The Supreme Court of Canada's New Duty of Good Faith in Contracts Will Apply to IP Commercialization

Nov 17, 2014

Author: Noel Courage

The Supreme Court of Canada recently reviewed a case involving businesses that marketed education savings plans ("ESP") to investors through retail dealers. This case has impacts for *all contracts*, including those involving companies cooperating in commercialization of intellectual property.

We have all heard the common expression, “dog eat dog world”, applied to business relationships. However, it is not a free-for-all where a contract is in place. A good contract provides a rule book by which companies will interact with each other as they each pursue their own legitimate self-interests. Contract law does not object if, under the terms of a contract, a company acting in good faith, pursuing its own self-interest, sometimes causes loss to the other party. This can even represent economic efficiency at work. However, sometimes one party to a contract goes rogue by acting in bad faith to try to seriously undermine the contract and other company. There have been conflicting Canadian court decisions on whether parties to a contract have obligations to perform the contract in good faith. The courts that suggested this obligation were not asserting it based on the wording of the contract, but as a common law principle underlying any contract.

The Supreme Court of Canada has now taken a position on this area of contract law. Its November 13, 2014 decision in *Bhasin v. Hrynew* (2014 SCC 71) decided that good faith contractual performance is a general organizing principle of the common law of contract. The contracting parties must act honestly in the performance of contractual obligations. Failure to abide by this duty can be considered a breach of contract. This Court stated that this duty is considered fair and in alignment with the reasonable expectations of the commercial parties. The Court further considered this duty sufficiently precise that it will enhance commercial certainty, rather than create uncertainty.

The duty of good faith is not a free-standing rule, but a guiding principle in contract law. The Supreme Court is not creating new causes of action, or saying that the list is closed. The principle may be given different weight in different situations. Existing contract laws should be interpreted with this principle in mind. New law should continue to be developed incrementally with this principle in mind.

The requirements of honesty and reasonableness are highly context-specific, so it will be challenging for lawyers to advise on how they may come into play, particularly since lawyers are often providing opinions while knowing only their clients’ side of the story. In practice, a contracting party should have some regard to the legitimate contractual interests of the contracting partner. This does not mean acting to serve the partner’s interests. It just means not undermining those interests in bad faith. This is a lower level of good faith than the legal concept of a fiduciary duty, where good faith performance may engage duties of loyalty to the other contracting party or a duty to put the interests of the other contracting party first.

The principle of good faith must be applied taking into consideration the great weight that contract law places on the freedom of contracting parties to pursue their individual self-interest. A business may cause another business to lose money, as long as they are honest with each other in relation to the performance of their contractual obligations. They may not lie or otherwise knowingly mislead each other in relation to the performance of the contract. On this point, the Court stated that, “This does not impose a duty of loyalty or of disclosure or require a party to forego advantages flowing from the contract; it is a simple requirement not to lie or mislead the other party about one’s contractual performance. Recognizing a duty of honest performance flowing directly from the common law organizing principle of good faith is a modest, incremental step.” Furthermore, “A party to a contract has no general duty to subordinate his or her interest to that of the other party. However, contracting parties must be able to rely on a minimum standard of

honesty from their contracting partner in relation to performing the contract as a reassurance that if the contract does not work out, they will have a fair opportunity to protect their interests."

In the case before the Supreme Court, the ESP company had a three-year renewable contract with one of its dealers. The contract would automatically renew unless six months' notice of termination was given. The ESP company wanted to restructure its business and repeatedly misled the dealer about business issues, including the role of another party the ESP company retained to review the dealer's business (the other party actually wanted in on the dealer's business). The ESP company threatened to terminate the agreement with its dealer, and eventually gave notice of non-renewal of the agreement. At the expiry of the contract term, the dealer lost the value of his business because he lost his workforce and his source of product.

The ESP company acted dishonestly with the dealer throughout the period leading up to its exercise of the non-renewal clause. Therefore, the Court found that the ESP company breached the contract when it failed to act honestly with its dealer in exercising the non-renewal clause.

The ESP company was liable for damages calculated on the basis of what the dealer's economic position would have been had the ESP company fulfilled its duty of good faith. Damages were assessed on the basis that if the ESP company had performed the contract honestly, the dealer would have been able to retain the value of his business rather than see it, in effect, expropriated and turned over to a competing dealer. The Court found that the value of the business around the time of non-renewal was $87,000, so this was the amount of damages awarded to the dealer.

Intellectual property is often commercialized by contractual partnerships, for example, a patented invention may be licensed out to other companies. This is the case particularly in industries such as pharmaceuticals and high technology. For example, pharmaceutical companies license drugs to other companies to get global reach. Upon termination of a partnering agreement, a commercial partner may lose access to the IP and its ability to operate in the specific area of business covered by the IP. In another circumstance, one technology company may supply another with a proprietary electronic component that is not readily replaced. Termination of supply could impair the partner's business selling finished product. IP owners are allowed to take self-interested actions under a contract which can harm the other party. However, the IP owner must be careful to act in good faith when carrying out, and ending, contracts because the Supreme Court has indicated that there is potential for damages based on the loss of value of a business. Taking away a collaborator's access to commercially important IP may not kill their business, but it can often lead to at least temporary loss of business value.