

Reasonability, Good Faith and Discretion in Commercial Leasing

A Contrast between Canada and the United States

Good Faith, Discretion and Reasonableness in the Exercise of Rights and the Making of Efforts

In both Canada and the United States, there is a legal doctrine of *good faith* in commercial contractual dealings. Where Canadian and American courts have differed is in the meaning of good faith and the application of the concept.

Likewise, in the exercise of approval rights or the making of determinations, designations, or decisions within commercial contracts, both Canadian and American courts contend with the rights of a party to rely on its own discretion as contrasted with the obligation to act reasonably. In both Canada and the United States, a reference to reasonableness imports an objective standard. However, the right to exercise discretion (whether sole and absolute, unfettered or arbitrary), leads to different outcomes on either side of the border.

As for the making of efforts to achieve stated contractual goals, there is a marked difference between the Canadian and American implications of a requirement to make reasonable efforts, as contrasted with best efforts.

This article explores those similarities and differences.

Good Faith

In the USA, the doctrine of good faith in commercial contractual dealings is enshrined in the Uniform Commercial Code¹ ("UCC") & Restatement of Contracts,² Section 205 as follows: "Every contract imposes upon each party a duty of good faith and fair dealing in its performance and enforcement." Further, Article 1-203 of the UCC stipulates that "Every contract or duty within this Act imposes an obligation of good faith in its performance or enforcement."

There is no statutory equivalent in Canada apart from the *Civil Code of Quebec* ("Civil Code").³ However, some of the work accomplished by the good faith doctrine in the United States has been accomplished in the Canadian common law provinces by judicial intervention.

Both Canada (*except for Quebec – see below*) and the USA impose no requirement to negotiate in good faith, but once an agreement has been signed, there is a requirement to perform the obligations of that agreement in a good faith manner.

In Canada's common law provinces (i.e., all but Quebec), this body of law has been entirely developed by the judiciary. (E.g. *Gateway Realty Ltd. v Arton Holdings Ltd.*⁴ (a Nova Scotia decision), *National Courier Services Ltd. v RHK Hydraulic Cylinder Services Inc.*⁵ (an Alberta decision), *Sector v Priatel*⁶ (a British Columbia decision)) The decisions are plentiful, and they are all to the effect that the duty of good faith is not a new, unbargained-for right, nor an alteration of the terms of the contract, but merely a qualification on the bargained-for rights. Outside of Quebec, however, there is no definition of "good faith" to be referred to for guidance. The requirement, that the performance or enforcement of a contractual term be done in good faith manner, essentially means that no bad faith will be tolerated.

As an example in the shopping centre context, the *Gateway Realty* case is apt. There, an anchor tenant of Shopping Centre A agreed to move into a competitor landlord's Shopping Centre B (a short distance

away from Shopping Centre A), and as part of the relocation agreement, assigned its lease of premises at Shopping Centre A to the landlord of Shopping Centre B. The landlord of Shopping Centre A cried foul when the landlord of Shopping Centre B interfered with attempts by the landlord of Shopping Centre A to attract another anchor to replace the one that had exited. The Court found that the conduct of the competitor landlord effectively deprived the landlord of Shopping Centre A, as well as the other tenants of Shopping Centre A, of significant economic benefits and caused a probable reduction of its equity value in the Shopping Centre. It therefore held that the landlord of Shopping Centre B breached its duty of good faith under the lease that had been assigned to it.

In the province of Quebec, good faith is codified in Articles 6, 7 and 1375 of the *Civil Code*⁷: Every person is required to exercise civil rights in good faith; no right may be exercised with intent of injuring another or in an excessive and unreasonable manner which is contrary to the requirements of good faith; and parties shall conduct themselves in good faith both at the time the obligation is created and at the time it is performed or extinguished.

By contrast, the American experience is that the duty of good faith in the performance of commercial contracts has been broadly recognized for a long time in various court rulings and was even given a statutory base in 1951 with the expression of the good faith requirement in the UCC. Article 1-209(19) defines good faith as “honest in fact in the conduct or transaction concerned”. And in the case of a merchant, Article 2-103(1)(b) stipulates that good faith is “honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade”. Likewise, Article 1-203 of the UCC is very blunt: “Every contract or duty within this Act imposes an obligation of good faith in its performance or enforcement.”, and in the 1979 “Restatement (Second) of Contracts”, Article 205, “every contract imposes upon each party a duty of good faith and fair dealing in its performance and execution”. As to what this means in practice, commentators have observed the presence of a similar “excluder analysis”⁸ to that which has been applied in Canada (being, that it is much easier to describe what is not good faith or what violates the duty of good faith). Although some courts have held that good faith is an implied, additional covenant (to refrain from conduct calculated to or having the effect of injuring or destroying the rights of the other party to receive the rewards of the contract),⁹ we are given to understand that the current trend is very much like that in the Canadian common law provinces, with the effect being one of interpretive relevance without injecting a substantive, independent term into a contract.

In sum, on both sides of the border, good faith is a somewhat mysterious concept that does impact business dealings within contractual relationships, albeit without much clarity or predictability. While the requirement is statutorily supported in the US, and in Quebec, that is not the case in the rest of Canada. The influence of the good faith requirement on contractual performance is both nebulous and pervasive, causing difficulty for lawyers attempting to advise their clients on their contractual duties and entitlements.

Discretion and Reasonableness in the Exercise of Rights and Making of Determinations

Reasonableness, in the exercise of approval rights or the making of determinations, designations, or decisions within commercial contracts in the United States, imports an objective standard.¹⁰ Coupled with the enshrined duty to act in good faith, reasonableness carries an expectation that judgment will be exercised in a way that a rational person (acting in good faith) would exercise their judgment; in a fair manner that would have been expected by both parties.

In Canada, reasonableness in the exercise of approval rights and the making of decisions within a contract clearly carries an expectation of objectivity. But some courts are willing to split discretion into two types: objective and subjective.

Where reasonableness is not expressly prescribed, but pure discretion is contemplated, the superimposed duty of good faith has led to differences between Canada and the United States. Canadian common law courts have held that although a discretion in a contract must be exercised in good faith, there is not necessarily a duty to act reasonably. In *Greenberg v Meffert*,¹¹ the court noted that objective discretions imply a duty of good faith and a duty to act reasonably, but subjective discretions imply no duty to act reasonably, even though a duty of good faith is present. Where the discretion goes to something that is objectively measurable, such as for example structural completion, mechanical utility, or operative fitness, the courts are willing to impose a duty to act reasonably in the exercise of discretion. However, where the discretion to be exercised is in the realm of judgment, compatibility, or taste, these have not historically incorporated any duty of reasonableness and the exerciser of discretion is free to do so subjectively.

By contrast, several American courts have implied that there is a reasonableness standard to exercising a contractual discretion. In *Gilson v Rainin Instrument, LLC*,¹² for example, the court held that in exercising a contracting party's discretion, it must act in a manner that is "consistent with the reasonable expectations of the other party". In *Legend Autorama Ltd. v Audi of America Inc.*,¹³ "sole discretion" was found to have implied a covenant of good faith and fair dealing, including "any promises a reasonable person would be justified in believing were included". The element of objectivity that is sometimes infused into discretion has led some American attorneys to move away from using terms such as "sole discretion" or even "sole and absolute discretion". An emerging trend, where pure discretion is intended, is to use the phrase, "for any reason or no reason". (*Quaere* whether this phrase suffices to replace good faith discretion with good faith whim.)

Reasonableness in the Making of Efforts

No discussion of reasonableness, good faith and discretion within contracts can be complete without a consideration of what it means to make reasonable efforts in the performance of a contractual duty. Reasonable efforts are sometimes described as best efforts. "Reasonable best efforts" are sometimes called for. "Commercially reasonable efforts" is also emerging as a common phrase (potentially implying that uneconomic or excessive costs need not be incurred in the making of efforts).

It seems that many courts in the United States are prepared to regard all these terms as interchangeable and effectively on par with "good faith". A reasonable effort is one that a reasonable person would make (i.e., an objective standard), in good faith, but per *Stewart v O'Neill*,¹⁴ it is no more onerous to be required to use best efforts. Similarly, in *Coady Corp. 495 v Toyota Motor Distributors, Inc.*,¹⁵ "best efforts cannot mean everything possible under the sun". "Best efforts does not mean perfection and expectations are only justifiable if they are reasonable." (*Corporate Lodging Consultants Inc. v. Bombardier Aerospace Corp.*)¹⁶

In Canadian common law jurisdictions, however, reasonable efforts have generally been held to be sensible efforts, made using sound judgment,¹⁷ whereas best efforts have been recognized as something more than reasonable efforts. In *Sheffield District Railway Co. v. Great Central Railway Co.*,¹⁸ the court equated best efforts to leaving no stone unturned. And in *Atmospheric Diving Systems Inc. v. International Hard Suits Inc.*,¹⁹ the principles of best efforts were described as clearly imposing a higher standard than reasonable efforts, taking all reasonable steps to achieve the objective in good faith.

However, the court did take pains to note that although everything “known to be usual, necessary and proper for ensuring the success of the endeavour” was required, that was not to say that the meaning of best efforts was boundless. The terms of the particular contract, the parties, the overall purpose of the contract, are all to be considered. Nevertheless, best efforts in Canadian jurisdictions is definitely a higher standard than reasonable efforts.

How to Work with these Unruly Concepts in Lease Negotiations

A prudent lease negotiator will want to avoid ambiguity and onerous terms. Considering that good faith in the performance and enforcement of leases will be expected on both sides of the border, the idea that either party to a contract can get away with behaving in a manner that respects only its own best interest is probably outdated. Indeed, it could very well be unnecessary to prescribe specific contractual duties to act reasonably; the standard may be imbued in the duty to act in good faith.

However, where pure discretion or even arbitrariness is desired, or where in the case of making efforts, the highest of standards is to be exacted, parties must ensure the language of the contract explicitly expresses these intentions, and must be mindful of the construction courts may give to certain terminology.

¹ Uniform Commercial Code [Hereinafter “UCC”].

² *Restatement (Second) of Contracts* § 205 (1979).

³ LRQ, c C-1991.

⁴ [1991] N.S.J. No. 362 [Hereinafter *Gateway Realty*].

⁵ [2005] A.J. No. 1608.

⁶ 2004 BCSC 45.

⁷ *Supra*, note 3.

⁸ Mark A. Senn, Esq., *Commercial Real Estate Leases: Preparation, Negotiations, and Forms, Fifth Edition* § 11.08 The Covenant of Good Faith and Fair Dealing in Leases (Use Provisions) (2011).

⁹ *The Kirke La Shelle Company, Appellant, v The Paul Armstrong Company et al Respondents*, 1933 N.Y. LEXIS 802.

¹⁰ *Dobb v Insurance Corp. of British Columbia*, [1991] BCJ No 2418.

¹¹ [1985] O.J. No. 2539.

¹² 2005 U.S. Dist. LEXIS 16825.

¹³ 2011 N.Y. Misc. LEXIS 3564.

¹⁴ 225 F.Supp.2d 6 (DDC 2002).

¹⁵ *Coady Corp. 495 v Toyota Motor Distributors Inc.*, 361 F.3d 50, 61 (1st Cir. 2004).

¹⁶ 2005 U.S. Dist. LEXIS 141.

¹⁷ *364511 Ontario Ltd. V Darena Holdings Ltd*, [1998] OJ No 603 (Ont Gen Div).

¹⁸ (1911), 27 TLR 451.

¹⁹ [1994] 5 WWR 719.