

The Operating Principle of “Good Faith” in Construction Contracts – Part III

SCC Judgment: Wastech Services Ltd. v Greater Vancouver Sewerage and Drainage

District – The Duty to Exercise Contractual Discretion in Good Faith

The Supreme Court of Canada (SCC) rendered its judgement in the case of *Wastech Services Ltd. v Greater Vancouver Sewerage and Drainage District*¹ on February 5, 2021. In this judgement, the SCC addressed the question of how the organizing legal principle of good faith affects the exercise of contractual discretion. The SCC in *Wastech* noted that the court in *Bhasin v Hrynew*² (the leading case discussing the principle of good faith in contract performance) recognized the existence of a duty to exercise contractual discretion in good faith, however it was not before that court to explore the “source” or “content” of this duty. Thus, it fell on the SCC in *Wastech* to address these matters. In regard to the “source” of the duty to exercise contractual discretion in good faith, the SCC concluded that this duty does not find its source in an implied term, but rather it operates as a general doctrine of contract law which applies to every contract irrespective of the intentions of the contract parties. In regard to the “content” of the duty, the SCC concluded that the duty will be breached where the exercise of discretion is unreasonable, meaning that the exercise is not connected to the purposes for which the discretionary power was granted to the party enjoying it.

This article is a continuation of the article we wrote in November 2020 about the operating principle of good faith in construction contracts, which included a discussion about the judgments rendered by the lower courts in the *Wastech* case; this article can be found at: <http://civiclegal.ca/wp-content/uploads/2020/11/CircuLAWr-Nov-2020-Good-Faith.pdf>. We also recently wrote an article on *C.M. Callow Inc. v Zollinger*³, another recent SCC case on this issue in which the SCC found that there had been a breach of the duty of good faith when a contractual termination clause was exercised; this article can be found at: <http://civiclegal.ca/wp-content/uploads/2021/03/CircuLAWr-Jan-2021-Good-Faith-Part-2.pdf>.

The SCC Judgment in *Wastech*

The Facts

Wastech Services Ltd. (Wastech) and the Greater Vancouver Sewerage and Drainage District (Metro) had a long-standing commercial relationship. Since 1986, they have been entering into contracts for the disposal of waste from the Greater Vancouver Regional District. In 1996, after months of negotiations, the two parties entered into a 20-year contract, which is the contract at issue in this case. The contract contemplated the removal and transportation of waste by Wastech to three disposal facilities. Wastech was to be paid a reduced rate for the transportation of waste to two of the three facilities. The contract gave Metro “absolute discretion” to determine and amend the minimum amount of waste to be transported to the facility associated with a regular rate.

Wastech’s compensation under the contract revolved around a “Target Operating Ratio” (Target OR), which when achieved would generate Wastech an operating profit of 11%. Importantly, the contract did not guarantee that Wastech would achieve the target in any given year. The contract also provided for a scheme of adjustments where the actual operating ratio was higher or lower than the Target OR, with the purpose of ensuring that the parties would share equally the financial consequences of the deviations from the Target OR.

Notably, during negotiations, the parties realized that the waste directed to the facility associated with a regular rate might be reduced, and that one reason for the reduction would be Metro’s decision to redirect the waste to a facility associated with a reduced rate. Both parties understood that such a decision could impede Wastech from achieving the Target OR. Both parties realized that such a scenario was unlikely. In an effort to simplify the contract, the parties agreed to not provide for special adjustments addressing this particular scenario. However, in 2010, this scenario was

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realized. Metro made the decision to redirect waste from the facility associated with a regular rate to a facility associated with a reduced rate. As a result of this re-allocation, even after taking into account the adjustments allowed under the contract, Wastech achieved an actual operating profit of 4%, which was far from the target operating profit of 11%.

Wastech referred this matter to arbitration pursuant to the contract, alleging that Metro breached the contract by allocating waste among the three facilities in a manner that precluded Wastech from achieving its Target OR. One of Wastech's arguments was that Metro's contractual discretion to allocate waste among the three facilities was subject to the duty of good faith, and Metro exercised its power in a manner that breached this duty. This is the argument that was considered by the SCC.

SCC Decision

The SCC reiterated that the court in *Bhasin* recognized as an existing doctrine under the umbrella of the organizing principle of good faith the duty to exercise contractual discretion in good faith. As such, the main question before the SCC was not whether this duty operates in relation to the contract in dispute, but rather what the basis and substance of this duty was.

In seeking to determine the substance of the duty to exercise contractual discretion in good faith, the SCC identified the appropriate measure to ascertain a breach of this duty. The SCC found support of the judgment in *Bhasin* and other Canadian judgments to state that the appropriate measure is reasonableness. The SCC clarified that the concept of reasonableness in the context of contractual discretion implies the exercise of the discretionary power in light of the purpose for which the discretion was granted. According to the SCC, the question to ask is: "was the exercise of contractual discretion unconnected to the purpose for which the contract granted the discretion?"⁴ If the answer is affirmative, the duty to exercise contractual discretion in good faith has been breached. The court emphasized that the "touchstone"⁵ for measuring whether a discretionary power was exercised in good faith is the purpose for which it was created, since exercising the discretion in harmony with its purpose is reasonable according to the bargain struck between the parties and reflected in their contract. Such exercise of contractual discretion is viewed as fair between

the parties, and a court should avoid imposing its own view of a fair exercise of the discretion. Conversely, when the exercise of the discretionary power falls outside the range of choices allowed by the purpose for which the power was created, the exercise of the discretion is considered unfair in light of the agreement between the parties, and thus contrary to the requirements of good faith, allowing the courts to intervene.

In some instances, the purpose of the discretionary power will be clear on the face of the provision granting the discretion; on others, the purpose will have to be construed based on the wording of the provision read in the context of the contract as a whole. The SCC suggested that when it is necessary to construe the purpose, one must form a "broad view of the venture to which the contract gives effect, and of what loyalty to that venture might involve for a party to it"⁶, and use the purposes identified as limits on the exercise of the discretionary power.

Importantly, the SCC admonished that the courts are not to scrutinize the morality of the exercise of discretion or question the motives of the exercise. The courts are only to ensure that the discretion was exercised in a manner connected to the purpose for which it was granted. This approach, the SCC noted, gives parties the flexibility to pursue their self-interest since, generally, there will be a range of choices in harmony with the purpose of a given discretionary power.

The SCC further clarified that what is unreasonable is "highly context-specific"⁷, and depends on the parties' intentions as reflected in the contract. To ascertain whether the duty was breached, one is to engage in contractual interpretation to determine the range of behaviour that is in line with the purpose for which the purpose was granted. As a general guide, the SCC advised that when the discretionary power refers to matters that can readily be objectively measured (such as, "operative fitness, structural completion, mechanical utility or marketability"⁸), the range of reasonable behaviour will be smaller; conversely, when the discretionary power refers to matters that cannot be readily objectively measured (such as, "matters involving taste, sensibility, personal compatibility or judgment of the party"⁹), the range will be larger.

The SCC rejected Wastech's argument that "substantial nullification or evisceration"¹⁰ of the benefit conferred by the

contract to a party as a result of the exercise of a discretionary power by the counterparty is an appropriate measure to determine a breach of the duty to exercise contractual discretion in good faith. However, the court conceded that “substantial nullification or evisceration” of the benefit under the contract, while not a necessary prerequisite, could be relevant to show that the discretion was not exercised in a manner connected to the purpose for which the power was granted.

Further, the SCC confirmed that the exercise of discretion “capriciously or arbitrarily”¹¹, in light of the purposes for which the discretion was created, will be a breach of the duty in question, since such exercise of contractual discretionary power would fall outside the range of behaviour contemplated by the parties.

As regards the basis for the duty to exercise contractual discretion in good faith, the court found that the duty is a general contract law doctrine as opposed to an implied contract term and that it operates irrespective of the parties’ intention. The SCC considered that recognizing this duty as a general contract duty interferes little with freedom of contract since: (1) the parties will rarely expect that the discretionary power included in the contract will be exercised in a manner unconnected to the purpose of the power; and (2) being guided by the intention of the parties as reflected in the contract, the duty does not interfere with the will of the parties.

Applying the above propositions to the facts of the case at hand, the SCC found that Metro had not breached the duty to exercise contractual discretion in good faith when it used its discretionary power to re-allocate the waste between the three facilities. The SCC noted that the contract between Metro and Wastech gave Metro “absolute discretion” to determine the minimum amount of waste to be allocated to the facility associated with regular rates. Interpreting the provisions in question in light of the contract as a whole, the SCC concluded that the purpose of giving Metro “absolute discretion”¹² was to secure flexibility to account for variable factors, such as waste volumes, operating costs and capacity of the facilities, in order to maximize efficiency and reduce the costs of operation. Based on this purpose, the SCC found that Metro exercised the discretionary power reasonably, meaning in line with the identified purpose. Metro made the decision to re-allocate waste to maximize the efficiency of one of the facilities associated with a reduced rate and preserve the remaining capacity of the facility associated with a regular

rate. The SCC noted that the duty in issue did not require Metro to subordinate its interest to the interests of Wastech when exercising its discretionary power to allocate waste. The contract did not guarantee that Wastech will achieve its Target OR, the parties understood the risks of the discretionary power and, after lengthy negotiations, decided not to contractually limit this power. The SCC concluded that Wastech was asking for a benefit it did not bargain for and was not contemplated by the contract, either expressly or implicitly. The fact that the contract represented a long-term relational agreement, did not assist Wastech’s position since the parties carefully considered the structure of the contract and the matter at issue was not an unforeseen or unprovided for matter that the parties left to be decided based on trust and cooperation. Ultimately, the SCC noted that the duty did not require Metro to show loyalty to Wastech; the loyalty required was to the bargain.

Key Takeaways

- The duty to exercise contractual discretion in good faith operates irrespective of the parties’ intentions. The parties cannot contract out of this duty;
- The duty to exercise contract discretion in good faith requires the parties to exercise the discretion reasonably. The concept of reasonableness in this context implies the exercise of the discretion for the purpose for which it was granted;
- When the purpose for which the discretion was granted is not clear on the face of the provision granting the discretionary power, the purpose of the power can only be understood by reading the provision in the context of the contract as a whole;
- The duty to exercise contractual discretion in good faith does not allow the parties to exercise the discretion capriciously or arbitrarily;
- The duty does not require the party to be loyal to the interests of the counterparty, or to subordinate its own interest to the interests of the other party when exercising a contractual discretion. Rather, the duty requires the party to be loyal to the bargain struck between the parties and contemplated by the contract; and
- Substantial nullification or evisceration of the

fundamental contractual benefit of the other party as a result of the exercise of a discretionary power by the counterparty, while not a necessary prerequisite, could be relevant to show that the discretion was not exercised in a manner connected to the purpose for which the power was granted.

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¹ *Wastech Services Ltd. v Greater Vancouver Sewerage and Drainage District*, 2021 SCC 7 [*Wastech*]

² *Bhasin v Hrynew*, 2014 SCC 71 [*Bhasin*]

³ *C.M. Callow Inc. v Zollinger*, 2020 SCC 45

⁴ *Supra* note 1 at para 69

⁵ *Ibid* at para 70

⁶ *Ibid* citing Lord P. Sales, *Use of Powers for Proper Purposes in Private Law* at para 72

⁷ *Ibid* at para 76

⁸ *Ibid* citing *Greenberg v Meffert* (1985), 50 OR (2d) 755 at para 77

⁹ *Ibid*

¹⁰ *Ibid* at para 82

¹¹ *Ibid* at para 86 and 88

¹² *Ibid* at para 97

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