

Supreme trash talk: The duty of good faith in contractual discretion clarified in *Wastech*

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Today, in its decision in *Wastech Services Ltd. v. Greater Vancouver Sewerage and Drainage District*¹, the Supreme Court has clarified the limits on the duty to exercise contractual discretion in good faith, ruling that the duty is only breached when a discretionary power is exercised in a manner unconnected to the purpose for which it was granted.

What you need to know

- The Supreme Court has recognized a general duty to exercise contractual discretion in good faith.
 - The duty applies to all contracts as a matter of law; it cannot be excluded by clauses granting “absolute discretion”, or by “entire agreement” clauses.
- The duty will be breached where the exercise of discretion is “unreasonable”; but, what is unreasonable is defined by whether the discretion is unconnected to the purposes for which it was granted.
 - Defining these purposes centres on properly interpreting the contract, not on general notions of fairness or commercial reasonableness.
 - Where a discretion is constrained by an objective measure (e.g., fair market value or a scientific/technical assessment), it will be construed more narrowly than a discretion based on a subjective assessment (e.g., matters involving taste, sensibility, or personal compatibility).
 - To breach the duty, an exercise of discretion need not “nullify” or “eviscerate” the bargained-for benefit under the contract—this stands in contrast to some earlier appellate decisions.
- When drafting contracts, consider being specific as to when a discretion can be applied, the bounds of the discretion, and the purposes of the discretion. Any such clauses will be given significant weight in determining whether the discretion was exercised in good faith.

Background

Greater Vancouver Sewerage and Drainage District (Metro) and Wastech Services Ltd. entered into a complex, 20-year agreement for moving waste from Vancouver to locations in British Columbia. The contract included a “target operating ratio” (ratio of operating costs to revenue) which, if met, would give Wastech an 11% operating profit margin. The contract included a limited profit/cost-sharing mechanism if the ratio deviated from this target.

Under the contract, Metro, at its discretion, could allocate waste between the two landfills and an incinerator. The locations chosen by Metro could have a material impact on Wastech’s operating ratio. In 2011, Metro substantially reduced its waste allocation to one of the landfills and, as a result, Wastech failed to achieve its target ratio. After the cost-sharing mechanism was applied, its operating profit margin dropped to 4%. Wastech commenced an arbitration, arguing that there was an implied term in the agreement that Metro would not deprive Wastech of the possibility of achieving the target ratio and that, by exercising its discretion to shift the waste allocation and refusing to compensate Wastech, Metro breached its contractual duty of good faith.

Lower court decisions

The arbitrator ruled in favour of Wastech. He first found that there was no implied term because the parties had turned their minds to and deliberately rejected such a term during negotiations. But the arbitrator ruled that Metro breached its duty of good faith because it failed to have “appropriate regard” for Wastech’s “legitimate contractual expectation” that Metro would not deprive it of the opportunity to achieve the target ratio. He therefore awarded Wastech compensation for its lost opportunity to obtain its target ratio in 2011.

The lower court ruled that the arbitrator’s decision should be set aside. The BC Court of Appeal agreed. The Supreme Court of Canada heard the appeal in December 2019.

Supreme Court of Canada’s decision

The Supreme Court of Canada unanimously held that Metro had not violated its duty to exercise contractual discretion in good faith. Justice Kasirer wrote the majority judgment for six judges, with Brown and Rowe JJ. writing concurring reasons (with Côté J. concurring).

The Supreme Court’s decision clarified the duty to exercise discretionary contractual powers in good faith. The Court agreed that where a party exercises contractual discretion unreasonably, it is a breach of the duty of good faith. However, what is a reasonable exercise of contractual discretion is defined by the bargain: the terms the parties agreed to and purposes of the discretion. In this case, Metro’s exercise of discretion was not unreasonable and there was no breach.

Contents of the duty to exercise contractual discretion in good faith: reasonableness defined by contract

The duty to exercise contractual discretion in good faith is a well-established principle in Canadian contract law. However, *Wastech* is the first Supreme Court decision to comment on the scope of this duty.

The Supreme Court held that the duty to exercise contractual discretion in good faith requires the parties to exercise their discretion in a manner consistent with the *purpose* for which it was granted in the contract. Where discretion is exercised in a manner that aligns with the purpose of the contract, that exercise of discretion may be characterized as “reasonable” based on the contract the parties had agreed to. However, when the exercise of discretion stands outside the “compass set by contractual purpose”, it will be in violation of the duty to exercise contractual discretion in good faith.

The Supreme Court's test puts the contracting parties in the driver's seat in terms of determining what is a "reasonable" exercise of discretion. Courts may only intervene where the exercise of power is unconnected to the purpose as decided by the parties, based on the contract interpreted as a whole. The measure of fairness is determined by the parties' own bargain, not the Court's objective measure of fairness or justice.

Reasonableness depends on the context

What a court considers reasonable is highly context-specific and ultimately turns on the intention of the parties as expressed by their contract. However, the nature of the discretion is itself relevant. For contracts that grant discretionary power whose subject matter is readily susceptible to objective measurement (e.g., fair market value or structural completion) the range of reasonable outcomes will be narrower than for contracts that grant discretionary power with regard to more subjective factors (e.g., matters involving taste, sensibility or personal compatibility).

Nullification is not the correct standard for assessing a breach of this duty

Before this decision, the standard of for good faith in contractual discretion was whether the decision "substantially nullified" or "eviscerated" the benefit of a contract for one of the parties. The Supreme Court rejected this standard. The fact that a party's exercise of discretion causes its contracting partner to lose some or even all of its anticipated benefit under the contract is not dispositive. It may be relevant for showing that discretion has been exercised in a manner unconnected to the relevant contractual purposes, but the question ultimately rests on the bargain struck between the parties.

Parties cannot contract out

The duty to exercise discretion in good faith is a general doctrine of contract law. This means that it does not need to be found as an implied term, and parties cannot contract out of the duty. The Court reasoned that this would not interfere with freedom of contract because the limits of the discretion are defined in reference to the parties' common intention as disclosed by their contract.

Reasonableness and good faith applied: Metro could act in its own interests

In this case, Metro's exercise of discretion was not unreasonable. The contract gave Metro the absolute discretion to determine how the waste is to be allocated with no guarantees as to allocation. When read as a whole, the purpose of this contract was clear: to allow Metro flexibility to maximize efficiency and minimize costs of the operation. The fact that there was also a cost-adjustment mechanism undermined Wastech's assertion that it was promised a certain level of profit. The doctrine of good faith in contractual discretion could not give Wastech a guaranteed profit margin that it did not bargain for.

Concurring judgments

Justices Côté, Brown, and Rowe agreed with the majority that Wastech's appeal should be dismissed, but nonetheless wrote that the majority decision would unnecessarily interfere with the freedom of contract. First, the concurrence emphasizes that, with respect to the limits on contractual discretion, the purpose of a discretionary power must arise from the terms of the contract, construed objectively, and not from a broad view of the objectives of the deal or business venture. Second, they advocate for the ability of businesses to agree to permit broad, unfettered discretion in contracts: where parties clearly agree that a discretion can be exercised for any purpose, then courts should give effect to that intention. The majority decision would always place limits on discretion, even where contracts, on their face, grant unfettered discretionary powers.

Practical implications

The Supreme Court's 2014 decision in *Bhasin* did not deal with the duty of good faith in contractual discretion. However, its reference to giving "appropriate regard" to the legitimate contractual expectations of counterparties created a lot of uncertainty in this good faith doctrine. *Wastech* goes some ways to sooth that uncertainty in the name of contractual certainty.

On the one hand, it is now clear that there is a general duty to exercise contractual discretion in good faith. As with the contractual duty of honest performance, it is not possible to contract out of the duty of good faith in contractual discretion, whether through an express absolute discretion or an entire agreement clause. Every exercise of contractual discretion must be reasonable.

On the other hand, *Wastech* confirms that what is reasonable depends on the bargain struck by the parties, not on what a court believes is fair or commercially wise. The terms of the contract and the purposes of the discretion are the benchmarks for determining the limits of a discretionary power. Likewise, the duty to exercise contractual discretion in good faith does not require a party to provide a benefit not contemplated under the contract. Nor does it require a party to put another party's interests ahead of its own.

This deferential approach to the parties' freedom to contract is intended to ensure "some elbow-room" for the "aggressive pursuit of self-interest". In doing so, the Supreme Court preserves the common law tradition of valuing competition and parties' ability to act in their own self-interest when contracting.

In clarifying the duty of good faith, *Wastech* offers some advice in contract drafting. If a discretionary power is drafted in very general terms or lends itself to objective measurement (e.g., clauses granting discretion to determine "fair market value", "operative fitness", or "marketability"), a court may have greater leeway to go beyond the terms of the contract to construe the scope of the discretion. To prevent this, parties should consider clearly articulating in the contract the circumstances in which they want to have discretion, the breadth of that discretion, and the reasons for it. If a party wishes to have broad discretion to do something, such as assign a contract, the terms of the contract should allow a court to conclude that this broad discretion is consistent with the purposes of the commercial arrangement. In this respect, purpose clauses—both in the recitals and in the body of the contract—may be a helpful, clarifying addition to the operative contractual clauses.

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

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