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(Un)Fettered Contractual Rights and Discretion

Canada's Top Court Clarifies the Duty of Good Faith in the Exercise of Contractual Powers

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How can the exercise of seemingly unfettered contractual rights and discretionary powers ever constitute a breach of contract if exercising such a power (even opportunistically) is merely doing what the other party agreed it could do?

Two recent companion decisions of the Supreme Court of Canada have answered this question and clarified two ways in which the organizing principle of good faith constrains the manner in which all contractual rights (including seemingly unfettered rights) are exercised.

First, in *C.M. Callow Inc. v Zollinger*[1] (*Callow*), the Supreme Court of Canada confirmed that the exercise of a seemingly unfettered right under a contract may constitute a breach of the duty of honest performance (and, therefore, a breach of contract) when a party lies or otherwise actively misleads a counterparty about matters directly linked to the performance of the contract. Specifically, the Court clarified that even a seemingly unfettered right to terminate a contract for convenience "cannot be exercised in a manner that transgresses the core expectations of honesty required by good faith in the performance of contracts."[2]

Second, in *Wastech Services Ltd. v Greater Vancouver Sewerage and Drainage District*[3] (*Wastech*), the Supreme Court of Canada confirmed that when a party exercises its seemingly unfettered contractual discretion unreasonably (meaning, in a manner not connected to the underlying purposes of the discretion granted by the contract), it will have breached the duty to exercise contractual discretionary powers in good faith (and, therefore, breached the contract).

Both *Callow* and *Wastech* build on the Supreme Court of Canada's 2014 decision in *Bhasin v Hrynew*[4] (*Bhasin*), in which the Court recognized a general organizing principle of good faith that requires parties to "perform their contractual duties honestly and reasonably and not capriciously or arbitrarily."[5] In *Bhasin*, the Court affirmed that this principle underlies three existing doctrines: (i) the duty to cooperate in the performance of agreements; (ii) the duty to avoid the evasion of contractual obligations; and (iii) the duty to exercise discretionary power in good faith. Moreover, the Court confirmed that this principle can also provide a basis for recognizing further specific rules and, indeed in *Bhasin*, the Court recognized a fourth doctrine: the duty of honest performance. As described in more detail below, *Callow* and *Wastech* explore the application of the duty of honest performance and the duty to exercise discretionary power in good faith.

The key takeaway from these decisions can be summarized as follows: Irrespective of the intention of the parties, the duty of honest performance and the duty to exercise discretionary power in good faith place "limits on how one can exercise facially unfettered contractual rights."[6] When these duties are violated, Canadian courts will find a breach of contract.

The Decision in *Callow*

Background

In 2012, a group of condominium corporations (Baycrest) entered into two contracts with C.M. Callow Inc. (Callow): a winter maintenance contract and a summer maintenance contract.

The winter maintenance contract had a two-winter term, ending in April 2014. However, the contract provided that Baycrest was entitled to terminate that agreement (i) if Callow failed to give satisfactory service in accordance with the terms of the contract, or (ii) upon 10 days' written notice if, for any other reason, Callow's services were no longer required.

In early 2013, Baycrest decided to terminate the winter maintenance contract. However, Baycrest chose not to inform Callow of its decision at that time, so as not to jeopardize Callow's performance under the summer services contract.

Throughout the spring and summer of 2013, Baycrest represented that it was satisfied with Callow's services and would likely renew the winter maintenance contract. During the summer of 2013, Callow performed free services above and beyond the services specified in the summer maintenance contract in the hopes that it would incentivize Baycrest to renew the winter maintenance contract.

Baycrest was aware that Callow was under the impression that the winter maintenance contract would not be terminated and would likely be renewed. Nevertheless, Baycrest continued to accept the free services offered by Callow and did not correct Callow's misapprehension until it formally terminated the winter maintenance contract by providing 10 days' written notice of termination in September 2013.

Callow subsequently sued Baycrest for breach of contract. Acknowledging that 10 days' written notice was given, Callow argued that Baycrest exercised the unilateral termination clause contrary to the requirements of good faith.

Lower Court Decisions

The Ontario Superior Court of Justice ruled in favour of Callow. The trial judge found that Baycrest breached the duty of honest performance because it actively deceived Callow from the time the termination decision was made to the time that notice was given. Specifically, the trial judge found that Baycrest acted in bad faith by (i) withholding the termination decision to ensure Callow performed the summer maintenance contract, and (ii) continuing to represent that the winter maintenance contract was not in danger, while knowing that Callow was taking on extra tasks to bolster the chances of the contract being renewed.

The Ontario Court of Appeal set aside the judgment at first instance, holding that while the trial judge's findings may suggest a failure to act honourably, the findings did not rise to the high level required to establish a breach of the duty of honest performance.

The Supreme Court of Canada's Decision

Majority Decision

Justice Kasirer, writing for a majority of five judges, allowed Callow's appeal and held that Baycrest had breached its duty of honest performance.

The majority viewed this appeal as an opportunity to "clarify what constitutes a breach of the duty of honest performance where it manifests itself in connection with the exercise of a seemingly unfettered, unilateral termination clause."[7] In this regard, the majority provided the following guidance:

- The duty of honest performance applies "both to the performance of one's obligations and to the exercise of one's rights under the contract" irrespective of the intentions of the parties.[8] No contractual right, even a seemingly unfettered unilateral termination right, can be exercised dishonestly.
- Dishonest conduct includes outright lies or knowingly misleading a counterparty through half-truths, omissions and even silence, depending on the circumstances. For example, one can knowingly mislead through action by saying something directly to one's counterparty or through inaction by failing to correct a misapprehension caused by one's own misleading conduct.[9]
- While the duty of honest performance may require a party to correct a misapprehension caused by one's own misleading conduct, the duty of honest performance does not go so far as to impose a duty of loyalty or a free-standing duty of disclosure, or require a party to forgo advantages flowing from the contract.[10]

- What matters is not the failure to act honestly in the abstract, but whether a party fails to act honestly with respect to matters directly linked to the performance of the contract. In determining whether dishonesty is directly linked to a given contract, "the relevant question is generally whether a right under that contract was exercised, or an obligation under that contract was performed, dishonestly."[11]

When applying these principles to the present case, the majority held that even though Baycrest had what was, on its face, an unfettered right to terminate the winter maintenance contract on 10 days' written notice, the right had to be exercised in keeping with the duty of honest performance.

The majority concluded that Baycrest breached the duty of honest performance because (i) it made statements to Callow that suggested that the renewal of the winter maintenance contract was likely; (ii) it gladly accepted Callow's free services despite knowing that those services were performed to incentivize Baycrest to renew the contract; (iii) it intentionally remained silent and failed to correct Callow's misapprehension caused by its own misleading conduct; and (iv) the dishonesty was directly linked to the performance of the winter maintenance contract, given that it concerned Baycrest's exercise of the termination right therein.

The majority confirmed that Baycrest was not found to have breached this duty simply because it withheld its decision to terminate the agreement. The duty of honest performance did not require Baycrest to promptly address Callow's alleged performance issues or promptly disclose its intention to terminate the contract. Rather, Baycrest was found to have breached this duty because it knowingly misled Callow through both its active communications and its decision to intentionally withhold information, knowing that silence, when combined with its active communications, would deceive Callow.

Concurrence and Dissent

Justices Brown, Moldaver and Rowe agreed with the majority that the appeal should be allowed and the trial judge's award restored. However, the justices disagreed with the majority's reference to civil law concepts in interpreting the duty of good faith and the majority's use of the expectation measure of damages as opposed to reliance damages.

Justice Côté, writing in dissent, concluded that the appeal should be dismissed for several reasons, including because Baycrest's conduct, while not laudable, did not fall within the category of "active dishonesty" prohibited by the duty of honest performance.

The Decision in *Wastech*

Background

Wastech Services Ltd. (Wastech) and Greater Vancouver Sewerage and Drainage District (Metro) had a long-standing commercial relationship. In 1996, after approximately 18 months of negotiations, Wastech and Metro entered into a new, complex 20-year waste disposal agreement.

Under the contract, Wastech's compensation was structured around a "Target Operating Ratio," which, if met, would result in an operating profit of 11% for Wastech. Importantly, however, nothing in the contract guaranteed that Wastech would achieve the Target Operating Ratio in any given year. Rather, the contract included certain cost-adjustment mechanisms to address fluctuations in Wastech's actual operating ratio and ensure that both parties would share the financial consequences of a deviation from the Target Operating Ratio equally.

The contract contemplated the removal and transportation of waste by Wastech to three disposal facilities: the Vancouver Landfill, the Burnaby Waste to Energy Facility and the Cache Creek Landfill. Wastech was to be paid at a reduced rate for the short-haul transportation of waste to the Vancouver Landfill and the Burnaby Waste to Energy Facility, and at a higher rate to transport waste to the Cache Creek Landfill, which is farther away. The contract provided that Metro could, at its sole discretion, allocate waste between the three disposal facilities. The locations chosen by Metro could have a material impact on Wastech's operating ratio.

In 2011, Metro reallocated a substantial amount of waste from the Cache Creek Landfill to the Vancouver Landfill. Metro exercised this discretion in an attempt to improve its own efficiency and address its own budget concerns. However, as a result of this decision, Wastech failed to achieve its Target Operating Ratio. After certain payments made in accordance with a contractual cost-adjustment mechanism, Wastech recorded an operating profit of 4% for the year – well shy of its target of 11%. Wastech subsequently commenced an arbitration alleging that Metro breached the contract by allocating waste in a manner that deprived Wastech of the possibility of achieving its Target Operating Profit that year.

The Arbitral and Lower Court Decisions

The arbitrator ruled in favour of Wastech and held that Metro breached the duty of good faith by acting in a manner that demonstrated a lack of appropriate regard for Wastech's legitimate expectations.

The Supreme Court of British Columbia and the British Columbia Court of Appeal held that the arbitrator's award should be set aside.

The Supreme Court of Canada's Decision

The Supreme Court of Canada unanimously dismissed Wastech's appeal and held that Metro did not violate its duty to exercise contractual discretion in good faith. However, the Court split 6/3 in its reasons for the judgment.

Majority Decision

Justice Kasirer, writing for the majority, rejected Wastech's submission that Metro exercised its contractual discretion contrary to the requirements of good faith.

The majority viewed this appeal as an opportunity to clarify "what constraints the duty to exercise discretion in good faith imposes on the holder of that discretion."[12] In this regard, the majority provided the following guidance:

- The duty to exercise contractual discretion in good faith requires the parties to exercise even seemingly unfettered discretion "reasonably," meaning in a manner consistent with the purposes for which it was granted in the contract.[13]
  - Determining the purpose will necessarily require an exercise of contractual interpretation. The court will consider the discretionary clause read in the context of the contract as a whole.[14]
- The "substantial nullification" or "evisceration" of the benefit of a contract is not a necessary prerequisite to finding that a party breached its duty to exercise contractual discretion in good faith. However, the fact that an exercise of discretion substantially nullifies or eviscerates the benefit of the contract could be relevant to show that discretion had been exercised in a manner unconnected to the purpose for which it was granted.[15]
- The duty to exercise discretion in good faith, like the duty of honest performance, operates in every contract irrespective of the intentions of the parties.[16]
- This duty does not go so far as to require a contracting party to subordinate its interests to those of the counterparty or require that a benefit be conferred on a counterparty that was not contemplated under the contract.[17]

When applying these principles to the present case, the majority considered the discretionary clauses in the context of the contract as a whole. In doing so, the majority determined that the purpose for granting the absolute discretion to determine waste allocation was "to allow [Metro] the flexibility necessary to maximize efficiency and minimize costs of the operation"[18] given the operational variability foreseen by the parties. Accordingly, when Metro exercised its discretion in an effort to improve its own efficiency and address its own budget concerns, it did not breach the duty to exercise its contractual discretion in good faith because its exercise of discretion was within the range of conduct contemplated by the purpose of the clause.

In the majority's view, to find otherwise would be to give Wastech an advantage that it did not bargain for under the contract. The parties agreed to include certain cost-adjustment mechanisms in the contract to ensure that the parties would share the financial consequences of a deviation from the Target Operating Ratio equally. The parties purposely did **not** include a guarantee that Wastech would achieve the Target Operating Ratio in the contract. Accordingly, Wastech could not now ask the Court to award it that advantage. This stems from the fact that the duty to exercise contractual discretion in good faith is not a fiduciary duty. As noted by the majority: "Metro is Wastech's contracting partner, not its fiduciary. The loyalty required of it in the exercise of this discretion was loyalty to the bargain, not loyalty to Wastech."[19]

Concurring Reasons

As noted above, Justices Brown, Rowe and Côté agreed with the result; however, they wrote separately for several reasons, including because they were "steadfast" in their view that "the purpose of a discretion is always defined by the parties' intentions, as revealed by the contract."[20] Accordingly, they disagreed with the majority's decision, which would always place limits on discretion irrespective of the intentions of the parties. Rather, they were of the view that where a contract discloses a clear intention to grant a discretion that can be exercised for any purpose, courts must give effect to that intention.

Key Takeaways

- **Contractual rights and discretionary powers are never entirely "unfettered."** Regardless of how seemingly broad, absolute or unrestricted contractual rights or discretionary powers appear, contracting parties must exercise those contractual powers in accordance with the duty of honest performance and the duty to exercise discretionary power in good faith.
  - Both duties are obligatory in all contracts and operate irrespective of the intentions of the parties. In other words, parties cannot "contract out" of these duties; they operate regardless of the existence of "entire agreement" clauses or clauses seemingly granting absolute rights.
- **Failure to correct a counterparty's induced misapprehension may amount to a breach of contract.** *Callow* teaches us that courts may find a breach of the duty of honest performance (and, therefore, a breach of contract) when a party fails to correct a false impression created through its own misleading conduct, and the misleading conduct is directly linked to the performance of an obligation or exercise of a right under the contract.
- **Exercising seemingly unfettered contractual discretion in a manner that is unreasonable may amount to a breach of contract.** *Wastech* teaches us that courts may find a breach of the duty to exercise discretionary power in good faith (and, therefore, a breach of contract) when a party exercises its discretion in a manner that is not connected to the underlying purposes of the discretion granted by the contract.
- **Contracting parties are not required to subordinate their own interests.** The duty of honest performance and the duty to exercise discretionary powers in good faith are not fiduciary duties. Contracting parties are not required to confer a benefit on a counterparty that was not a part of their original agreement, or otherwise subordinate its interests to those of the other party. In the words of Justice Kasirer, good faith performance should not be confused with "an injunction to act selflessly in a way that stands outside the ordinary compass of social ordering by contract, in service of a notional solidarity between the parties."[21]
- **Contracts should be explicit and specific.** Both *Callow* and *Wastech* remind us of the importance of clear, thoughtful drafting:
  - If you have specific expectations (such as an expectation to achieve a certain target profit or to be provided with prompt notice of performance issues), you must explicitly provide for them in the agreement. While the duty of good faith imposes certain limits on the exercise of contractual rights and discretionary powers, you should not expect that your counterparty will be required to confer a benefit upon you that was not otherwise contemplated, expressly or impliedly, under the contract.
  - Courts will consider the terms of the contract when determining whether contractual discretion was exercised in good faith. Accordingly, when drafting contracts, parties should consider inserting clauses that specifically address the bounds of

contractual discretion and the purpose for which that discretion is granted. In doing so, the parties may themselves agree to greatly expand or limit the range of reasonable outcomes of the exercise of contractual discretion – and thereby increase contractual certainty.

[1] 2020 SCC 45 [*Callow*].
[2] *Callow*, at para 84.
[3] 2021 SCC 7 [*Wastech*].
[4] 2014 SCC 71 [*Bhasin*].
[5] *Bhasin*, at para 63.
[6] *Wastech*, at para 62.
[7] *Callow*, at para 30.
[8] *Callow*, at para 42.
[9] *Callow*, at para 90.
[10] *Callow*, at para 80.
[11] *Callow*, at para 37.
[12] *Wastech*, at para 59.
[13] *Wastech*, at para 63.
[14] *Wastech*, at paras 72 and 76.
[15] *Wastech*, at para 84.
[16] *Wastech*, at para 91.
[17] *Wastech*, at para 6.
[18] *Wastech*, at para 99.
[19] *Wastech*, at para 107.
[20] *Wastech*, at para 133.
[21] *Wastech*, at para 7.

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