

Wastech and discretion: The Supreme Court of Canada on the duty to exercise contractual discretion in good faith

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Good faith requires a party to exercise contractual discretion reasonably, and not in a manner unconnected to the purposes for which it was granted – even when the contract on its face provides for unfettered discretion. So said the majority of the Supreme Court of Canada (the SCC) in *Wastech Services Ltd v Greater Vancouver Sewerage District* (2021 SCC 7). (*Wastech* was heard alongside a companion case, [which Osler commented on here](#).) In *Wastech*, the SCC sought to clarify the scope of the duty to exercise contractual discretionary powers in good faith previously recognized in *Bhasin v. Hrynew* (2014 SCC 71). In dismissing the appeal, the SCC held that the defendant did not breach the duty of good faith, even though the defendant's actions effectively deprived the plaintiff of profits under the contract, because the impugned conduct fell within the scope and purpose of the discretion bargained for by both parties. The majority of the SCC held:

- Discretionary powers under a contract must be exercised reasonably and in a manner connected with the purpose for which the discretion was granted.
- An unreasonable exercise of discretionary power is one that falls outside of the range of choices connected to this underlying contractual purpose, and is a breach of the duty of good faith.
- Where the text of the discretionary provision does not explicitly state the purpose for the grant of discretion, such purpose may be ascertained from the contract, interpreted as a whole.
- Depending on the terms of the contract and the purpose underlying the grant of discretion, “reasonable” may still mean “for one party’s exclusive economic benefit.” Indeed, even an exercise of discretion that substantially nullifies the other party’s expected benefits under a contract (a standard put forward in prior cases) may be reasonable in the context of the parties’ bargain.
- Parties cannot contract out of this obligation. Even seemingly unfettered discretion must be exercised reasonably within the purpose of the grant of the discretion.

Facts

In 1996, the Greater Vancouver Sewerage and Drainage District (Metro) entered into a 20-year services contract with Wastech Services Ltd. (Wastech) for the transport of waste. Wastech was to transport waste to three disposal facilities: Vancouver, Burnaby, and Cache Creek. Wastech earned different haulage rates depending on where waste was transported: lower, short-haul rates for transport to Vancouver and Burnaby, and a greater long-haul rate

for transport to Cache Creek. The contract specifically granted Metro “absolute discretion” to allocate waste among the facilities. The contract contained an arbitration clause.

Payment under the contract was determined by reference to: (i) Wastech’s actual operating profit (the Actual OR); (ii) the “Target Operating Ratio” (the Target OR), which codified a target operating profit of 11%; and (iii) an established range or “band” of actual operating profit on either side of the Target OR. If Wastech’s Actual OR fell within the band but was higher or lower than the Target OR, the parties agreed to split the overage or shortage equally through an “adjustment payment.” If Wastech’s actual operating profit for one year fell outside the band (i.e., either significantly lower or significantly higher than the Target OR), Wastech would either receive or pay an “outside band adjustment” to bring the next year’s projected earnings to within the band.

Importantly, the contract never guaranteed that Wastech would achieve the Target OR. Indeed, in negotiating the contract, both parties were aware that scenarios could arise which would preclude Wastech from achieving the Target OR. Both parties believed that such a scenario was highly unlikely, and the parties agreed not to include an adjustment provision dealing with that scenario.

In 2011, based on its own internal business and economic considerations, Metro changed the waste allocation, sending more waste to Vancouver and Burnaby and much less to Cache Creek. This change lowered Wastech’s haulage fees and reduced Wastech’s Actual OR to 4%, after adjustments, which was well below the Target OR of 11%.

Wastech initiated an arbitration, arguing (in part) that Metro’s conduct breached the contract by failing to have appropriate regard for its legitimate contractual interests, which it alleged violated the organizing principle of good faith. Wastech sought damages that would bring its operating profit up to the Target OR.

The arbitral award and appeals

Applying the SCC’s then-recent decision in *Bhasin*, the arbitrator found that discretionary powers under a contract must be exercised in good faith and with “appropriate regard for the legitimate contractual interests” of the counterparty. The arbitrator further held that, although Metro’s reallocation of waste was honest and reasonable from Metro’s perspective, Metro exercised its discretionary power without appropriate regard for Wastech’s legitimate expectations. Metro therefore breached the duty of good faith and was ordered to pay Wastech damages representing its lost opportunity to achieve the Target OR.

On appeal, the Supreme Court of British Columbia determined that there was no contractual basis for the finding that Metro failed to have appropriate regard for Wastech’s commercial interests and set aside the arbitrator’s award. The British Columbia Court of Appeal dismissed the subsequent appeal.

The Supreme Court of Canada’s decision

Both the majority and the concurring judges of the SCC dismissed the appeal. Nevertheless, in doing so the SCC clarified a duty on all contracting parties to exercise discretionary powers under a contract “reasonably.” Like the duty of honest contractual performance, which the SCC had recognized in *Bhasin* and reiterated recently in *C.M. Callow Inc v Zollinger* (2020 SCC 45), this duty springs from the organizing principle of good faith that applies to all contracts at common law. This organizing principle is not an implied term and therefore cannot be contracted out of.

The duty to exercise contractual discretion in good faith is breached where such discretion is exercised “unreasonably.” Regardless of the breadth or content of the discretionary power, and even where the discretion is apparently unfettered, all exercises of contractual discretionary power are constrained by the duty of good faith. The duty requires the party exercising discretion to act “reasonably.” A party who exercises its discretion unreasonably breaches its contractual obligations.

The majority held that an “unreasonable” exercise of discretion is one unconnected to the purpose underlying the grant of discretion. Where that purpose is not clear from the text of the discretionary provision itself, courts may construe the purpose by looking to the contract as a whole. Where the grant of discretionary power is capable of objective measurement (such as matters relating to “operative fitness, structural completion, mechanical utility or marketability”), the range of possible “reasonable” outcomes will be smaller than where the discretionary power is subjective or less amenable to objective evaluation.

Importantly, the majority of the SCC rejected the theory that a party may not exercise its discretion to “substantially nullify” the benefit of the contract for the counterparty. This was a standard that had been articulated in prior cases and was relied upon by Wastech on appeal. Conduct that has this effect may nonetheless be consistent with the purpose of the parties’ bargain and the grant of discretionary power. However, the fact that the exercise of a discretion nullifies the benefit of the contract may be relevant as an evidentiary matter in demonstrating that the discretion has been exercised in a manner unconnected to the relevant contractual purposes.

Also key is the SCC’s confirmation (consistent with *Bhasin* and *Callow*) that the duty of good faith is not tantamount to a fiduciary obligation. Thus, the duty of good faith did not require Metro to subordinate its interests to those of Wastech in exercising its discretionary powers. A contract may allocate discretionary powers to allow each party to pursue its own self-interest, even if the exercise of discretion causes loss or harm to the other party. The majority also stressed repeatedly that the duty of good faith is not intended to confer unbargained-for benefits on contracting parties.

Applying these principles to the facts of this case, the SCC concluded that Metro exercised its discretion reasonably. No deception or arbitrary conduct was alleged beyond Metro acting in its own self-interest. While the discretionary provision did not specify a purpose, the majority analyzed the contract as a whole, paying particular attention to the recitals, and considered the negotiations leading up to the contract to construe the purpose of the provision. The recitals described the parties’ common intention to “maximize efficiency and minimize costs,” signalling that the purpose of the provision granting Metro discretion to determine waste allocation at its “absolute discretion” was to allow Metro maximum flexibility to achieve these objectives. Moreover, the parties’ pre-contractual negotiations revealed that Wastech and Metro considered the remote possibility that Metro might allocate very little waste to the Cache Creek facility, but opted not to provide for this eventuality.

The SCC rejected Wastech’s argument, which had been accepted by the arbitrator, that additional or broader duties should apply given the long-term relational aspects of the agreement that arguably required trust and co-operation by the parties. Notwithstanding these considerations, the parties chose to carefully structure their relationship and precisely allocate risk. The contract did not guarantee Wastech the opportunity to achieve the Target OR; in fact, the “adjustment payment” scheme demonstrated clearly that both parties understood that the exercise of discretion by Metro could result, in some years, in the Target OR not being achieved. Although this result was unlikely, the parties chose to allocate this risk to Wastech. In seeking damages that essentially guaranteed the Target OR every year, Wastech was asking for an advantage it did not bargain for, and which it in fact bargained away.

The minority decision, while concurring in the result and agreeing that parties generally

expect that contractual discretion must be exercised reasonably, held that contractual discretion is always defined by the parties' intention. Thus, where a contract discloses a clear intention to grant an unfettered discretion, courts must give effect to that intention.

Practical implications

- **Unreasonable exercises of discretion may constitute a breach of contract, even where the grant of discretion is open-ended or expressly absolute.** It remains to be seen how the majority's decision will be applied to the interpretation of contracts that expressly authorize a party to exercise its discretion without constraint (e.g., "in its absolute discretion," "unreasonably" or "for any reason or no reason"), particularly where the parties can point to such language as being consistent with a clear contractual purpose for structuring the discretion in this way. Indeed, such open-ended language may inform the standard for what constitutes good faith in the circumstances.
- **Clarifying the purpose of discretionary provisions is important.** Since the purpose of a discretionary provision will determine the scope of reasonableness, parties should draft discretionary provisions with care and consider expressly including a statement of purpose in connection with each discretionary provision and other related terms. In exercising discretion pursuant to existing contracts, parties should consider how the reasonableness of such an exercise of discretion might be assessed by a court in light of the recitals to the contract and other contextual factors.
- **In evaluating the purpose of the discretionary power, courts may be prepared to consider extrinsic evidence relevant to the parties' intentions.** The majority in *Wastech* considered not only the terms of the contract itself, but also evidence of the parties' pre-contractual negotiations, despite the presence of an "entire agreement" clause in the contract. However, it does not appear that the admissibility of such evidence was in dispute in *Wastech*.