

Good Gracious, Good Faith: The Supreme Court of Canada Explores the Parameters of the Duty of Good Faith in *Callow* and *Wastech*

Derek Ronde, Christopher Horkins

May 26, 2021

The contractual duty of good faith has taken on significant importance in the context of franchising in Canada in recent years. Given the overlap between the concepts of statutory good faith and fair dealing in franchising legislation and common law good faith and given the ongoing franchising case law that involves attempts by franchisees to apply this duty to franchise agreements and franchisor conduct, Supreme Court of Canada decisions on the topic merit close examination. Two recent cases, *Callow*¹ and *Wastech*,² together with the Supreme Court's 2014 decision in *Bhasin*,³ form a trilogy that explores the parameters of the duty of good faith and the extent to which express contractual language can be deviated from in light of the conduct of contractual parties.

In *Callow*, the Supreme Court addressed and expanded on the duty of honest performance in the context of the renewal/termination of a service contract, finding that, in certain circumstances, dishonesty by silence or omission may be sufficient to establish a breach of the duty of good faith. This decision is of particular importance to franchisors as renewal and termination are key contractual concepts within the industry. In *Wastech*, the Supreme Court addressed the limits of the duty of good faith in respect of the exercise of contractual discretion and provided helpful guidance for franchisors regarding discretionary contractual decisions.

Callow: Honesty is the Best and Only Policy

In *Callow*, the plaintiff, Callow, provided winter maintenance services (e.g., snow removal) for the Baycrest condominium complexes (the defendant, Baycrest). The parties entered into a two-year contract from November 1, 2012 to April 30, 2014. Pursuant to the contract, Baycrest could terminate the agreement for any reason upon giving ten days' notice to Callow.

During the first year of the agreement, there were complaints from Baycrest residents in respect of snow removal. These were raised directly with Callow and there was a general understanding that the issues had been addressed and resolved. However, towards the end of the winter of 2012-2013, Baycrest appointed a new property manager, Ms. Zollinger, who advised that Baycrest should terminate Callow's contract and that they could do so without penalty. In March or April 2013, the Baycrest condominium board decided to terminate the contract but did not inform Callow of this decision.

In the meantime, Callow had discussions with Baycrest about a potential renewal of the winter maintenance agreement. Callow continued work on its summer maintenance contract with Baycrest, including "freebie" work "above and beyond" its summer maintenance contract that it believed would incentivize Baycrest to renew the winter contract. Based on communication between the parties, it was generally understood that Callow believed that he would be kept on for the winter of 2013/2014.

Baycrest did not advise Callow of the termination until September 2013 in accordance with the provision in the parties' agreement allowing for termination on ten days' notice. Callow sued Baycrest for breach of contract for accepting the free services while knowing Callow would be terminated and alleged that Baycrest knew or ought to have known that Callow would not seek other winter maintenance contracts in reliance of Baycrest's representations that Callow was providing satisfactory services. The claim against Baycrest was framed as a breach of the duty of good faith – specifically, the duty of honest performance in respect of the enforcement of the termination provision.

The Supreme Court of Canada specifically addressed the issue of what constituted a breach of the duty of honest performance in light of what was an express right of unilateral termination under the winter maintenance agreement providing only for ten days' notice.[4] The Court examined whether Baycrest failed to satisfy its duty of good faith – namely the duty not to lie or knowingly deceive Callow about the status of the winter maintenance agreement. The Court, in overturning the Ontario Court of Appeal's decision below, held that Baycrest, despite its right to terminate the contract with minimal notice, had an obligation to exercise that right in accordance with the duty of honest performance. In other words, Baycrest could not lie or otherwise knowingly mislead Callow about issues related to the performance of the contract. The Court relied on the trial court's finding that Baycrest had represented that the winter contract was not in danger of non-renewal, and that this dishonesty was directly related to the eventual termination of the winter contract. Boiling the issue down to its essence, the Court held that "if someone is led to believe that their counterparty is content with their work and their ongoing contract is likely to be renewed, it is reasonable for that person to infer that

Cassels

the ongoing contract is in good standing and will not be terminated early.”

The Supreme Court also clarified its view on whether the duty of honest performance (as part of the duty of good faith) included a positive obligation of disclosure. The Court held that although Baycrest had no free-standing obligation to disclose its intention to terminate the winter maintenance agreement, it did have an obligation to not mislead Callow or give Callow a false impression that the agreement would not be terminated.

The Supreme Court upheld the trial judge’s findings that Baycrest deceived Callow through a series of “active communications.” These active communications including making statements to Callow that the renewal of the winter maintenance agreement was likely and accepting the “freebies” offered by Callow during the summer of 2013 because Callow wanted Baycrest to renew the winter agreement.

In summary, the Court held that Baycrest “intentionally withheld information in anticipation of exercising clause 9, knowing that such silence, when combined with its active communications, had deceived Callow. By failing to correct Mr. Callow’s misapprehension thereafter, Baycrest breached its contractual duty of honest performance.” Baycrest engaged in a series of acts that it knew would cause Callow to draw an incorrect inference and then failed to correct Callow’s misapprehension. This gave rise to a breach of the duty of good faith.

However, in limiting the scope of the duty of good faith, the Court held that the minimum standard of honesty did not include addressing the alleged performance issues and providing prompt notice of non-renewal outside of what was required out of the contract. The duty of honesty does not “[alter] the bargain struck by the parties.” Rather, Baycrest simply had to refrain from false representations in anticipation of the notice period.

The Court upheld that the trial judge’s determination of damages, which was an amount that was at least equal to the profit Callow lost under the winter maintenance agreement if Baycrest’s dishonesty had not deprived Callow of the opportunity to bid on other contracts.

Wastech: Good Faith is a Question of Purpose

Shortly after the decision in *Callow*, the Supreme Court issued its decision in *Wastech* which focused on the duty of good faith and, more specifically, what constitutes a good faith exercise of contractual discretion. To the extent that *Callow* can be considered an expansion of the duty of good faith, *Wastech* helps to clarify and rein in that duty, setting clear and confirming that courts will not rewrite an agreement if a party exercises its contractual discretion in a manner that is within the contemplated purposes of the agreement and not arbitrary or capricious.

In this case, Wastech, a BC-based waste transportation and disposal company, had a long-standing contractual relationship with Metro, a statutory corporation responsible for the administration of waste disposal for the Metro Vancouver Regional District. Under the parties’ agreement, Wastech would remove and transport waste to three disposal facilities. Wastech was paid at a differing rate depending on which disposal facility the waste was directed to. Importantly, the contract did not guarantee that Wastech would achieve a certain profit in any given year. The contract also gave Metro absolute discretion to allocate waste as it so chose.

In 2011, Metro directed that certain waste was to go to a closer disposal facility rather than one that was farther away. This negatively affected Wastech’s profit for that year. Wastech challenged Metro’s decision and submitted the dispute to arbitration. After successive appeals, the case made its way to the Supreme Court of Canada, which held that Wastech had not breached its duty of good faith.⁵

The Supreme Court confirmed that the duty of good faith contains a duty to exercise contractual discretion in good faith. Importantly, the Court held that this duty exists regardless of whether the contract purports to confer absolute discretion on a particular matter. The Court held that the duty to exercise contractual discretion is only breached when the discretion is exercised unreasonably, in an “arbitrary or capricious” manner. A party exercising its contractual rights must do so having appropriate regard for the legitimate contractual interests of its contracting partner.

Cassels

In this case, there was no evidence that Metro had acted capriciously, arbitrarily, or in a dishonest fashion. However, Metro was not required to act in a manner that subordinated its own interests to that of Wastech or give a benefit to Wastech that Wastech did not bargain for. In rejecting the appeal, the Court refused to award Wastech “an advantage not provided for in the agreement between the parties in the absence of any appreciable breach of contract or identifiable wrong.”

It is important to note that Metro had an “honest and reasonable” reason to reallocate its waste distribution. In the initial arbitration, the arbitrator acknowledged that Metro was “guided by the objectives of maximizing [one facility’s] efficiency, preserving remaining site capacity at [another facility], and operating the system in the most cost-effective manner.”

In distinguishing *Wastech* from *Callow*, the Court noted that the duty of honest performance was not at issue in the case. There were no allegations that Metro lied to or misled Wastech in respect of the parties’ contract. Instead, the Court focused on the duty to exercise contractual discretion in good faith and held that this duty “requires the parties to exercise their discretion in a manner consistent with the purposes for which it was granted in the contract, or...to exercise their discretion reasonably.”

In examining this idea of reasonableness, the Court identified that “courts must only ensure parties have not exercised their discretion in ways unconnected to the purposes for which the contract grants that power.” With this focus on contractual purpose, the Court rejected the broad position that if an exercise of discretion “substantially nullifies” the bargained for objective between the parties, it constitutes a breach of the duty of good faith. Instead, the Court took a more nuanced approach. The Court noted that the fact that a party’s exercise of discretion causes its contracting partner to lose some or even all of its anticipated benefit under the contract should not be regarded as dispositive, in itself, as to whether the discretion was exercised in good faith. Rather, “substantial nullification” is likely only potential evidence that discretion has been exercised in a manner unconnected to the relevant contractual purpose. Similarly, evidence of the capricious or arbitrary exercise of a discretionary power is also evidence of the power being exercised for an improper purpose.

The Court held that for Wastech and Metro, the purpose of the parties’ contract was to maximize efficiency and minimize costs, and Metro’s discretion to allocate waste in its “absolute discretion” arose out of this purpose. The purpose of the agreement, and the role of Metro’s discretion in fulfilling that purpose, was further described as follows:

Further, the fact that this discretion exists alongside a detailed framework to adjust payments towards the goal of a negotiated level of profitability, contradicts the idea that the parties intended this discretion be exercised so as to provide Wastech with a certain level of profit. Those incentives are already carefully created elsewhere in the Contract. Reading these clauses in context, then, the purposes for granting Metro “absolute discretion” was to allow it to structure the disposal of waste for which it had contracted Wastech in an efficient and cost-effective manner given the operational variability the parties foresaw.

The Court rejected Wastech’s position that the fact that the agreement was long-term, relational, and built upon trust and cooperation should have an impact on the analysis of good faith. The Court noted that the pricing mechanism and allocation discretion was not an “unforeseen or unregulated matter that, by reason of the relational character of the Contract, was left to the trust and cooperation said to be inherent in the long-term arrangement. The parties foresaw this risk — and chose to leave the discretion in place.” In fact, the long-term nature of the agreement made the idea of Wastech not being profitable “in one year of the 20-year Agreement” unsurprising and inoffensive. Risk was inherent in the contract and understood by the parties:

The risk that the exercise of discretion would affect profitability of either party in a given year was thus a considered one and, that risk notwithstanding, the discretionary power was left in place. In these circumstances, the purpose of the clause was plainly to give Metro the leeway, based on its judgment as to what was best for itself, to adjust the proportions of the allocations of waste amongst the three sites as it required to ensure the efficiency of the operation. The ability to make that allocation was not only permitted, but it could be said to reflect the purpose of the clause.

In summary, the Court held that the duty of good faith did not require Metro to subordinate its interests to Wastech or guarantee Wastech a benefit (namely, profitability) that Wastech did not bargain for despite engaging in painstaking negotiations on profitability and allocation rights. There was a valid purpose behind Metro’s broad allocation discretion, and Metro properly exercised that discretion in good faith.

Takeaways for Franchisors

Cassels

The Supreme Court's reasons in *Callow* and *Wastech* are complex and reflect detailed analyses of the nature of good faith in Canadian common law. However, there are some key lessons for franchisors that can be gleaned from the decisions:

- In dealing with renewal and termination matters, franchisors should exercise care to not actively mislead or misinform franchisees about the prospects of renewal or termination, particularly in circumstances where a decision has been made to terminate or not offer a renewal of the franchise agreement.
- There is not, as of yet, a positive obligation of disclosure arising from the duty of honest performance. However, franchisors should exercise care in respect of dealing with franchisees honestly, particularly where there is reliance by franchisees that results in significant economic decisions or commitments being made by franchisees ahead of key franchisor decisions. In certain circumstances, silence or omissions in communications between franchisor and franchisee may be held to constitute dishonesty sufficient to trigger a breach of the duty of good faith.
- Whether a franchisor's contractual discretion is exercised in good faith is a contextual matter that depends on the specific terms of the franchise agreement. A franchisor must not act arbitrarily, capriciously, or dishonestly, but also does *not* have to subsume its own economic interests to those of the franchisee. Courts will examine the purpose of the franchise agreement to determine if the exercise of discretion aligns with that purpose. The history of negotiation and the purpose of specific contractual terms in the context of the parties' commercial relationship are important to this exercise.
- In practical terms, franchisors are always assisted in having documented business and financial support for decisions where their discretion is exercised. Not only is this helpful in communications with franchisees, it is helpful if the decision is ever litigated in Canadian courts.

If you have any questions concerning these decisions or any other franchise litigation matters, please feel free to reach out to the authors of this article or any other member of our Franchise Group.

¹ *C.M. Callow Inc. v. Zollinger*, 2020 SCC 45 (*Callow*).

² *Wastech Services Ltd. v. Greater Vancouver Sewerage and Drainage District*, 2021 SCC 7 (CanLII), <<https://canlii.ca/t/jd1d6>>

³ *Bhasin v. Hrynew*, 2014 SCC 71, [2014] 3 S.C.R. 494.

⁴ The majority decision of the Court is addressed in this article. There were separate concurring reasons provided by three judges, as well as a strong dissent by Cote, J. that expressed concern that the majority's decision was an unnecessarily confusing application of the duty of honest performance, particularly in light of the express language of the contract.

⁵ Three judges wrote a concurring set of reasons.

This publication is a general summary of the law. It does not replace legal advice tailored to your specific circumstances.