeding and demonstrate compliance with section 363. To satisfy these requirements, debtors must be able to demonstrate that its proceeding is a main proceeding and that the sale was conducted free of self-dealing through a process reasonably calculated to return the highest value for the assets.

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Honest: Bad faith found even though non-renewal clause was complied with

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core requirements of the duty of honesty, and can only agree to "relax" its scope in some contexts. Further, the duty of honest performance, as it was applied in *Bhasin v. Hrynew*, was extended to conduct which was "in relation to" or "linked" to the performance of a contractual obligation.

In *Bhasin*, the duty of honest performance was applied to the exercise of a non-renewal clause, which expressly provided that either party could choose to not renew their fixed-term agreement if six months' notice was given. A reason for exercising non-renewal did not need to be provided.

The Supreme Court restored the finding by the trial judge that the non-renewal clause had been exercised for a bad faith reason and held that this constituted a breach of the duty of honest performance "in relation to" the non-renewal clause. This, notwithstanding that the non-renewal clause had been complied with and even though there was no obligation to provide any reason at all for the exercise of that contractual right.

The unfortunate effect is that a party may now feel the need to limit their communications with their contracting partners to avoid the risk that those communications may be perceived as dishonest and used as a basis to allege a breach of contract if those communications are considered to be linked to the performance of a contractual right.

A party exercising a right of non-renewal may be far better off by staying silent as to their reasons for exercising such a clause. This would reduce the risk of a claim by the other party that he or she had been misled in relation to the performance of the non-renewal clause.

The same result could apply to an employee who exercises a right of termination in accordance with the strict terms of a contract and provides the requisite amount of notice, but tells a "lie" to the employer about what he or she intends to do next. Even though there was no restriction in the contract about working for a competitor, if the employee knew that he or she was going to work for a competitor and was not forthright about it, the employer could arguably claim that the employee breached the duty of honest performance in relation to the termination and the employer had been "actively misled" about the employee's subsequent plans.

The full implications of the duty of honest performance will only be known over time. But it does seem likely that this new duty will broaden the scope for contractual disputes and ensuing litigation.

Eli Lederman is a partner at Lenczner Slaght with a practice covering a broad range of complex commercial litigation matters, including securities law, class actions, commercial contracts, oppression and other shareholder litigation. He acted as co-counsel in the Supreme Court of Canada on behalf of the respondents in Bhasin v. Hrynew.