

# The Application of the Bhasin Principle of Good Faith: An Early Example

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In its November 13, 2014 landmark decision of *Bhasin v Hrynew*, the Supreme Court of Canada established that a general principle of good faith underlies Canadian contract law. The good faith principle requires that the parties to a contract "perform their contractual duties honestly and reasonably and not capriciously or arbitrarily."<sup>[1]</sup> Describing the application of the vague standard of honesty, Cromwell J., writing for a unanimous court, explained that honesty requires that parties to an agreement "not lie or otherwise knowingly mislead each other about matters directly linked to the performance of the contract."<sup>[2]</sup>

A recent decision from the Supreme Court of British Columbia (the "Court") provides an early example of how courts will apply the principle and duties established in *Bhasin*. In its December 23, 2014 decision of *0856464 B.C. Ltd. v TimberWest Forest*, the Court relied heavily on *Bhasin* to determine that the defendant, TimberWest Forest Corp. ("TimberWest"), failed to negotiate annual timber fees in good faith in breach of its contractual obligations.

## The Facts in 0856464

In *Bhasin* Cromwell J. stressed that a determination of good faith "calls for a highly context-specific understanding of what honesty and reasonableness in performance requires so as to give appropriate consideration to the legitimate interests of both contracting parties."<sup>[3]</sup> Accordingly, a significant portion of the *0856464* decision was dedicated to establishing context by distilling the facts to determine the motives and interests of the parties.

Briefly, the dispute in *0856464* stemmed from two five year-agreements entered into in 2004 between TimberWest and Munns Lumber (1956) Limited ("Munns") which governed timber harvesting by Munns on two of TimberWest's woodland plots. The agreements set the harvesting rates charged by Munns for the first year, while for each subsequent year the agreements provided that the parties were to negotiate in good faith to agree upon rates payable. If the parties were unable to agree on new rates, either party could terminate the agreement with 90 days' notice.

Ultimately this is what happened. Unable to reach an agreement on new rates for 2008, TimberWest terminated the contract. The plaintiffs (the assignee in bankruptcy to Munns, among others) alleged that by 2007 TimberWest had determined that subdividing the harvesting rights to the woodland plots would be more profitable than the arrangement

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with Munns. It was alleged, therefore, that TimberWest developed a strategy to reach an impasse in the negotiation of rates thereby violating its contractual obligation to negotiate new rates in good faith.

### **Determination of Good Faith**

With reference to *Bhasin*, the Court asked what the standard of good faith was in the 2008 negotiations and, secondly, whether TimberWest breached this standard.

Although the parties were obligated to negotiate in good faith, the term was not defined in the agreements. Therefore, the Court adopted the standard of good faith articulated in *Bhasin*, namely, that the parties perform their contractual duties "honestly and reasonably and not capriciously or arbitrarily."<sup>[4]</sup>

After considering the overriding interests and strategies of the parties during the negotiations, the Court concluded that TimberWest had not met its obligation to negotiate honestly and reasonably.<sup>[5]</sup> The Court held that TimberWest had an active strategy to further subdivide the woodland plots and that the success of this strategy was dependent on the termination of the agreements. In reaching this conclusion, the Court put weight on the fact that TimberWest's pattern of negotiation changed dramatically in 2008, including the offering of lower timber rates and shortening the negotiations relative to previous years, "suggesting a different intention" on the part of TimberWest.<sup>[6]</sup>

The Court considered TimberWest's argument that it had met the standard of good faith by offering Munns harvesting rates that were consistent with those prevailing in the market.<sup>[7]</sup> The Court dismissed this, noting that in the context of the parties' relationship, TimberWest knew that Munns could not have performed its services at the offered rates.<sup>[8]</sup>

In short, the Court held that an honest and reasonable approach to the negotiation would have required that TimberWest not put a strategy to terminate the contracts for a collateral benefit ahead of a good faith attempt to reach an agreement on the timber rates.<sup>[9]</sup>

### **Damages and Indemnification**

Damages of \$1,736,071 were awarded to the plaintiffs for breach of contract, calculated on the basis of what likely would have been earned had the contracts been properly performed.<sup>[10]</sup>

The plaintiffs argued that an indemnity provision in the agreements in which TimberWest agreed to indemnify Munns against all losses suffered or incurred by Munns arising in any manner whatsoever from a breach of the agreement entitled the plaintiffs to other damages for claims arising from the defendant's breach of contract, including as a result of certain bank loans and guarantees that Munns defaulted on. The Court rejected this claim, relying on case law to support the position that the availability of indemnification under an indemnity clause requires an "unbroken chain of causation" between the breach and the resulting damages, and that this causal connection could not be drawn in respect of the other damages.<sup>[11]</sup>

### **Conclusion**

Any party to any contract should be alert to the potential significant damages for breaching the new general standard of good faith. A contractual obligation of good faith does not preclude a party from acting in its own interests, but does require appropriate

regard for the other parties' interests and does not permit acting in a manner that would eviscerate the very purpose of the contract.

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[1] *Bhasin v Hrynew*, 2014 SCC 71 [2014], at 63 ("*Bhasin*").

[2] *Ibid*, at 73.

[3] *Ibid*, at 69.

[4] *0856464 B.C. Ltd. v TimberWest Forest*, 2014 BCSC 2433 (CanLII), at 183 ("*0856464*").

[5] *Ibid*, at 308.

[6] *Ibid*, at 297.

[7] *Ibid*, at 303.

[8] *Ibid*.

[9] *Ibid*, at 306.

[10] *Ibid*, at 373, 374 and 417.

[11] *Ibid*, at 388-392.