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## Choices, Choices: What You Now Need to Know about Contractual Discretion

By Marco P. Falco

Since 2014, the Supreme Court of Canada has recognized that all commercial contracts must be performed honestly, in accordance with the principle of good faith: *Bhasin v. Hyrnew*, 2014 SCC 71 and *C.M. Callow v. Zollinger*, 2020 SCC 45.

A recent decision of the Court, *Wastech Services Ltd. v. Greater Vancouver*, 2021 SCC 7, now establishes that good faith includes not only honest contractual performance, but also a duty to exercise any discretion under the contract “reasonably”.

What that may mean for your commercial agreement is a question of fact and interpretation.

### A Wasteful Affair

*Wastech* arose out a commercial agreement between the plaintiff waste disposal service and a statutory corporation that administered waste in the Vancouver region (“Metro”).

The services provided by the plaintiff to Metro over the years were set out in a complex commercial agreement (the “Contract”). Broadly speaking, the Contract provided that the plaintiff would remove and transport waste for Metro to one of three disposal facilities. The plaintiff would receive more compensation for its services if the site chosen by Metro was further away.

Specifically, the plaintiff’s compensation depended on a target operating ratio (“TOR”) which was 0.89, meaning costs amounted to 89% of revenue, leaving a profit of 11%. The Contract, however, in no way guaranteed that the plaintiff would achieve the TOR in any particular year.

The Contract further required Metro to provide the plaintiff each year with a prediction of the allocated waste to be handled in the following year.

Most important, the Contract gave Metro the “absolute discretion” to determine and change the minimum quantity of waste to be transported to a landfill of its choice.

Both parties knew that it was possible that Metro’s exercise of “absolute discretion” could prevent *Wastech* from achieving its TOR. Since both parties assumed such a situation was unlikely, no mechanism was set out in the Contract to address this situation.

In 2011, Metro chose to send waste to a closer location, which had the effect of depriving the plaintiff of reaching its TOR that year. The plaintiff only earned a profit of 4%.

At arbitration, the plaintiff argued that Metro’s discretion to allocate waste between the facilities in 2011 violated the duty of good faith as it deprived the plaintiff of the opportunity to achieve the TOR. The plaintiff sought compensation of \$2.9 million, representing the additional amount of money the plaintiff allegedly would have earned had Metro not breached its duty.

The arbitrator agreed with the plaintiff. Both the British Columbia Supreme Court and Court of Appeal overturned the arbitrator’s decision, holding that recognizing a breach of good faith contradicted the agreement between the parties and extended the legal principle beyond its conceptual boundaries.

The majority of the Supreme Court of Canada upheld the B.C. Court’s decision and set aside the arbitration award.

Reading the Contract as a whole, the Court held that it in no way guaranteed that the plaintiff would achieve the TOR in any given year. The risk that revenues to the plaintiff would vary from one year to the next based on the way Metro exercised its discretion under the Contract was clearly within the parties’ contemplation when they entered into the Contract.

The plaintiff was asking the Court to constrain Metro’s discretion under the Contract “so that it c[ould] achieve a result - an advantage - for which it did not bargain and, in fact, that it might have been said to have bargained away”.

### **What Does Exercising Contractual Discretion in Good Faith Mean?**

In reaching its decision on the facts, the Supreme Court of Canada made a number of important points about the meaning of good faith and its effect on contractual discretion. They are:

#### **1. The duty of honest contractual performance and the duty to exercise contractual discretion in good faith are not the same thing.**

The Court was careful to note that the *Wastech* decision was not about the duty of honest contractual performance established in the *Bhasin* and *Callow* decisions, *supra*. There was no allegation that Metro had lied to the plaintiff in this case.

Rather, *Wastech* concerns another aspect of the principle of good faith which applies to all contracts in Canada: the duty to exercise contractual discretion in good faith.

Accordingly, while honest contractual performance and the exercise of contractual discretion are both informed by the legal principle of good faith, they remain discrete doctrines.

#### **2. Contractual discretion must be exercised “reasonably”.**

The Court noted that a discretionary power in a contract, “even if unfettered”, is necessarily constrained by good faith.

This means the power must be exercised “reasonably”, i.e. not arbitrarily and capriciously. It further means that the discretion must be exercised in a “manner consistent with the purposes for which it was granted in the contract”.

This duty accords with notions of “corrective justice”, which is the foundation of all contractual relations in Canada:

Where a party to a contract exercises its discretion unreasonably, which in this context means in a manner not connected to the underlying purpose of the discretion granted by the contract, its conduct amounts to a breach of the duty to exercise contractual discretionary powers in good faith - a wrongful exercise of the discretionary power - and thus a contractual breach that must be corrected. Requiring a party to pay damages to repair such a wrong accords with the theory of corrective justice and does not amount to a reallocation of the benefits as determined by the parties or [to] a gift from one party to another.

Thus, where the discretion is exercised for an improper purpose, “ulterior or extraneous to” the parties’ intentions, it is exercised in bad faith.

### **3. Good faith does not require one contractual party to subordinate its interests to the other.**

The Court was very careful to narrow the scope of how good faith can constrain contractual discretion. The fact that a party exercises its contractual discretion somehow causes the other party to lose some or all of its anticipated benefit under the agreement is “not dispositive” of whether the duty of good faith has been violated.

Good faith in no way requires a party to confer a benefit on the other party that was not part of the original contract, nor “does it require a party to subordinate its interests to those of the other party”.

### **4. Good faith discretion is a free-standing, contract law doctrine.**

As with the duty of honest contractual performance, the duty of good faith contractual discretion does not depend on the intention of the parties, nor does it depend on implying any terms into the contract itself.

Rather, the doctrine applies to **all** contracts in Canada and is a free-standing legal duty, regardless of how broad the contractual discretion at issue may be.

### **5. The court is confident the duty will not hinder freedom of contract.**

The Court noted that its recognition of a duty to exercise contractual discretion reasonably would not have a significant impact on the principle that contractual parties ought to be free to structure their relations as they best see fit.

The Court’s belief is grounded in two principles:

- Contracting parties will never expect discretion under a contract to be exercised “in a manner unconnected to the purposes for which it was conferred”; and
- Good faith discretion is consistent with the parties’ contractual bargain. The “content of the duty is guided by the will of the parties as expressed in their contract”.

### **A Narrow Doctrine?**

*Wastech* seeks to abate any alarmism caused by the Court’s recognition of a duty of good faith discretion.

The majority of the Court took pains to emphasize that exercising discretion reasonably would have little to no impact on the principle of freedom of contract: no one would ever expect that they have entered into a contract where one party has the power to make choices that could affect them in an arbitrary or capricious way. But no one would also expect that they must subordinate their own commercial interests to that of the opposing contracting party either. It’s a fine balance.

There is no doubt that the duty of good faith discretion will inevitably affect how parties structure and operate under their respective commercial agreements. As a free-standing common law doctrine, good faith will curtail how parties behave, even where they expressly enjoy a right of “unfettered” discretion under the agreement that could otherwise be exercised unreasonably.

Knowing their conduct may become the object of judicial scrutiny, commercial parties may very well behave differently now - in a manner that does not necessarily impair their commercial interests, but certainly forces them to consider what it means to act “reasonably”.

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