

# ‘WHY’D YA DO IT?’ THE SUPREME COURT OF CANADA EXPLAINS THE DUTY TO EXERCISE CONTRACTUAL DISCRETION IN GOOD FAITH

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The Supreme Court of Canada (“**SCC**”) recently released its long awaited decision in [Wastech Services Ltd v Greater Vancouver Sewerage and Drainage District](#) (“**Wastech**”).<sup>[1]</sup>

The decision is the first time the SCC has provided guidance on the scope of the duty to exercise discretionary contractual powers in good faith. Significantly, *Wastech*:

- Confirms that the duty to exercise discretionary contractual powers in good faith, like the duty of honest contractual performance, applies to all contracts and cannot be excluded by the parties;
- Clarifies that the duty is breached where a party exercises a contractual power “unreasonably”, meaning in a manner not connected to the underlying purposes for which the discretion is granted;
- Mandates that when ascertaining whether an exercise of discretion is unreasonable, and therefore a breach of the duty, the court must interpret the contract (the “first source of justice between the parties”) as a whole. The content of the duty is guided by the intentions of the parties as expressed in their agreement. Where discretion is exercised in a manner that falls “outside the compass set by contractual purpose”, it is unreasonable and constitutes a breach of the duty. Conversely, where discretion is exercised in a manner consistent with the purposes for which it is granted, it is reasonable and does not breach that duty. In other words, the measure of fairness is what is reasonable according to the parties’ contract, and not what a court may regard as fair, moral or reasonable in the abstract;
- Recognizes that the fact that a party’s exercise of discretion causes its counterparty to lose some, or even all, of the anticipated benefit under the contract, is not the standard for determining a breach of the duty. While this can be relevant to show that discretion was exercised unreasonably, it is not a necessary precondition to finding a breach of the duty; and
- Confirms that the common law recognizes that competition between parties regularly involves each of them taking steps to promote their interests at the expense of the other, and that, far from prohibiting such conduct, the law seeks to encourage and protect it. This leaves room for the aggressive pursuit of

self-interest and prevents the law of good faith from veering into judicial moralism or “palm tree justice”. The role of the courts must only be to ensure parties exercise contractual discretionary powers in ways that are connected to the purpose(s) for which such powers are granted.<sup>[2]</sup>

Applying these principles, the SCC concluded that the defendant in *Wastech* did not exercise the discretionary power at issue unreasonably, and therefore, no breach of the duty to do so in good faith occurred.

### **Background: Uncertainty Regarding the Exercise of Contractual Discretion Following *Bhasin***

The duty to exercise contractual discretion in good faith is well-established in Canadian common law. In *Bhasin v Hrynew* (“*Bhasin*”), the SCC recognized ‘good faith’ as a general organizing principle of contract law that requires a party to a contract to have “appropriate regard to the legitimate interests of the contracting partner.”<sup>[3]</sup> This principle requires parties, at minimum, to perform their contractual duties, and exercise their contractual rights, “honestly, reasonably, and not capriciously or arbitrarily.”<sup>[4]</sup> The general organizing principle is manifest in specific doctrines of good faith, including the duty to exercise contractual discretion in good faith.

In *Bhasin*, the SCC explained that “appropriate regard” will vary depending on the context of the contractual relationship. It did not set out, however, a standard for the exercise of contractual discretion. This left uncertainty as to whether the duty of good faith could limit a party’s freedom to exercise its discretion in its own commercial interest where doing so would deprive the other party of an anticipated benefit under their agreement or cause them a loss. This issue came squarely before the SCC in *Wastech*.

### **The Facts in *Wastech***

The Plaintiff, Wastech Services Ltd. (“**Wastech**”), provides waste transportation and disposal services to the Greater Vancouver Sewerage and Drainage District (referred to in the decision as “**Metro**”) under a 20-year long-term agreement the parties entered into in 1996. The agreement is complex and resulted from lengthy negotiations.<sup>[5]</sup> Among other things, it gives Metro the “absolute discretion” to direct waste to any of three disposal sites. Metro paid Wastech different rates depending on the disposal site to which Metro directed waste be hauled (and how far away the site was located).

Wastech’s compensation under the agreement was tied to a “target operating ratio” that was based on historical performance (the “**Target OR**”). Wastech’s ability to achieve the Target OR depended in part on the allocation of waste between the three disposal sites, one of which attracted a higher rate due to its greater distance from Vancouver. During their negotiations, the parties considered the possibility that Metro would reallocate waste to the more cost-efficient sites. They understood that such reallocation would likely preclude Wastech from achieving its Target OR but declined to include express protections for Wastech in such

event.<sup>[6]</sup>

For the 2011 year, Metro directed Wastech to reallocate a portion of waste from a disposal site located further away (and more lucrative for Wastech) to the two sites that were closer, resulting in Wastech recording an operating profit that was well short of its target. Wastech commenced an arbitration against Metro for breach of contract. It alleged, among other things, that Metro breached its duty to exercise its contractual discretion in good faith by reallocating the waste between sites in a manner that precluded it from achieving its Target OR, and sought damages of approximately \$2.9 million.<sup>[7]</sup>

### **The Arbitrator's Decision**

In arbitration, Wastech conceded that the agreement provided Metro the “absolute discretion” to allocate waste among the three disposal sites. It claimed, however, that Metro’s decision constituted a breach of contract in two respects. First, Wastech argued that the contract contained an implied term providing for a retroactive rate adjustment if the Target OR was not achievable because of Metro’s waste allocation. Second, Wastech argued that the duty of good faith prohibited Metro from exercising its discretion in a manner that precluded Wastech from achieving the Target OR.<sup>[8]</sup>

The arbitrator dismissed Wastech’s implied term argument, finding that the parties had turned their minds to the possibility that Metro would reduce the waste flows to the more expensive site during their negotiations but decided not to include any provision to address that risk. Regarding Wastech’s second argument, the arbitrator accepted that Metro had no malign purpose in making its reallocation decision and held that the basis for its conduct was in furtherance of its own honest and reasonable business objectives. However, the arbitrator concluded that Metro’s behavior lacked “appropriate regard” for Wastech’s legitimate contractual interests and was, in effect, “dishonest”.<sup>[9]</sup>

The arbitrator interpreted the duty of good faith in *Bhasin* to prevent Metro from exercising its contractual discretion in a manner that is “wholly at odds with the legitimate contractual expectations” of Wastech. Accordingly, the arbitrator found that Metro failed to consider Wastech’s expectation that Metro would not exercise its discretion in a way that would prevent Wastech from achieving the Target OR.

### **The Lower Courts Set Aside the Arbitrator's Decision**

Metro appealed the arbitrator’s decision to the British Columbia Supreme Court (“**BCSC**”) on the basis that the arbitrator misapplied the organizing principle of good faith set out in *Bhasin*. The BCSC allowed the appeal, holding that the duty of good faith does not impose an obligation to have “appropriate regard” for the interests of the other contracting party unless specifically agreed to by the parties.<sup>[10]</sup> By restricting Metro’s discretionary contractual power, the arbitrator effectively ignored a contractual provision reached between two

sophisticated parties who chose to exclude a term that might have provided Wastech with additional protection.<sup>[11]</sup>

Wastech then unsuccessfully appealed to the British Columbia Court of Appeal (“**BCCA**”). The BCCA agreed with the BCSC’s ruling but substituted its own findings regarding the arbitrator’s decision. Among other things, the BCCA held that a breach of the duty of good faith requires some subjective element of dishonesty, untruthfulness, improper motive or “bad faith”.<sup>[12]</sup> Wastech then appealed to the SCC.

### **The SCC Dismissed Wastech’s Appeal**

A six-justice majority of the SCC dismissed Wastech’s appeal, with a three-justice minority concurring in the result. In doing so, they set out important guidance as to how the duty of good faith affects contractual discretionary powers. Significantly, both the majority and minority held that the duty of good faith is offended where a discretionary power is exercised in a manner that is unconnected to the purpose(s) for which it was granted in the relevant agreement.

#### ***The Majority Decision***

As a preliminary point, the majority noted that Metro had not breached its duty of honest contractual performance (a separate legal doctrine within the organizing principle of ‘good faith’). The majority generally agreed with the BCCA that a breach of the duty of good faith must include some subjective element of dishonesty. Metro had not, however, lied or otherwise knowingly misled Wastech about its discretionary power to allocate waste between the different sites.<sup>[13]</sup>

The SCC also disagreed with Wastech’s argument that Metro breached the duty of good faith by unreasonably exercising its discretion to reallocate waste between disposal sites in a manner that substantially nullified Wastech’s ability to make a profit.

The majority held that “substantial nullification” of a contractual benefit or advantage is not the appropriate standard for assessing whether a party has breached its duty to exercise discretionary powers in good faith.<sup>[14]</sup>

The majority went on to note that the fact that a party’s exercise of discretion may cause its counterparty to lose some or even all of its anticipated benefit under the agreement is not dispositive of whether that power was exercised in good faith (though it may be relevant to that question).<sup>[15]</sup>

Instead, a party must show that an exercise of discretion is unreasonable in the sense that it is outside the bargain struck between the parties. In other words, for a party to exercise its discretionary power in good faith, it must do so consistently with the *purpose(s)* for which the discretion was granted.<sup>[16]</sup> Where the exercise of discretion “stands outside the compass set by contractual purpose”, it will be unreasonable and a breach of the duty of good faith.<sup>[17]</sup>

Determining the reasonableness of a party's exercise of contractual discretion is an interpretive exercise. Sometimes, the text of the discretionary provision will make its purpose clear.<sup>[18]</sup> In other circumstances, the purpose can only be understood by reading the clause in the context of the contract as a whole. The majority cited approvingly from an English authority for the proposition that courts "must construe the ambit" of a discretionary power where it is entirely general: they must "form a broad view of the purposes of the venture to which the contract gives effect".<sup>[19]</sup> This appears to mean that courts should look to the overall purpose of the parties' agreement rather than just the purpose of the discretionary provision.

Importantly, the legal test does not involve examining whether an exercise of discretion was "morally opportune or wise".<sup>[20]</sup>

The majority noted that, as a general guide, clauses that restrict the exercise of a discretionary power on the basis of objective criteria (such as operative fitness, structural completion, mechanical utility or marketability) will give rise to a smaller range of reasonable discretionary outcomes than clauses that do not (such as matters involving taste, sensibility, personal compatibility or subjective judgment).<sup>[21]</sup>

The majority found that Metro's reallocation of waste was consistent with the purposes for the discretionary power in the agreement. Reviewing the agreement as a whole (including the recitals, which described the intentions of the parties as including: to incentivize each other to "maximize efficiency and minimize costs" and to provide for the "maximization of the municipal solid waste disposal capacity [at the disposal site that was further away from Vancouver]"), the majority concluded that the purposes underlying Metro's discretion were clear: to give it the flexibility required to structure the disposal of waste in an efficient and cost effective manner.<sup>[22]</sup>

The majority also noted that Metro's discretion exists alongside a contractual framework to adjust payments towards the goal of a negotiated level of profitability – which contradicts Wastech's argument that the parties intended the discretion to be exercised in a way that provided Wastech with a certain level of profit. Moreover, the contract did not guarantee Wastech would achieve the Target OR in any given year and the complex adjustment mechanism contained therein, which only applied where its actual operating revenue for a given year deviates from the Target OR, demonstrates the parties understood the Target OR would not be achieved in some years.<sup>[23]</sup>

Based on the above, the majority concluded that the purposes of the discretion was to give Metro leeway, based on its judgment as to what was best for itself, to adjust the allocation of waste among the three sites as required to ensure efficiency of the operation. Significantly, the SCC confirmed that the duty does not require Metro to subordinate its interests to those of Wastech. Metro will have complied with the duty of good faith as long as it exercised the discretion in a manner consistent with the purposes in the agreement. While Metro's

choice was disadvantageous to Wastech, it was within the range permitted by the purposes of the clause. Because Metro exercised its discretion within the range of conduct contemplated by the purposes for the clause, the court concluded it acted reasonably and did not breach the duty of good faith.<sup>[24]</sup>

### ***The Minority Decision***

The three concurring justices agreed with the majority that the purpose of a discretionary power is the proper focus of the good faith analysis, and that Wastech's appeal should be dismissed. They departed from the majority on a few issues, including the scope of the reviewing court's interpretative exercise in identifying the purpose of a discretionary power.<sup>[25]</sup> Importantly, they held that a discretionary power should only be limited by its purpose "where the purpose of a discretionary power arises from the terms of the contract, construed objectively, having regard to the factual matrix". In other words, they would prefer a narrower focus on the text and context of the agreement to determine the purpose of the discretion. They would reject the majority's view that a court must "form a broad view of the purposes of the venture to which the contract gives effect".<sup>[26]</sup> The minority were steadfast in their view that the purpose for a discretionary power must always be defined by the parties' intentions, "as revealed by the contract".<sup>[27]</sup> The parties have the freedom to immunize themselves from review by the courts by careful drafting that establishes a standard for exercising discretion. Where parties have granted unfettered discretion, there is no obligation on the discretion-exercising party to subvert its interest in favour of the other party.

### **Key Takeaways**

- Parties must exercise contractual discretionary powers in good faith. This duty, like the duty of honest contractual performance, is not an implied term but rather a general doctrine of law that applies to all contracts. Parties cannot contract out of this duty by, for example, using the term "absolute and sole discretion" or words to that effect.
- The duty to exercise discretionary powers in good faith is breached where the exercise of discretion is "unreasonable", in that it is unconnected to the purpose(s) for which the discretion was granted. In this regard, *Wastech* provides some much needed clarity and certainty as to when the duty may be found to have been breached, and when it will not.
- What is "reasonable" is highly context-specific and depends primarily on the intention of the parties as disclosed by the language of their contract, not general notions of fairness or morality. The court will examine the contract as a whole to ascertain the purpose(s) for which discretion is granted, and thereby delineate the boundaries for assessing whether such discretion was exercised in a reasonable manner. As the SCC put it: "Good faith does not eliminate the discretion-exercising party's power of choice. Rather, it simply limits the range of legitimate ways in which a discretionary power may be exercised in

light of the relevant purposes”.<sup>[28]</sup>

- An exercise of discretion will be regarded as unreasonable (and therefore, contrary to the duty of good faith) if it is arbitrary or capricious, made for purposes extraneous or collateral to the contract, or where it is unconnected to the purpose(s) for which the contract granted the discretion (where it can be said to stand “outside the compass set” by the contract).
- By contrast, an exercise of discretion will be regarded as reasonable (and therefore consistent with the duty of good faith) where it is consonant with the purpose(s) for which such discretion was granted. Such an exercise of discretion will not violate the duty simply because it is motivated by self-interest, causes loss to the other party or is against the other party’s commercial interests.
- Moreover, whether a party’s exercise of discretion substantially nullifies or eviscerates an anticipated benefit of its counterparty is not the standard for determining whether the duty is breached. While this may be relevant to whether a party acted unreasonably, it alone is not a precondition to finding a breach of the duty.
- The duty does not require parties to provide their counterparties with benefits not contemplated by the contract, and cannot be used as a tool to rewrite contracts. Further, it does not require parties to put their counterparties’ interests before their own, or require them to act as a fiduciary. The loyalty required by the duty is loyalty to the *bargain*, (meaning the contractual purpose(s) for which the discretion is granted), not loyalty to one’s contractual counterparty.<sup>[29]</sup>
- Generally, the range of reasonable outcomes will be relatively smaller where the discretionary power at issue is susceptible to objective measurement. By contrast, where the discretion at issue is not readily susceptible to objective measurement, the range of reasonable outcomes will be relatively larger.<sup>[30]</sup>
- Although parties cannot contract out of the duty to exercise discretionary powers in good faith, they can to a large extent immunize the exercise of such powers from court review through careful drafting. Parties are accordingly advised to set out, in clear and express contractual terms, the circumstances in which discretion is to be exercised, the purpose(s) for which discretion is to be exercised and the breadth of such discretion. This may be accomplished in the discretion-granting clause itself, or elsewhere in the agreement such as the recitals. Recital clauses may be used, as they were in *Wastech*, as evidence of the parties’ intentions regarding both the purpose(s) of the contractual arrangement as a whole as well as those relating to specific discretion-granting provisions.

[1] 2021 SCC 7. The *Wastech* case is the second of two SCC decisions in 2021 revisiting the duty of good faith in contracts that that was recognized in *Bhasin v Hrynew*. The SCC heard the *Wastech* case together a companion case, *C.M. Callow Inc. v. Tammy Zollinger et. al* (“**Callow**”), which addressed the duty of honest contractual performance. Our commentary on the *Callow* case is available [here](#).

[2] The *Wastech* decision also presented the SCC with the opportunity to consider the standard of review

applicable to appeals of commercial arbitration awards. The majority, however, declined to do so, noting that the parties did not make submissions on that point and, in any event, the outcome of this appeal did not turn on whether the standard is reasonableness or correctness.

[3] *Bhasin*, 2014 SCC 71 at para 65.

[4] *Ibid* at paras 63-64.

[5] *Greater Vancouver Sewerage and Drainage District v. Wastech Services Ltd.*, 2018 BCSC 605 at para 8.

[6] *Wastech*, *supra* note 1 at para 14; 2018 BCSC 608 at para 19.

[7] *Wastech*, *supra* note 1 at para 18.

[8] *Ibid* at para 20.

[9] *Ibid* at para 24.

[10] *Greater Vancouver Sewerage and Drainage District v. Wastech Services Ltd.*, 2018 BCSC 605 at para 56.

[11] *Wastech*, *supra* note 1 at para 33.

[12] *Ibid* at para 40.

[13] *Ibid* at para 56.

[14] *Ibid* at para 82.

[15] *Ibid* at paras 83-84.

[16] *Wastech*, *supra* note 1 at para 69.

[17] *Ibid*, at para 71.

[18] *Ibid*, at para 72.

[19] *Ibid*, at para 72, citing P. Sales “Use of Powers for Proper Purposes in Private Law”, (2020), 136 LQR 384 at p. 393.

[20] *Ibid*, at para 73.

[21] *Wastech*, *supra* note at para 77.

[22] *Ibid*, at paras 97-98.

[23] *Ibid*, at paras 99 and 103.

[24] *Wastech*, *supra* note 1 at paras 104-106.

[25] The concurring minority’s reasons also addressed the appropriate standard of review on appeal from an arbitrator’s decision, the usefulness of comparisons with notions of good faith under Quebec *Civil Code* and the majority’s reference to the duty of honest performance, which are not discussed in this bulletin.

[26] *Wastech*, *supra* note 1 at paras 72 and 132.

[27] *Ibid*, at para 133 [emphasis added].

[28] *Wastech*, *supra* note 1 at para 75.

[29] *Ibid*, at para 107.

[30] *Ibid*, at para 77.

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### **A Cautionary Note**

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.

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