

**THE COMMONS INSTITUTE  
COMMERCIAL LEASING ESSENTIALS  
LIVE WEBCAST: TUESDAY, FEBRUARY 25, 2014  
10:00 A.M. – 12:00 P.M.**

**“GOOD FAITH NEGOTIATION AND  
PERFORMANCE OF LEASE COVENANTS”**

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## **INTRODUCTION**

“Good faith” is a term that is often batted around, but what does it really mean? When does it apply to a commercial lease? It’s one of those terms that’s difficult, if not impossible, to define; at times described as nothing more than the absence of bad faith.

This paper begins by looking at how the courts have attempted to define the term. We will discover that good faith “can be illustrated but hardly defined”<sup>1</sup>.

Armed with an understanding of good faith we will then examine its application to commercial leases.

An analysis of the case law shows

1. There is no duty to negotiate in good faith
2. There is a duty to perform a contract in good faith
3. There may be a duty to negotiation further terms of a contract, such as an option to extend, in good faith.

## **DEFINING GOOD FAITH**

Much of the resistance to judicial recognition of a duty of good faith can be attributed to the inability to find a precise definition. The English Court of Appeal has stated that good faith is “perhaps most aptly conveyed by such metaphorical colloquialisms as ‘playing fair’, ‘coming clean’ or ‘putting one’s cards face upwards on the table’”<sup>2</sup>.

In *Katotikidis v Mr. Submarine Ltd.* the Ontario Superior Court states that good faith “does not lend itself to a precise definition...what is more readily identifiable is bad faith”<sup>3</sup>.

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<sup>1</sup> Lord Wilberforce in *Reardon Smith Line v Yngvar Hansen-Tangen*, [1976] 1 WLR 989 at 995-996 (HL) referring to “surrounding circumstances” of a contract.

<sup>2</sup> *Interfoto Picture Library Ltd. v Stiletto Visual Programmes Ltd.*, [1989] 1 QB 433 at 439 (CA).

<sup>3</sup> [2002] OTC 367 at para 72.

In the seminal case of *Gateway Realty Ltd. v Arton Holdings Ltd.*<sup>4</sup> Kelly J quotes with approval

[G]ood faith is an excluder. It is a phrase without general meaning or meanings of its own and serves to exclude the wide range of heterogeneous forms of bad faith<sup>5</sup>

The duty is described as requiring honesty and fairness, independent of reasonableness. For example, in *Greenberg v Meffert et al.*<sup>6</sup> the court states that “apart altogether from the question of reasonableness, a discretion must be exercised honestly and in good faith”<sup>7</sup>.

However, there are instances where good faith includes reasonableness. In *Shelanu Inc. v Print Three Franchising Corporation*<sup>8</sup>, the Ontario Court of Appeal implies that a party will meet its duty of good faith “so long as [it] deals honestly and reasonably with [the other party]”<sup>9</sup>. The court also states that the defendant “had a duty of good faith in the sense that it had an obligation to ...deal promptly, honestly, fairly and reasonably”<sup>10</sup>.

Not only is good faith difficult to define, the terms used to describe it are just as difficult to define. In addition, the relationship between good faith and reasonableness remains unclear. An understanding of what the duty of good faith requires is best achieved by reviewing cases where the courts have found that a party has failed to act in good faith.

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<sup>4</sup> (1991), 106 NSR (2d) 180 (Sup CT (TD)), aff'd on other grounds 112 NSR (2d) 180 (NS CA) [*Gateway Realty*] discussed in more detail below.

<sup>5</sup> Robert Summers, “‘Good Faith’ in General Contract Law and the Sales Provision of the Uniform Commercial Code” (1968) 54 Virginia LR 195 at 200-201.

<sup>6</sup> (1985), 56 OR (2d) 320 (CA) [*Greenberg*].

<sup>7</sup> *Ibid* at 8.

<sup>8</sup> (2003), 64 OR (3d) 533 (CA) [*Shelanu*].

<sup>9</sup> *Ibid* at para 69.

<sup>10</sup> *Ibid* at para 5.

## **GOOD FAITH IN CONTRACT NEGOTIATE**

### **Contract Negotiation**

Canadian common law courts have consistently denied the existence of a duty to negotiate in good faith. The Supreme Court of Canada in *Martel Building Ltd. v Canada* recognized that self-interest in negotiation is expected. The court stated

The primary goal of any economically rational actor engaged in commercial negotiation is to achieve the most advantageous financial bargain... [and that] such gains are realized at the expense of the other negotiating party<sup>11</sup>

Good faith requires a party to have regard for the other's interests. The clash between the pursuit of self-interest inherent in negotiation and the consideration of the other party's interest required by good faith make the two concepts incompatible. The House of Lords has described the imposition of a duty of good faith as "repugnant"<sup>12</sup> to the adversarial nature of the bargaining process.

### **Negligent Negotiation**

Prior to the *Martel* decision by the Supreme Court of Canada in 2000, there was an emerging area of law which suggested that a party can sue for mistreatment during the negotiating process. The claim was dubbed "negligent negotiation". This nascent tort was quashed by the Supreme Court of Canada in *Martel*.

In *Martel*, the landlord owned a building in downtown Ottawa. The premises was under a ten year lease to the federal government. Prior to the expiration of the term the landlord contacted the tenant to discuss renewal. The tenant informed the landlord that it planned on calling for tenders unless the landlord's renewal offer was particularly attractive.

The landlord and tenant met several times over the course of many months. The landlord worked hard to meet the various obligations and deadlines the tenant frequently imposed. Ultimately, the landlord made an offer that it had been led to believe would secure the renewal. The tenant then informed the landlord that tendering would commence unless the landlord

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<sup>11</sup> *Martel Building Ltd. v Canada*, 2000 SCC 60 at para 62 [*Martel*].

<sup>12</sup> *Walford v Miles*, [1992] 2 AC 128 at 138.

provided full details of the renewal proposal (including drawing of a proposed retrofit) by the end of the day. The landlord was unable to meet the deadline.

Shortly thereafter, a call for tender was issued. Even though the landlord's bid was the lowest, it was rejected. The landlord sued for, among other things, negligent negotiation. The case was ultimately heard by the Supreme Court of Canada. The court ruled that in arms-length negotiations there are compelling reasons why a commercial party should not have to be mindful of another commercial party's interests. In the result, the court denied the existence of a claim for negligent negotiation.

### **Recent Cases**

In 2011, the Ontario Court of Appeal confirmed that there is no duty in contract or negligence law to negotiate in good faith.<sup>13</sup> The court noted that there is a possibility that a duty to bargain in good faith applies if the parties are in a "special relationship"<sup>14</sup>, but that such a duty has "not been recognized to date in Canadian Law"<sup>15</sup>. The court confirmed that, as the law stands, there is no obligation on a party to negotiations to have regard for the other party's interests.

### **Misrepresentation, unconscionability, promissory estoppel**

Negotiating parties remain exposed to potential claims for misrepresentation, unconscionability, and promissory estoppel. These claims are often used to "provide redress against bargains obtained as a result of improper negotiation"<sup>16</sup>.

### **United States**

The United States legal system has similarly not recognized a free-standing duty to negotiate in good faith. However, where parties have agreed on some points American courts may require them to undertake good faith negotiations of outstanding issues.<sup>17</sup>

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<sup>13</sup> *Oz Optics Limited v Timbercon, Inc.*, 2011 ONCA 714.

<sup>14</sup> *Ibid* citing *978011 Ontario Ltd. v Cornell Engineering Co.* (2001), 53 OR (3d) 783 (ON CA), at para 32, leave to appeal to SCC refused [2001] SCCA No 315 [*Cornell*].

<sup>15</sup> *Supra* note 15 at para 65.

<sup>16</sup> *Supra* note 12 at para 70.

## Quebec

In contrast, the *Civil Code of Quebec*<sup>18</sup> does impose a duty to negotiate in good faith. The *Civil Code* provides that parties to a contract “shall conduct themselves in good faith...at the time the obligation is created”<sup>19</sup>. The concept was introduced to the *Civil Code* from, among other sources, France’s civil law, where good faith imports a duty of loyalty as well as the obligation to inform, cooperate, and not use one’s rights abusively.<sup>20</sup> An analysis of the obligation to negotiate in good faith under the *Civil Code* is beyond the scope of this paper.

## **GOOD FAITH PERFORMANCE OF CONTRACTUAL OBLIGATIONS**

### **Is there a duty?**

Parties are required to perform their contractual obligations in good faith. Courts have implied a duty of good faith with a view to securing performance and enforcement of a contract. In the context of a commercial lease, courts have often recognized the duty of landlords and tenants to perform their lease obligations in good faith.

The leading case on good faith performance of commercial leases is *Gateway Realty Ltd. v Arton Holdings Ltd.*<sup>21</sup> In this case, the plaintiff owned a shopping centre. Zellers was the anchor tenant, occupying approximately half of the centre’s rentable area. The defendant, a neighboring landlord, enticed Zellers to relocate to its shopping centre. Zellers assigned the remaining seventeen years of its lease to the defendant. The defendant promised the plaintiff it would make “best efforts” to sublet the former Zellers location. The plaintiff referred potential tenants to the defendant; however, the space was not re-let.

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<sup>17</sup> See Angela Swan & Jakub Adamski, *Halsbury’s Laws of Canada – Offer and Acceptance* at para HCO-37 (QL).

<sup>18</sup> *Civil Code of Québec*, LRQ, c C-1991 [*Civil Code*].

<sup>19</sup> *Ibid* at Article 1375.

<sup>20</sup> See Paul Mayer, “The New Civil Code Quebec: Adhesion Contracts and the Obligation of Good Faith” in Harvey Haber, ed *Tenant’s Rights and Remedies in a Commercial Lease: A Practical Guide* (Toronto: Canada Law Book, 1998) 141 at 147.

<sup>21</sup> *Supra* note 4.

The Nova Scotia trial judge found that defendant feared the adverse impact re-letting the space may have on its own mall. The court held that the defendant failed to execute its obligations as assignee in good faith. Notably, the court acknowledged the interdependency of landlords and tenants in a shopping centre; referring to it as a “joint commercial enterprise”<sup>22</sup>. The court also recognized the importance of anchor tenants to the success of the entire shopping centre. The court stated that “[t]he law requires that parties to a contract exercise their rights under that agreement honestly, fairly and in good faith”<sup>23</sup>. The court found the defendant’s attempts to fulfill its obligations under the lease so insignificant as to constitute bad faith. The breach was held to be serious enough as to justify termination.<sup>24</sup>

### **Scope of the Duty**

Courts have justified the requirement for good faith performance as being a means by which the agreement is given effect. In a commercial contract business efficacy requires the parties to fulfill obligations in a manner consistent with the contract’s commercial purpose.

The duty is intended to give effect to the rights bargained for. In *Transamerica Life Canada Inc. v ING Canada Inc.*<sup>25</sup>, the Ontario Court of Appeal stated that the duty of good faith is imposed

[W]ith a view to securing the performance and enforcement of the contract made by the parties, or as it is sometimes put, to ensure that parties do not act in a way that eviscerates or defeats the objectives of the agreement<sup>26</sup>...

...Canadian courts have not recognized a stand-alone duty of good faith that is independent from the terms expressed in a contract or from the objectives that emerge from those provisions. The implication of a duty of good faith has not gone so far as to create new, unbargained-for, rights and obligations<sup>27</sup>

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<sup>22</sup> *Ibid.*

<sup>23</sup> *Ibid.*

<sup>24</sup> Note: The decision was appealed. The appellate court avoided a discussion regarding good faith but held that the defendant breached its contract with the plaintiff by failing to use “best efforts” to re-let the space. Despite the appeal, the trial level decision is often cited as authority for the duty to perform contractual obligations in good faith.

<sup>25</sup> (2003), 68 OR (3d) 457 (CA).

<sup>26</sup> *Ibid* at para 53.

<sup>27</sup> *Ibid.*

More recently in *National Logistics Services (2006) Inc. v American Eagle Outfitters Canada Corp.* the court stated that

In order to advance a claim of breach of a duty of good faith in the performance of a contract a plaintiff must point to a specific term of the contract, whether express or implied, which the defendant has not performed in good faith<sup>28</sup>

The duty of good faith does not create obligations outside the four corners of the contract. It is intended to ensure that a party receives the benefit of the rights bargained for, not more.

### **Bad Faith Behavior**

In *MDS Health Group Ltd. v King Street Medical Arts Centre Ltd.*<sup>29</sup>, the defendant landlord owned an office building in Mississauga. The tenants of the building were shareholders, and in some cases directors, of the landlord corporation.

MDS was a tenant pursuant to a lease which granted it the exclusive right to operate a business in the shopping centre for taking medical laboratory specimens. The exclusive was subject to the exception that a physician was permitted to personally take laboratory specimens in the ordinary course of its practice.

A few years after the leases were signed the building began experiencing financial difficulties. MDS agreed to increase its rent, but not to the extent requested by the numerous shareholder doctors. The doctors then collectively rented a unit in the building, hired staff, and used the suite to collect blood samples. The samples were picked up and processed by one of MDS's competitors. The plaintiff's business decreased drastically.

The doctors argued that their behavior was within the scope of the exception. The court disagreed. Holding that the landlord had breached the exclusive, the court went on to find that the landlord was in "breach of the good faith requirement of the law of parties to a contract"<sup>30</sup>.

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<sup>28</sup> 2012 ONSC 384 at para 49.

<sup>29</sup> (1994), 12 BLR (2d) 209 (ON Ct J (Gen Div) Comm List) [*MDS v King Street*].

<sup>30</sup> *Ibid* at para 29.



The court held that the landlord had knowingly entered into the new lease in order to “nullify the restrictive covenant”<sup>31</sup> and that it had “done so in bad faith”<sup>32</sup>.

### **Other’s Interests**

*MDS v King Street* indicates that good faith requires a party to perform without nullifying the rights of the other party. This obligation is consistent with the rationale for the imposition of the duty. In order to satisfy the intent underlying the contract one party should not be able to rob the other of the rights bargained for.

Consequently, in order for a party to meet its duty of good faith it must consider what contractual rights the other party is holding and respect that the other party is entitled to exercise and enjoy those rights. The duty of good faith, therefore, places a limitation on the pursuit of self-interest. It imports a duty to “have regard to the legitimate interests ...of the other”<sup>33</sup>.

In *Shelanu*, the Ontario Court of Appeal described the duty of good faith as a point on a continuum of “which the law acknowledges a limitation on the principle of self-reliance and imposes an obligation to respect the interests of the other”<sup>34</sup>.

The court places the duty of good faith somewhere between the doctrine of unconscionability, which accepts self-interested behavior but proscribes that which is excessively so, and a fiduciary duty, which requires a party to act selflessly with undivided loyalty. The duty of good faith requires a party to “give consideration”<sup>35</sup> to the other party’s interests. In *Barclays Bank PLC v Devonshire Trust*<sup>36</sup> the Ontario Superior Court qualified that while good faith “does not preclude self-interested behavior... a party may be required to temper it”<sup>37</sup>.

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<sup>31</sup> *Ibid* at para 30.

<sup>32</sup> *Ibid*.

<sup>33</sup> *Supra* note 9 at para 68 citing P. Finn, "The Fiduciary Principle" in T. Youdan, ed., *Equity, Fiduciaries and Trusts* (Toronto: Carswell 1989).

<sup>34</sup> *Supra* note 9 at para 68 citing *Cornell*.

<sup>35</sup> *Supra* note 9 at para 69.

<sup>36</sup> 2011 ONSC 5008.

<sup>37</sup> *Ibid* at para 304.

## **In Summary**

The duty of good faith requires a party to perform its contractual obligations in a manner which does not deprive the counterparty of its side of the bargain.

In order to meet this duty a party must consider the interests of the other party and refrain from acting in a manner that eviscerates its rights. While not required to put a counterparty's interests ahead of one's own, the duty of good faith imposes an upper limit on the pursuit of self-interest in contractual performance. In other words, pursuit of self-interest is impermissible where such action would defeat the intention of the contract or rob one's counterparty of rights fairly bargained for.

## **Remedies**

With respect to remedies, the duty of good faith is treated as a covenant of the contract and contract remedies apply. Termination is permitted where the breach is fundamental and deprives the innocent party of substantially the whole benefit of the bargain. In *Gateway Realty* the court found the effect of the assignee's breach of the duty so significant that the landlord was entitled to terminate the lease. Otherwise the innocent party is entitled to its damages for breach of contract.

## **OPTION CLAUSES AND NEGOTIATION OF TERMS**

### **Agreements to Agree**

Commercial leases often contain a covenant to negotiate the terms of a tenant's renewal. Unlike negotiation between unrelated parties, where an existing contract contains a covenant to negotiate, the parties may be under an obligation to negotiate in good faith.

The general rule in Canadian law is that an agreement to agree is not a contract; it's too uncertain to enforce. A covenant to negotiate is vulnerable to the same attack. Nevertheless,

courts have enforced agreements to negotiate where the clause “provides objective criteria against which the negotiations can be evaluated”<sup>38</sup>.

### **Good Faith and Enforceability**

In *Empress Towers Ltd. v Bank of Nova Scotia*<sup>39</sup> a tenant exercised its option to renew the lease. The clause provided that renewal rent was to be “market rate...as mutually agreed between the Landlord and the Tenant”. The clause provided further that if the parties do not reach an agreement within two months the lease is terminable at the option of either party.

The court stated that if rent were simply “to be agreed” the clause would not be enforceable. In this case, the clause provided that renewal rent was to be at “market rate”. It was the determination of market rate which required the parties’ agreement. The court noted that if the lease contained a mechanism for determining market rate the clause would be enforceable. However, this clause provided no such mechanism.

Instead of finding that the clause was unenforceable, the court applied officious bystander and business efficacy principles in finding an implied term to negotiate in good faith. The court stated that the term was implied “in order to permit the renewal clause, which was clearly intended to have legal effect, from being struck down as uncertain”<sup>40</sup>.

### **Performance of the Covenant to Negotiate**

In *Canada Trustco Mortgage Co. v 1098748 Ontario Ltd.*<sup>41</sup> the tenant’s renewal option was to be on the “terms, conditions, and ...Rent... [as] mutually agreed”. The clause did not contain an arbitration provision. Cumming J held that the clause “is at most an agreement to agree”<sup>42</sup> and that “[s]uch an ‘agreement’ is not enforceable”<sup>43</sup>.

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<sup>38</sup> *Labatt Brewing Co. v NHL Enterprises Canada, LP.*, 2011 ONSC 5652 at para 69.

<sup>39</sup> (1990), 73 DLR (4th) 400 (BC CA) [*Empress*].

<sup>40</sup> *Ibid.*

<sup>41</sup> (1999), 97 OTC 282 (ON Ct J (Gen Div)).

<sup>42</sup> *Ibid* at para 18.

<sup>43</sup> *Ibid.*

Nevertheless, the judge goes on to reason that the “term ... must give rise to something”<sup>44</sup>. When the tenant argued that the clause implies a duty to negotiate in good faith, Cumming J responded that the argument “raises the issue of good faith in *performance* of contractual terms”<sup>45</sup>. Explicitly avoiding a finding of whether a duty to perform in good faith exists as an underlying tenant of contract law, the judge finds an implied “duty on both parties to make a good faith attempt to negotiate renewal terms”<sup>46</sup>.

This judgment is perplexing. First, because Cumming J holds that the clause is unenforceable then that it creates an obligation to negotiate. And second, because it appears to rationalize the duty to negotiate in good faith as an application of the duty to *perform* a covenant in good faith; the covenant being a promise to negotiate. This contrasts with the reasoning in *Empress* where the court implied the duty of good faith so the clause would be sufficiently certain to enforce.

In *ClubLink Corp. v Pro-Hedge Funds Inc.*<sup>47</sup> the court also found that the parties had a duty to negotiate in good faith. In this case, the tenant had a right of first offer over additional space. The clause provided that the additional lease was to be “upon the same terms as those contained in [the original lease]”. The parties were unable to agree on the commencement date and details of the leasehold improvements. The landlord found an alternative tenant for the space.

The Ontario Superior Court did not address the enforceability of the option clause. Presumably, the reference to “same terms” provided sufficient objective criteria for it to be enforced. The court held that the parties were under a duty to negotiate in good faith to give effect to what was “clearly an important contractual right”<sup>48</sup>. This rationale is consistent with precedents which require the parties to *perform* in good faith.<sup>49</sup>

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<sup>44</sup> *Ibid* at para 25.

<sup>45</sup> *Ibid* at para 25 [emphasis added].

<sup>46</sup> *Ibid* at para 23.

<sup>47</sup> (2009), 84 RPR (4th) 274 (ON Sup Ct) [*Clublink*].

<sup>48</sup> *Ibid* at para 61.

<sup>49</sup> Note: The court cited *MDS v King Street* as authority, a case which recognized the duty to *perform* contractual obligations in good faith.

In summary, the courts rationalize the imposition of a duty to negotiate in good faith in two ways. First, as in *Empress*, the court uses good faith to give a clause sufficient certainty to be enforced. Second, as in *Clublink*, the court finds an enforceable covenant to negotiate then implies the duty to perform that covenant in good faith. Both rationales provide a method whereby a court is empowered to give value to a right which would otherwise be worthless.

## **CONCLUSION**

“Good faith” is difficult to define, but its absence can be detected. When a party deprives its counterparty of the benefit of the bargain, the party is not acting in good faith.

Under Canadian common law, arms-length parties are not required to conduct their negotiations in good faith. Negotiating parties need not concern themselves with the other party’s interests.

However, once a contract is formed, the parties are under a duty to perform their contractual obligations in good faith. This duty requires a party to have regard for the legitimate interests of its counterparty.

Where the parties have a pre-existing contract which contains an agreement to negotiate, the parties may be under a duty to conduct those negotiations in good faith.

It’s unclear from the case law whether the duty of good faith is a rule of law - applicable to all contracts; or a rule of interpretation - implied only where required to give effect to an agreement. On the one hand, the courts have indicated that the “law requires”<sup>50</sup> good faith performance. On the other hand, the duty is often held to be an implied term, making it seem like the obligation emerges from the contract itself. If the duty is imposed in order to give effect to the agreement, can the parties contract-out of the duty of good faith? Does an “entire agreement” clause accomplish this? Cases which address this issue would help identify the source of the duty and help contracting parties understand their legal obligations.

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<sup>50</sup> *Supra* at note 25.

It remains difficult to predict when a court will require the parties to act in good faith. The cases discussed in this paper indicate that courts use the duty as another flexible tool in which to do justice between the parties. In many of the above cases, while in technical compliance with the written terms of the agreement, the breaching party appears to be mistreating its counterparty. While some substantive elements of the doctrine of good faith can be extrapolated from the case law, the line between legitimately exercising one's contractual rights and breaching the duty of good faith remains blurry.