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Contractual Good Faith: Can Australia Benefit from the American Experience?

Elisabeth Peden*

*University of Sydney,

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Abstract

The existence and enforceability of contractual good faith obligations seem less in doubt in Australia than ever before. Recent decisions in different jurisdictions reveal an increasing trend for courts to recognise and uphold express obligations and implied obligations of good faith. While there has been a greater acceptance of express and implied good faith obligations, there is still some uncertainty as to the meaning of 'good faith' and the actual content of the obligation in any context. This article considers the different meanings given to 'good faith' in Australia, and compares those with 'good faith' in jurisdictions in the USA, which has incorporated good faith in contract law for some time, both at common law and through codification, such as the Uniform Commercial Code.

KEYWORDS: good faith, contract law, Australia, United States

CONTRACTUAL GOOD FAITH: CAN AUSTRALIA BENEFIT FROM THE AMERICAN EXPERIENCE?

*Elisabeth Peden**

Introduction

The existence and enforceability of contractual good faith obligations seem less in doubt in Australia than ever before. Recent decisions in different jurisdictions reveal an increasing trend for courts to recognise and uphold express obligations and implied obligations of good faith.[1] While there has been a greater acceptance of express and implied good faith obligations, there is still some uncertainty as to the meaning of 'good faith' and the actual content of the obligation in any context. This article considers the different meanings given to 'good faith' in Australia, and compares those with 'good faith' in jurisdictions in the USA, which has incorporated good faith in contract law for some time, both at common law and through codification, such as the Uniform Commercial Code. Some Australian judges have tried to bolster their decisions for incorporating good faith by reference to the American experience. This article considers the use that is being made of American cases, and then considers the various meanings of 'good faith' used in America and Australia. It reasons that Australian law will not benefit significantly from the American experience, and goes on to argue that the best meaning of 'good faith' is 'honesty' and is inherent in contract principles generally. Most often, 'good faith' will be seen in the process of construction.

Use of American Experience in Australian Decisions

It is generally thought that the decision of Priestley JA in *Renard Constructions (ME) Pty Ltd v Minister for Public Works*[2] started the development of good faith in contractual performance in Australia. In his judgment, Priestley JA spends considerable time discussing the position in the USA, including the UCC. Since then, other courts have often approved Priestley JA's discussion[3] or added further references to American cases.

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* Senior Lecturer in Law, University of Sydney.

1 The majority of the High Court declined to decide the issue of the existence of the obligation in *Royal Botanic Gardens and Domain Trust v South Sydney City Council* (2002)186 ALR 289 (Gleeson CJ, Gaudron, McHugh, Gummow and Hayne JJ), [40]; Callinan J at [155]. Kirby J indicated he did not think such an obligation sat well with caveat emptor, but also declined to explore the question further, [86] - [88].

2 *Renard* (1992) 26 NSWLR 234, 266-268. This has been approved of by the NSW Court of Appeal in *Burger King Corp v Hungry Jack's Pty Ltd* [2001] NSWCA 187, [147].

3 See eg *Burger King Corp v Hungry Jack's Pty Ltd* [2001] NSWCA 187, [147].

The other major proponent of good faith seems to be Justice Finn, who has championed an implied obligation of good faith in judgments[4] and extra-judicially. Recently at an international conference, Finn J argued that Australian contract law could not avoid obligations of good faith and fair dealing because they are 'writ large in international and transnational developments already in train'.[5] As examples, Finn J cites the *Convention on Contracts for the International Sale of Goods*, article 7, *Contract Law of the People's Republic of China*, the *UNIDROIT Principles* and the *UCC* and *Restatement of Contracts, Second*. His Honour's main concerns seem to be that 'good faith' be expressly recognised in Australia as an obligation applicable to all contracts, and that the obligation be compulsory, rather than one that can be contracted out of by the parties. For these reasons he particularly discusses the American position, where good faith is a compulsory term of all contracts under the *UCC* and *Restatement, Second*. He relies less on American case law.

Admittedly, courts are becoming increasingly prepared to consider developments in different jurisdictions. However, there are some strong arguments against relying heavily on the American experience. For example, Atiyah points out[6] there are major differences between the American political and legislative system and the English or Australian systems. Sir Anthony Mason poetically stated:[7]

> *American case law is a trackless jungle in which only the most intrepid and discerning Australian lawyers should venture. It is possible to find American authority to support almost any conceivable proposition of law.*

Indeed, in a study of the use of American precedents by the High Court of Australia, von Nessen revealed that of all the American cases cited by the High Court from 1901-1987, commercial cases were cited the least.[8]

The two seemingly opposite positions of enthusiastic embracing 'the American way' and the strong warning against the use of US law can in fact be reconciled. The advocates of the US position are in favour of the express recognition of 'good faith' in every contract. This paper will argue that it is possible to achieve this incorporation of good faith without resorting to US legislation or unrepresentative

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4 Perhaps most often cited is Justice Finn's decision in *Hughes Aircraft Systems International v Airservices Australia* (1997) 146 ALR 1. See also *GEC Marconi Systems Pty Ltd v BHP Information Technology Pty Ltd* [2003] FCA 40 (12 February 2003), particularly paras [915] - [922].

5 'Equity and Commercial Contracts: a comment' [2001] *AMPLA Yearbook* 414, 416.

6 'Common Law and Statute Law' (1985) 48 *MLR* 1, 27.

7 'The Use and Abuse of Precedent' (1988) 4 *Aust Bar Rev* 93, 108.

8 'The Use of American Precedents by the High Court of Australia, 1901-1987' (1992) 14 *Adel LR* 181. Of 3541 references to US cases by the High Court, only 135 concerned commercial law. Within this group it is not indicated how many related to contract principles.

case law. First, it is worth looking at the similarities that seem to exist between the meanings given to good faith in US and Australian law.

Meaning of 'Good Faith' in USA and Australia[9]

'We caution anyone who is confident about the meaning of good faith to reconsider', write two leading American scholars, White and Summers.[10] Nevertheless, it is possible to set out some accepted aspects of a contractual good faith obligation. However, at the outset, it is clear that there is no uniformly agreed definition of 'good faith' in America or Australia, either in judicial decisions or academic writing.[11] Many believe that 'good faith' takes on different meanings depending on its context.[12] Most of the different approaches taken by courts and writers in America have gained some support in Australia.

While there is no precise definition of 'good faith' in American law, the *UCC* defines good faith as 'honesty in fact in the conduct or transaction concerned'.[13] Forty years ago Farnsworth criticised this definition as 'so enfeebled that it could scarcely qualify … as an 'overriding' or 'super-eminent' principle', [14] a criticism he still holds.[15] Similarly, broad definitions of good faith, based on general moral standards of cooperation, fairness and justice,[16] can seem uncertain and vague,[17]

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9 Other similarities apart from meaning can be noticed. For example, in Australian and US law it seems that good faith exists as a principle dependent on express obligations, rather than on its own. For a further discussion see E Peden, *Good Faith in the Performance of Contracts*, 2003, especially para [6.18].

10 *Uniform Commercial Code*, Vol 1 (4th ed), 1995, 187.

11 See eg TRH Cole, 'Law - All in good faith' (1994) *BCL* 18, 19; PD Finn, 'Commerce, the Common Law and Morality' (1989) 17 *MULR* 87, 87. Bridge has said it is 'a concept which means different things to different people in different moods at different times and in different places': 'Does Anglo-Canadian Contract Law Need a Doctrine of Good Faith?' (1984) 9 *Can Bus LJ* 385, 407.

12 See eg *Aiton v Transfield* (2000) 16 BCL 70, para [156], per Einstein J; Brownsword, Hird & Howells (eds), *Good Faith in Contract - Concept and Context*, 1999, 3. Steyn J has doubted good faith can be defined: 'The Role of Good Faith and Fair Dealing in Contract Law: A Hair-Shirt Philosophy?' [1991] *Denning LJ* 131, 140.

13 UCC, s1-209(19).

14 Farnsworth, 'Good Faith Performance and Commercial Reasonableness Under the Uniform Commercial Code' (1963) 30 *Uni Chicago LR* 666, 674.

15 Farnsworth, 'Good Faith and Fair Dealing in United States Contract Law' [2002] *AMPLA Yearbook* 1, 4.

16 See eg R Brownsword, 'Two Concepts of Good Faith' (1994) 7 *JCL* 197; HK Lücke, 'Good Faith and Contractual Performance' in PD Finn (ed), *Essays on Contract*, 1987; N Seddon, 'Australian Contract Law: Maelstrom or Measured Mutation?' (1994) 7 *JCL* 93.

17 See eg G Brennan, 'Commercial Law and Morality', (1989) 17 *Melb ULR* 100, 103; Jeannie Marie Paterson, 'Duty of good faith. Does it have a place in contract law?' (2000) 74 *LIJ* 47, 50.

and too much the exercise of judicial discretion.[18] The only certainty, it seems is that 'good faith' does not require contracting parties to behave as fiduciaries.

In Australia, there is also no one definition of good faith. Some courts use definitions from American cases and commentators. Many courts in Australia[19] have also cited with approval the propositions of Sir Anthony Mason,[20] who suggested that 'good faith' embraces three notions:

(1) an obligation on the parties to cooperate in achieving the contractual objects (loyalty to the promise itself);
(2) compliance with honest standards of conduct; and
(3) compliance with standards of conduct which are reasonable having regard to the interests of the parties.

It is worth considering some of the different approaches taken in the USA and Australia individually, before considering how useful the American approaches are to the development of an Australian definition of good faith.

'Legitimate Business Judgment'

It is suggested that the true meaning of good faith must be a requirement to behave honestly and to have regard of the interests of the other party, without subordinating one's own interests.[21] In USA, there is also some support for this idea that good faith does not interfere with 'legitimate business judgment', which comes within the spirit of the contract. There are examples of such an approach both in the USA and in Australia. For example, in *Dickey v Philadelphia Minit-Man Corp*[22] a lessee of premises for a car washing business decided to only wax and polish cars, rather than wash them as well. The lessor was entitled under the lease to a percentage of gross receipts, and as these reduced as a consequence of the lessee's business decision, the lessor sued the lessee for being in breach of the duty of good faith and fair dealing. The Supreme Court of Pennsylvania held that there was no breach, because the decision to stop car washing was taken in 'good

18 See eg D Yates, 'Two Concepts of Good Faith' (1995) 8 *JCL* 145, 145.

19 See eg *Burger King Corp v Hungry Jack's Pty Ltd* [2001] NSWCA 187 (21 June 2001), [171]; *Alcatel Australia Ltd v Scarcella* (1998) 44 NSWLR 349, 367 (Sheller JA); *Hughes Aircraft Systems International v Airservices Australia* (1997) 146 ALR 1, 37.

20 Sir Anthony Mason, 'Contract and its Relationship with Equitable Standards and the Doctrine of Good Faith', The Cambridge Lectures, 1993 (8 July 1993), which was the basis of his later article, 'Contract, Good Faith and Equitable Standards in Fair Dealing' (2000) 116 *LQR* 66.

21 It has been thought for some time that good faith cannot require the subordination of one party's interests to those of the other party. See eg JW Carter and MP Furmston, 'Good Faith and Fairness in the Negotiation of Contracts' (1994) 8 *JCL* 1 and 93, 6.

22 105 A.2d 580 (Pa. 1954).

faith and in exercise of legitimate business judgment'. The lessee's overall profit had increased, despite the reduction in gross receipts.

This definition has also recently been given strong support in NSW by Barratt J in *Overlook v Foxtel*,[23]where he states:

> *… the implied obligation of good faith underwrites the spirit of the contract and supports the integrity of its character. A party is precluded from cynical resort to the black letter. But no party is fixed with the duty to subordinate self-interest entirely which is the lot of the fiduciary… The duty is not a duty to prefer the interests of the other contracting party. It is, rather, a duty to recognise and to have due regard to the legitimate interests of both the parties in the enjoyment of the fruits of the contract as delineated by its terms.*

'Excluder' Definition

In the USA, two writers have had some influence on the judicial interpretation of good faith, namely, Summers and Burton. Summers' classic 'excluder' definition of good faith[24] explains that it is easier to define what 'bad faith' is, rather than what 'good faith' is. This has gained some support in the USA. For example, the commentary on the good faith provision in the Restatement Second relies on an excluder analysis, stating[25]:

> *A complete catalogue of types of bad faith is impossible, but the following types are among those which have been recognized in judicial decisions:*

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23 (2002) Aust Contracts Rep 90-143, [67]. See also Einstein J's 'essential or core content' of the obligation to mediate or negotiate in good faith in *Aiton v Transfield* (2000) 16 BCL 70, [156]:

(1) to undertake to subject oneself to the process of negotiation or mediation (which must be sufficiently precisely defined by the agreement to be certain and hence enforceable).

(2) to undertake in subjecting oneself to that process, to have an open mind in the sense of:

(a) a willingness to consider such options for the resolution of the dispute as may be propounded by the opposing party or by the mediator, as appropriate;

(b) a willingness to give consideration to putting forward options for the resolution of the dispute.'

He specifically excluded from this any requirement: '(a) to act for or on behalf or in the interests of the other party; (b) to act otherwise than by having regard to self-interest.'

24 Robert S Summers, 'Good Faith in General Contract Law and the Sales Provisions of the Uniform Commercial Code' (1968) 54 *Va L Rev* 195. See also G Shalev, 'Negotiating in Good Faith' in S Goldstein (ed), *Equity and Contemporary Legal Developments* (1992).

25 *Restatement (Second)*, s205 cmt d. This list comes from Summers' examples.

> *evasion of the spirit of the bargain, lack of diligence and slacking off, wilful rendering of imperfect performance, abuse of a power to specify terms, and interference with or failure to cooperate in the other party's performance.*

This approach has also some endorsement in Australia, including being favoured by Priestley JA in *Renard Constructions (ME) Pty Ltd v Minister for Public Works*.[26] For example, in *Far Horizons Pty Ltd v McDonald's Australia Ltd*,[27] Byrne J held it was for the plaintiff to prove 'bad faith', which in the circumstances would have meant that the defendant exercised its powers for an extraneous purpose, such as trying to punish the plaintiff or force him out of the franchise.

'Foregone Opportunity' Definition

Burton adopts a 'foregone opportunity' approach.[28] His basic thesis is that parties necessarily forego certain opportunities when they enter into a contract. When a party behaves in a way that amounts to an attempt to regain those foregone opportunities, they are behaving in 'bad faith'. Burton sees good faith issues arising where a party has retained or been given some 'discretion' under the contract, as for example, where one party can determine the quality, price or time. Good faith operates to restrict a party exercising a discretion in a way that falls outside the justified expectations of the parties at the time of formation. Thus, he looks at the reasons why a party behaves in a certain way, and if that reason falls outside the justified expectations of the parties arising from their agreement.[29]

This definition is similar to the first element (co-operation or loyalty) of the definition Sir Anthony Mason suggested, which was outlined above. Duties of co-operation have been accepted as part of the law since *Mackay v Dick*[30] in 1881, and can be seen to be part of the obligation of good faith.

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26 *Renard* (1992) 26 NSWLR 234, 266. This approach was mentioned (seemingly with approval) by the NSW Court of Appeal in *Burger King Corp v Hungry Jack's Pty Ltd* [2001] NSWCA 187 (21 June 2001), [149]. See also *Radly Corporation Ltd v Suncorp Metway Ltd* [2001] VSC 272 (14 August 2001), per Senior Master Mahony.

27 [2000] VSC 310 (Byrne J, 18 August 2000), [124]

28 See Steven Burton, 'Breach of Contract and the Common Law Duty to Perform in Good Faith' (1980) 94 *Harv Law Rev* 369; Steven Burton & Eric Andersen, *Contractual Good Faith*, 1995.

29 Steven Burton & Eric Andersen, *Contractual Good Faith*, 1995, especially chapter 2. See also Jane Stapleton, who includes in the concept of a breach of 'good faith' where a 'person conduct[s] himself contrary to his word/undertaking in the sense of contradict[ing]: Good Faith in Private Law', (1999) 52 *Current Legal Problems* 1, 7-8.

30 (1881) 6 App Cas 251.

Both Summers' and Burton's definitions have been used by courts.[31] However, sometimes there is confusion between the two. Thus, Australian cases that claim to adopt the 'excluder' definition, have cited cases that actually provide examples of the courts using the 'foregone opportunities approach' or 'loyalty' approach. For example, in *Burger King v Hungry Jack's Pty Ltd*, the NSW Court of Appeal cited with approval Priestley JA's reference to the 'excluder' definition,[32] and then cite the American case of *Metropolitan Life Insurance Co v RJR Nabisco Inc*,[33] which provides:

> *the implied covenant of good faith is breached only when one party seeks to prevent the contract's performance or to withhold its benefits.... As a result, it thus ensures that parties to a contract perform the substantive, bargained-for terms of their agreement.*

The NSW Court of Appeal also held that there was a breach of an obligation of reasonableness or good faith, because otherwise the enjoyment of the rights conferred by the contract would be rendered worthless or nugatory.[34] This is similar reasoning to that of Priestley JA in *Renard*, where he held that the clause empowering the principal to give a notice to show cause upon any default had to be read with the constraint of reasonable use (or good faith), as otherwise it would be "quite inconsistent with all the main contractual promises by each party to the contract to the other".[35] This goes no further than existing obligations of co-operation.

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31 See eg *Foley v Interactiv Data Corp*, 765 P 2d 373 (Cal 1988), citing Burton and Summers. See also *Renard Constructions (ME) Pty Ltd v Minister for Public Works* (1992) 26 NSWLR 234, citing Farnsworth, Burton and Summers.

32 [2001] NSWCA 187 (21 June 2001), [150].

33 (1989) 716 F Supp 1504, 1517.

34 [2001] NSWCA 187 (21 June 2001), [177]. Rolfe J at first instance took a similar view: [1999] NSWSC 1029 (5 November 1999), [273], where he explained that good faith would play a role if a party acted without proper regard to the rights of the other party and in circumstances where its own conduct precluded the enjoyment of their rights without justification. See also *Australian Co-op Foods Ltd v Norco Co-op Ltd* (1999) 46 NSWLR 267, [61] per Bryson J.

35 (1992) 26 NSWLR 234, 258. See also Sir Anthony Mason's statement that: 'in the interpretation of contractual powers, there is a developing tendency to tie them closely to the objects of the contract, and more than that, to ensure that, within reason and in conformity with the express provisions of the contract, the exercise of power is not capricious, arbitrary, unconscionable or unreasonable, even to the extent of insisting upon, in an appropriate case, taking account of the interests of the other party': (2000) 116 *LQR* 66, 77. See also *Hungry Jack's Pty Ltd v Burger King Corp* [1999] NSWSC 1029 (Rolfe J, 5 November 1999), Rolfe J.

Honesty and Reasonableness

The one common ground seems to be that good faith requires 'honesty'. Honesty is included in the *UCC* definition and is part of a definition provided by Sir Anthony Mason. Furthermore, 'honesty' is also a definition of good faith frequently used in legislation either expressly or via legislative interpretation.[36]

One concern is whether 'honesty' requires a subjective approach or an objective standard of reasonableness. The *Restatement (Second)*, s205 requires 'good faith and fair dealing', and the current proposals for reformulating the *UCC* would add the requirement of fair dealing.[37] Farnsworth states that a 'requirement of fair dealing arguably incorporates an objective standard and may invite expert testimony as to the practices of a particular trade or profession.'[38]

To incorporate a standard of reasonableness would seem extreme in Australia. Nevertheless, several courts have been prepared to imply a term of 'good faith and reasonableness'. Sir Anthony Mason states that the obligation of good faith includes 'compliance with standards of conduct which are reasonable having regard to the interests of the parties'. If by this were meant that contracts will be construed reasonably,[39] considering the position of the parties, then there would be no argument that that is a correct statement of principle, and another example of an element of good faith in our law. Indeed, this is what is probably meant by Lord Wright in *Hillas & Co Ltd v Arcos Ltd*:[40]

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36 In fact, many judgments rely on legislative use of good faith or 'fairness' provisions to justify and bolster the development of common law good faith obligations. See eg *Renard Constructions (ME) Pty Ltd v Minister for Public Works* (1992) 26 NSWLR 234, 263, where Priestley JA includes a heading 'Statutory Analogy'; *Hughes Aircraft Systems International v Airservices Australia* (1997) 146 ALR 1. In *Burger King Corp v Hungry Jack's Pty Ltd* [2001] NSWCA 187, [151]-[152], the NSW Court of Appeal also referred to Priestley JA's use of legislation.

37 At present only merchant sales require good faith that includes 'the observance of reasonable commercial standards of fair dealing in the trade': see s2-103

38 Farnsworth, 'Good Faith and Fair Dealing in United States Contract Law' [2002] *AMPLA Yearbook* 1, 9, citing *May v ERA Landmark Real Estate*, 15 P 3d 1179 (Mont 2000), where expert testimony on the issue of reasonable commercial standards was considered proper.

39 There are well-known 'rules' of construction, such as the main requirement to give effect to the parties' intentions (see eg *River Wear Commissioners v Adamson* (1877) 2 App Cas 743, 763; *Metrolands Investments Ltd v JH Dewhurst Ltd* [1986] 3 All ER 659 at 668), to construe the contract as a whole, and to avoid an unreasonable construction where possible (see generally, Kim Lewison, *The Interpretation of Contracts*, 2nd ed, (1997), ch 6). There are also construction 'presumptions', such as the general presumption that contracting parties intend to enter contracts which operate to produce sensible results.

40 [1932] All ER 494, 507.

> *[one should not ignore] the legal implication in contracts of what is reasonable, which runs throughout the whole of modern English law in relation to business contracts.*

It is also true that some gaps in contracts will be filled with concepts of 'reasonableness', such a 'reasonable time'[41] and 'reasonable price', where no time or price is specified.[42] However, this is not the same as requiring a standard of objectively 'reasonable' exercise of rights, when the contract does not require such a standard.

If, what is meant by 'reasonable behaviour' is subjective reasonableness, then this description really goes no further than requiring 'honesty'. However, it seems that many are confusing an obligation of objective 'reasonable' behaviour with 'good faith', or imposing both obligations at once. In *Burger King Corp v Hungry Jack's Pty Ltd* ,[43] the NSW Court of Appeal repeatedly referred to terms of "good faith and reasonableness",[44] and in fact states:[45]

> it is worth noting that the Australian cases make no distinction of substance between the implied term of reasonableness and that of good faith. As Priestley JA said in Renard at 263: 'The kind of reasonableness I have been discussing seems to me to have much in common with the notions of good faith.' Priestley JA commented further at 265 that: '… in ordinary English usage there has been constant association between the words fair and reasonable. Similarly there is a close association of ideas between the terms unreasonableness, lack of good faith and unconscionability.'.

With respect, to equate an obligation of reasonableness and one of good faith is misconceived. There is no doubt that our law, including contract law, is concerned about fairness and justice. There are arguments that there is no need for a distinct

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41 See generally KE Lindgren, *Time in the Performance of Contracts*, 2nd ed, 1982, paras 451-453.

42 See eg *Foley v Classique Coaches Ltd* [1934] 2 KB 1, and discussion in Carter and Harland, *Contract Law in Australia*, 4th ed, 2002, para [268].

43 [2001] NSWCA 187 (21 June 2001).

44 See eg [2001] NSWCA 187 (21 June 2001), [159], [163], [164].

45 [2001] NSWCA 187 (21 June 2001), [169]-[170]. For other examples of combining of 'reasonableness' and 'good faith', see eg *Elfic Ltd v Macks* [2000] QSC 18 (25 February 2000), per Williams J, [109]; *Commonwealth Bank of Australia v Renstell Nominees Pty Ltd* [2001] VSC 167 (8 June 2001), per Byrne J, [47]; *Francis v South Sydney District Rugby League Football Club Ltd* [2002] FCA 1306 (8/11/02), per Lindgren J, [203] - [208]; *Commonwealth Bank of Australia v Spira* [2002] NSWSC 905 (21/11/02), per Gzell J, [140], [155]. In *NSW v Banabelle Electrical Pty Ltd* [2002] NSWSC 178, [72], Einstein J hinted there might be a difference between reasonableness and good faith, but then cited *Burger King*, which states there is no difference.

obligation of good faith, since the law is scattered with examples of legal principles designed to bring about fairness and justice,[46] such as promissory estoppel, many construction rules, such as *contra proferentum* etc. However, as more courts are incorporating good faith obligations into contracts, the meaning of 'good faith' must be given a much more precise meaning than 'fairness', 'justice' or even 'reasonableness'. This distinction has been recognised in other areas, such as 'satisfactory finance' clauses, where the High Court has construed such conditions as requiring honesty, but has not taken the step of also requiring reasonable behaviour.[47]

To introduce a requirement that parties exercise their rights 'reasonably' would also require a reconsideration of the principle in *White and Carter (Councils) Ltd v McGregor*,[48] which, to date, has never even been discussed in 'good faith' cases. The decision is taken as authority for the propositions that a party does not have to mitigate loss if suing in debt rather than damages and that a party cannot be compelled to terminate a contract for repudiation by the other party, and the choice need not be exercised reasonably. At present, the authority seems to be at odds with the introduction in other areas of a good faith obligation.

It is interesting that in *Renard*, Priestley JA moved away from his earlier extra-judicial statement that '[r]easonableness and good faith are distinct concepts in contract law, each also being distinct from the idea of unconscionability; each one may tend to overlap with either of the others'.[49] As Stapleton has pointed out a standard of objectively reasonable behaviour is far more onerous than a requirement of good faith behaviour.[50] A party may have behaved in good faith, yet still have behaved unreasonably.[51] Also, 'provided the party exercising the power acts reasonably in all the circumstances, the duty to act fairly and in good faith will ordinarily be satisfied'.[52] Furthermore, it is possible that a party has behaved reasonably, yet still an 'unreasonable' outcome is achieved, viewed from the perspective of the other party.[53]

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46 See eg Bridge, 'Does Anglo-Canadian Contract Law Need a Doctrine of Good Faith?' (1984) 9 *Can Bus LR* 385, 409ff. See also JW Carter and Elisabeth Peden, "Good Faith in Australian Contract Law" (2003) 19 *JCL* 155.

47 See *Meehan v Jones* (1982) 149 CLR 571. The distinction is recognized in the area of a mortgagee's power of sale as well. See G Kelly, 'The Mortgagee's Duty of Sale: Retracing some Well Worn Paths' (1998) 6 *APLJ* 1.

48 [1962] AC 413.

49 'Contract - The Burgeoning Maelstrom' (1988) 1 *JCL* 15, 28.

50 'Good Faith in Private Law' (1999) 52 *CLP* 1, 8.

51 Compare the many legislative definitions of good faith that will permit negligent behaviour, which would arguably not be sanctioned by a standard of reasonableness.

52 *Garry Rogers Motors (Aust) Pty Ltd v Subaru (Aust) Pty Ltd* (1999) ATPR 41-703, 43,014. See also *Lay v Alliswell Pty Ltd* (2002)V Conv R 54-651, per Balmford J, [31].

53 See eg *Paragon Finance Plc v Staunton; Paragon Finance Plc v Nash* [2002] 2 All ER 248, 267, where a mortgage company had a discretion to vary interest rates, and it

While 'reasonable' or 'fair' behaviour is imposed by legislation on corporations vis à vis consumers in a variety of contexts, it seems an extreme step for courts to impose an obligation of reasonableness on commercial parties contracting at arms' length. It seems bizarre that courts are prepared to require commercial parties to behave reasonably towards each other, when they have not expressly included such a standard and the terms of the mutually agreed contract are very clear. As the English Court of Appeal has said when refusing to imply a term in law:[54] '[t]he common law cannot … devise such a duty which the legislature has not thought fit to impose and it could not be just or reasonable for the court to impose it'.

Has a standard of objective reasonableness been imposed in situations more commonly described as the 'exercise of discretion', rather than the exercise of rights? Where there is no issue of illusory consideration concerning a discretion,[55] there is conflicting authority about whether discretions expressly given to one party must be exercised reasonably or not, and how such a limitation of reasonableness should be imposed. In some contexts the issue is resolved by legislation, such as s133B *Conveyancing Act* 1919 (NSW), which provides that consent to assignments and licences etc of a lease cannot be 'unreasonably withheld', irrespective of the wording used. In other situations, the contract might expressly provide limitations of the exercise of the discretion.

What about when there is no express limitation? In *Meehan v Jones*,[56] the High Court was concerned with the enforceability of a 'subject to finance clause'. The judges agreed that such a clause was included for the benefit of the purchaser, and the only clear limitation on the exercise of the obligation to find finance was that the purchaser behave honestly. The possibility that the obligation might extend to a requirement of reasonable behaviour was mentioned, but not decided,[57] and some judges expressly rejected it.[58] Other cases have also decided that honest exercise of a discretion is required, but not a reasonable exercise.[59] Another case has held that a power to formulate certain terms was not an unfettered power. Instead, there was an implied obligation to behave honestly and 'to do all such things as are necessary to enable the other party to have the benefit of the contract',[60] which are elements of 'good faith', not objective reasonableness.

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was held the company had to behave reasonably, but this did not extend to requiring the company to set reasonable rates.

54 *Reid v Rush Tompkins Group Plc* [1990] 1 WLR 212, 230.

55 See generally, Carter & Harland, *Contract Law in Australia*, 4th ed, 2002, [338].

56 (1982) 149 CLR 571.

57 (1982) 149 CLR 571, 592 per Mason J.

58 (1982) 149 CLR 571, 597 per Wilson J, who preferred just honesty, as did Gibbs CJ at 581; see also Murphy J at 597. See also *Erley Pty Ltd v Gunzburg Nominees Pty Ltd* (1998) Aust Contract Reports 90-093.

59 See eg *Gold Coast Waterways Authority v Salmead Pty Ltd* [1997] 1 Qd R 346.

60 *Black v Australand Holdings Pty Ltd* (17 August 1998, BC9806863), where arguably Einstein J incorrectly identified the obligation as a 'duty to act reasonably': pp100-1.

There have been a number of cases in different commercial contexts[61] that have held that where a discretion is given to one party, then that discretion must not be exercised unreasonably, in an administrative law sense.[62]. Arguably another way of expressing this would have been simply to say that the power would be construed to require 'good faith'.

A recent English case draws a strong analogy with administrative law. In *Paragon Finance Plc v Staunton; Paragon Finance Plc v Nash*[63] the issue of reasonableness is approached from the basis of implication of a term, rather than construction. The question for the court was whether a discretion to vary the interest rate payable that was given to the mortgage company was subject to an implied term fettering the exercise of the discretion. Dyson LJ, with whom Astill and Thorpe LLJ agreed, had little problem implying that the mortgage company was bound not to exercise that discretion 'dishonestly, for an improper purpose, capriciously or arbitrarily'.[64] He gives an example of capricious behaviour as where a lender raises interest rates because it does not like the colour of the borrower's hair. An example of an improper purpose would be raising rates in order to 'get rid of' a nuisance borrower.[65] In considering whether there was the added restriction of 'reasonable' exercise of the discretion, Dyson LJ thought earlier decisions[66] indicated inclusions of the concept of *Wednesbury* unreasonableness, which he

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61 See also in the employment context, where there has been a development of the notion of an employer's obligation of 'fair dealing': *BG plc v O'Brien* [2001] IRLR 496; *Clark v Nomura International plc* [2000] IRLR 766, especially at 774; *Clark v BET plc* [1997] IRLR 348.

62 For example, in *Abu Dhabi National Tanker Co v Product Star Shipping Ltd (The 'Product Star') (No 2)* [1993] 1 Lloyd's Rep 397, the charter party agreement gave one party the right to choose a different port for unloading goods if it considered the nominated port too dangerous or impossible due to war. The Court of Appeal held that such discretions must 'be exercised honestly and in good faith, but having regard to the provisions of the contract by which it is conferred, it must not be exercised arbitrarily, capriciously, or unreasonably. That entails a proper consideration of the matter after making any necessary inquiries' (at 404 per Leggatt LJ, with whom the then members of the Court agreed). However, Leggatt LJ was not prepared to necessarily equate this with administrative law principles of *Wednesbury* unreasonableness. See also *Equitable Life v Hyman* [2000] 3 All ER 961, especially at 971 per Lord Cooke, who stated that that no discretion, 'however widely worded … can be exercised for purposes contrary to those of the instrument by which it is conferred', a principle he saw as common to all areas of the law. (Constrast Lord Steyn at 969-970, who thought such a fetter required an implied term.) See also *Gan Insurance Co Ltd v Tai Ping Insurance Co Ltd (No 2)* [2001] 2 All ER (Comm) 299.

63 [2002] 2 All ER 248.

64 [2002] 2 All ER 248, 261.

65 [2002] 2 All ER 248, 261.

66 *Gan Insurance Co Ltd v Tai Ping Insurance Co Ltd (No 2)* [2001] 2 All ER (Comm) 299 and *Abu Dhabi National Tanker Co v Product Star Shipping Ltd (The 'Product Star') (No 2)* [1993] 1 Lloyd's Rep 397.

then included in his implied term. *Paragon Finance* provides authority for the concept that administrative law principles are applicable in the consideration of discretions.

In this and other cases,[67] the courts seem to be falling into two problems: first, trying to find a justification for the introduction of a fetter on the power, and secondly, the method of imposing the fetter. If the courts were prepared to accept that good faith is a principle of construction, then the discretions or powers could be construed as requiring an exercise of good faith, which would be given meaning in the particular context.[68] The standard of behaviour required by good faith would only be honesty, loyalty to the contract and a requirement to consider the interests of the other party. This would place contractual exercise of discretions in the same position as the general exercise of powers: they must be exercised for a 'proper purpose', within the meaning of the contract. This would remove the artificial reasoning concerning implied terms. These problems will be discussed in more detail below.

It is clear that the courts want to impose some fetter on the exercise of discretions. If the parties have been contracting at arms' length and have willingly entered into the contract, it is not necessary for the courts to rewrite the parties' contract.[69] However, it is uncontroversial that powers or discretions must be

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67 See those cases in footnote 66

68 See *Western Metals Resources Ltd v Murrin Murrin East Pty L*td [1999] WASC 257, where Templeman J construed a discretion to give consent to an assignment as requiring an obligation not to withhold consent unreasonably: [22] However, he does later talk in terms of implication on the basis of necessity at [33], [39], [40], [49ff].

69 *Gan Insurance Co Ltd v Tai Ping Insurance Co Ltd (No 2)*[2001] 2 All ER (Comm) 299 [92], [97] per Sir Christopher Staughton; *Thiess Contractors Pty Ltd v Placer (Granny Smith) Pty Ltd* (2000) 16 BCL 130, 171 per Templeman J: 'cl 6.5.1 provided it with an absolute and uncontrolled discretion which it was entitled to exercise for any reason it might deem advisable. That is a contractual right which relieved Placer from any obligation to have regard to Thiess' interest". See also *Arena Properties Pty Ltd v Bernard Hastie Austrlalia Pty Ltd* (1979) 1 NSWLR 480, 486-7 per Reynolds J to the effect that a lessor was entitled to withhold its consent to a change of use, even if this was unreasonable in the circumstances; *Western Metals Resources Ltd v Murrin Murrin East Pty L*td [1999] WASC 257, where Templeman J suggests the type of relationship may determine the issue of whether a fetter is to be imposed at [38]. There are situations that seem to sit in-between classic notions of contract and administrative law, such as 'cover' offered on a discretionary basis to health professional via a professional association. For example, when Medical Defence Organisations are incorporated, and their relationship with professionals is contractual, and so the limitations on discretions provided can be implied or construed. However, if they are unincorporated, then sometimes administrative principles of fairness are resorted to. For a discussion see J Bloomfield, 'Medical Defence Organisation membership – Not a substitute for malpractice insurance' (1999) 10 *Ins LJ* 227.

exercised according to their intended purpose, which can be construed from the particular context. In contrast, the exercise of contractual rights (as opposed to discretions or powers) arguably should be completely unfettered, as contracting parties are not obliged to enter contracts, and presumably they do so for some advantage, commercial or otherwise, accepting that certain rights are given to each side, which can be exercised when triggered.

The second problem is the method of incorporation of the limitation. The Anglo-Australian courts seem to favour the notion of implying a term to fetter the exercise of the discretions on the basis of implication in fact, that is, the term is necessary for the business efficacy of the contract.[70] This approach seems highly artificial. It is difficult to conceive of why the contract does not operate effectively without a term fettering the exercise of the discretion. In fact, if the discretion was to be exercised in a way that was acceptable to both sides, no doubt the contract would operate easily and the matter would never come to court. The issue only arises because one party feels hardly done by when the other party exercises the power, which is not expressed to contain any fetter, in a way that does not suit them, or they claim is 'unfair'. The better approach would seem to be to use construction of the contract, and in particular the discretion provided. The principle of good faith would inform this process and the issue of whether the discretion was fettered could be considered on the particular facts.

This suggested approach is really what was proposed in 1973 in *Pierce Bell Sales Pty Ltd v Fraser*,[71] where Barwick CJ stated:

> *If a contract confers power on a contracting party in terms wider than necessary for the protection of the legitimate interests of that party, the courts may interpret the power as not extending to the action proposed by the party in whom the power is vested or, alternatively, that the powers are being exercised in a capricious or arbitrary manner for an extraneous purpose, which is another was (sic) of saying the same thing. Thus a vendor may not be allowed to exercise a contractual power where it would be unconscionable in the circumstances to do so.*

This approach uses construction of the contract and the particular power or discretion to determine the appropriate meaning, without drawing on implied terms and concepts of objective reasonableness.

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70 See eg *Paragon Finance Plc v Staunton; Paragon Finance Plc v Nash* [2002] 2 All ER 248, [42]; *Equitable Life Assurance Society v Hyman* [2000] 3 All ER 961, 970-1 per Lord Steyn; *Gan Insurance Co Ltd v Tai Ping Insurance Co Ltd (No 2)* [2001] 2 All ER (Comm) 299. Contrast *In re Nicholas and Grant's Lease* (1923) 44 ALT 169, where Irvine CJ construed or 'read into' the express right of a landlord to increase rent the word 'reasonably'.

71 (1973) 130 CLR 575, 587. McTiernan J agreed as did Gibbs J, adding some extra comments.

Unconscionability

One issue faced in Australia, but not in the USA, is whether there is a close correlation between good faith and unconscionability. In *Renard*, Priestley JA considered that legislation dealing with unconscionable and unfair transactions[72] could be used by analogy in the development of good faith at common law. In *Alcatel Australia Ltd v Scarcella*[73] Sheller JA (with whom Powell and Beazley JJA agreed) held that an obligation to exercise contractual rights in good faith can be implied in commercial contracts.[74] On the facts, Sheller JA held that the defendant had not breached the obligation of good faith or behaved unconscionably, seeming to consider both elements essential.[75]

Obviously, in a broad sense both concepts are dealing with issues of fairness. However, the meanings of 'unconscionability' and good faith are quite different.[76] The concept of good faith, as it is developing, is being used to implement the parties' agreements, ensuring they remain true to their original agreement and have regard to the interests of the other party. In contrast, unconscionability is used in a variety of ways. In the legislation Priestley JA cites, unfairness or unconscionability is used to override the parties' agreements. Good faith is concerned not with controlling the content or formation of the agreement, but rather with the behaviour of performance.

More recent legislation in the form of ss51AA and 51AC *Trade Practices Act* 1974 (Cth) does extend legislative remedies to common law unconscionability in certain business contexts. However, there is no common understanding of the meaning of 'unconscionability' in these sections yet.[77] Furthermore, the fact that s51AC lists 'good faith' as a factor to be taken into account in deciding whether there has been a breach does not mean that there is suddenly a close analogy between the concepts of good faith and unconscionability. The use of 'good faith' in s51AC could just mean 'honesty', as in many other pieces of legislation.[78] A further distinction

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72 (1992) 26 NSWLR 234, 268, where he lists *Moneylenders and Infants Loans Act* 1905 (NSW), *Usury Bills of Lading and Written Memoranda Act* 1902 (NSW), *Credit Act* 1984 (NSW), *Contracts Review Act* 1980 (NSW), *Trade Practices Act* 1974 (Cth), s52A.

73 (1998) 44 NSWLR 349.

74 (1998) 44 NSWLR 349, 369. This vague and general approach has been adopted in other decisions. See eg *Howtrac Rentals Pty Ltd v Thiess Contractors (NZ) Limited* (unreported, 21 December 2000, SCVic, Gillard J), [422]-[423], citing *Alcatel Australia Ltd v Scarcella* (1998) 44 NSWLR 349.

75 (1998) 44 NSWLR 349, 369.

76 In fact, in his earlier article, Priestley JA did distinguish unconscionability from good faith quite clearly. See "Contract - The Burgeoning Maelstrom" (1988) 1 *JCL* 15, 19-22, 28-29.

77 See JW Carter & DJ Harland, *Contract Law in Australia*, 4th ed, 2002, [1527]-[1528].

78 See discussion of legislative use of 'good faith' in Elisabeth Peden, *Good Faith in the Performance of Contracts*, 2003, paras 7.20ff.

is that many judges feel an obligation of good faith can be imposed in all contracts, or all commercial contracts, whereas for unconscionability to operate there usually needs to be some vulnerability, such as a special disability in the *Amadio*[79] sense, or a presumed weakness (such as the weaker position of a consumer in many pieces of legislation), which limits the operation of the principle.

Perhaps the closest unconscionability comes to the operation of good faith is where the exercise of contractual rights is restricted in cases where it would be unconscionable to allow the party to exercise those rights, a principle taken from the High Court reasoning in *Legione v Hateley*.[80] Carter and Harland provide the following example of how this operates:[81] 'if a seller tenders documents under a sale of goods contract and the buyer takes these up notwithstanding the presence in the documents of a clear indication that the goods were shipped late, the buyer may be treated as having impliedly represented (by conduct) that the goods will not be rejected when they arrive. If it would be unconscionable to allow contradiction of the (earlier) representation, for example, because the seller has tendered the goods in reliance, the buyer will be precluded from terminating the contract on the ground of late shipment, and any termination based on that ground would be ineffective.' To say a party has behaved unconscionably is more difficult than to show the party has behaved in breach of an obligation of good faith. However, if good faith is taken to require objective 'reasonableness', then this would catch even more conduct than a test of 'unconscionability'.

What Can be Learnt from this Comparison?

There are some striking differences between the law in Australia and the USA. The most obvious difference is the number of jurisdictions in each country. Australian state courts tend to take notice of the developments in other states and the High Court ultimately decides on the meaning of contractual principles for the whole of Australia. In comparison, in the USA there is no effective review of state law by the Supreme Court, which has meant that the common law was able to develop independently in fifty separate jurisdictions,[82] making it virtually impossible to analyse all the cases from every state.[83]

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79 *Commercial Bank of Australia Ltd v Amadio* (1983) 151 CLR 447. See generally, T Duggan, 'Unconscientious Dealing', in P Parkinson, ed, *The Principles of Equity*, 2nd ed, 2002, ch 5.

80 (1983) 152 CLR 406. See also *Tanwar Enterprises Pty Ltd v Cauchi* [2003] HCA 57 (7 October 2003).

81 *Contract Law in Australia*, 4th ed, 2002, [1976].

82 Paul E von Nessen, "The Use of American Precedents by the High Court of Australia, 1901-1987" (1992) 14 *Adel LR* 181, 215.

83 See eg *Service Station Association Ltd v Berg Bennett and Associates Pty Ltd* (1993) 117 ALR 393, [35] per Gummow J, who said: 'Given the diversity of common law jurisdictions in the United States, it will remain difficult to speak with any certainty of a generally accepted doctrine [of good faith].'

Perhaps even more significant for the comparison here is that contractual good faith in the USA is primarily code-based. The *Uniform Commercial Code* 'imposes an obligation of good faith in … the performance and enforcement'[84] of every contract under the Code. Admittedly, the courts have been 'generous in imposing such a duty in cases not covered by the Code, whether as a matter of common law, by analogy to the Code, or both.'[85] Furthermore, many courts look to s205 of the *Restatement (Second)* of Contracts, which incorporates a duty of good faith and fair dealing in all contracts. Both the *UCC* and the Restatement concern a duty that can not be expressly excluded by the parties. In contrast, in Australia, where good faith in contractual performance is incorporated into contracts it is through the common law. The mechanism favoured by Australian courts to incorporate good faith is by an implied term, either in law or fact.[86] It is therefore possible for parties to expressly exclude such a term, since terms are only implied when there is in fact a gap to fill. Thus, part of the test for implying a term in fact is that the term be necessary for business efficacy and not be inconsistent with the express terms.[87] These elements could not be satisfied if a term already existed concerning good faith. Similarly, a term can only be implied in law if there is a gap to fill and the term is 'necessary'.[88] A term requiring good faith will not be 'necessary' if it is already dealt with by the parties. Currently, the only terms that cannot be excluded expressly by the parties are terms incorporated by legislation, such as terms under the Sale of Goods and Trade Practices legislation protecting consumers.[89]

It was noted above that there is probably an American precedent for any proposition.[90] Nevertheless, cases are sometimes misused. For example, it is interesting that the American case of *Kham & Nate's Shoes* was quoted approvingly by the NSW Court of Appeal *Burger King* when it was trying to provide a strong precedent for the incorporation of good faith, since the judgment

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84 UCC, s1-203.

85 Farnsworth, 'Good Faith and Fair Dealing in United States Contract Law' [2002] *AMPLA Yearbook* 1, 2.

86 See eg *Burger King Corp v Hungry Jack's Pty Ltd* [2001] NSWCA 187 (21 June 2001); Alcatel Australia Ltd v Scarcella (1998) 44 NSWLR 349; *Renard Constructions (ME) Pty Ltd v Minister for Public Works* (1992) 26 NSWLR 234, per Priestley JA. For a discussion of the implied term approach see Elisabeth Peden, *Good Faith in the Performance of Contracts*, 2003, chapter 6.

87 See *BP Refinery (Westernport) Pty Ltd v Shire of Hastings* (1977) 180 CLR 266.

88 Thus, in the leading case on terms implied in law, *Liverpool City Council v Irwin* [1977] AC 239, it was only because the lease did not expressly state which party should be responsible for the common parts of the building that the House of Lords was prepared to imply a term that the landlord take reasonable care of those parts.

89 However, Justice Finn claims that good faith should be a term implied in law, out of which parties should not be allowed to contract: 'Equity and Commercial Contracts: A Comment' (2001) *AMPLA Yearbook* 414, 418. With respect, this is not possible with the current state of the common law.

90 See above, text at footnote 7

of Judge Frank Easterbrook in *Kham & Nate's Shoes* did not require good faith behaviour, but rather took an approach similar to that argued by Burger King, namely, a strict, literal approach. In *Kham & Nate's Shoes*, a lender abruptly terminated a line of credit that had been offered. The bankruptcy court held this was a breach of the obligation of good faith. However, the US Court of Appeals for the Seventh Circuit vacated that order. Judge Easterbrook based his decision on the literal meaning of the contract, which provided that cancellation was permitted on five days' notice and 'nothing provided herein shall constitute a waiver of the right of the Bank to terminate financing at any time'. Judge Easterbrook stated:[91]

> … *Firms that have negotiated contracts are entitled to enforce them to the letter, even to the great discomfort of their trading partners without being mulcted for lack of 'good faith'. Although courts often refer to the obligation of good faith that exists in every contractual relation… this is not an invitation to the court to decide whether one party ought to have exercised privileges expressly reserved in the document.* …
>
> … *knowledge that literal enforcement means some mismatch between the parties' expectation and the outcome does not imply a general duty of 'kindness' in performance, or judicial oversight into whether a party had 'good cause' to act as it did. Parties to a contract are not each others' fiduciaries; they are not bound to treat customers with the same consideration reserved for their families.*

The *Kham & Nate's Shoes* case has also been strongly criticised by American academics, Burton and Andersen, for not only using general construction principles, rather than considering the context of the agreement, namely, loan agreements, and further, for not considering the good faith alternative, which sits between a literalist approach and altruism.[92] However, if a distinction is drawn between contractual discretions and powers, that must be exercised in good faith, or for a proper purpose, and express contractual rights that can be exercised strictly, the approach taken by Judge Easterbrook seems appropriate.

It would therefore seem rather bold for Australian courts to rely heavily upon the American experience in relation to good faith. There is no clear definition or law concerning good faith in America, and there are precedents available for most propositions. Now that Australian courts are becoming more prepared to consider the notion and application of good faith in contract law, there will be a growing body of local cases, from which judges can draw precedents and inspiration. If Australian courts do rely upon their own jurisprudence in relation to good faith, in which direction should they head?

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91 908 F.2d 1351, 1357 (7th Cir.1990).

92 *Contractual Good Faith*, 1995, [4.4.4].

What Should Good Faith Mean in Australia?

It was noted above that the common ground in USA and Australia was that 'good faith' must mean 'honesty'. The characteristics which conduct must have to be honest conduct will depend on the circumstances. While some aspects of good faith are usually expressed in negative terms, there is no need to resort to the 'excluder' analysis,[93] since 'good faith' sets a standard, which can be expressed either in positive or negative terms. Good faith is not really an independent concept, but rather inherent in Australian (and arguably American) contract law. Thus, the good faith content of contract law will depend on the particular rule or principle and, the terms of each contract. Characteristics which conduct must have to be honest will necessarily include: not acting arbitrarily or capriciously; not acting with an intention to cause harm; and acting with due respect for the intent of bargain as a matter of substance not form.

In the context of contract performance and the exercise of discretions and rights, the presence of good faith will be seen in the process of interpretation. The Australian cases dealing with 'implied terms of good faith' can be better explained as examples of the courts using a 'good faith construction' approach. Depending on the term in question, good faith may include: acting for a proper purpose; consistency of conduct; communication of decisions; co-operation with the other party; or consideration of the interests of the other party.

Accepting a broad understanding of 'good faith' casts doubt on the current method in Australia of incorporating the obligation of good faith. In the USA good faith is primarily incorporated by legislation, namely the UCC. Alternatively, the courts imply a term of good faith. The current preference of Australian courts is to use a term implied in law,[94] however, there are several cases which have used a term implied in fact,[95] or both types of implied term.[96] In *Renard*, Priestley JA thought there may not in fact be any difference between the types of implied terms or a

93 The 'classic' explanation along these lines is by Robert S Summers, '"Good Faith" in General Contract Law and the Sales Provisions of the Uniform Commercial Code' (1968) 54 *Va L Rev* 195. This definition has received some judicial support in Australia, including being favoured by Priestley JA in *Record Constructions (ME) Pty Ltd v Minister for Public Works, Renard* (1992) 26 NSWLR 234, 266. The New South Wales Court of Appeal also mentioned it with seeming approval in *Burger King Corp v Hungry Jack's Pty Ltd* [2001] NSWCA 187 (21 June 2001), [149].

94 See eg *Burger King Corp v Hungry Jack's Pty Ltd* [2001] NSWCA 187 (21 June 2001), [159], [164] and the cases cited there.

95 See eg *Advance Fitness Corporation Pty Ltd v Bondi Diggers Memorial and Sporting Club Ltd* (NSW Supreme Court, Austin J, 30 March 1999); *Dalcon Constructions Pty Ltd v State Housing Commission* (1998) 14 BCLC 477.

96 See eg *Hughes Aircraft Systems International v Airservices Australia* (1997) 146 ALR 1.

hybrid form could be used.[97] Finn J believes that the incorporation of good faith into contracts will require the rewriting of the principles behind implied terms and construction.[98] It is very easy to criticise the use of implied terms to incorporate an obligation of good faith, which has been done elsewhere.[99] Priestley JA himself admitted that it may be very difficult to satisfy the 'business efficacy' test of implication in fact.[100] Terms implied in law apply to particular types of relationships, such as landlord and tenant, employer and employee, rather than to all contracts generally, as has been suggested with an obligation of good faith.[101] Furthermore, if good faith is an obligation that courts would like to apply to all contracts,[102] then by using a term implied in law, the parties are free to expressly exclude the operation of the term, thus thwarting the intention of the courts. If an implied term approach is to be used, that is meant to apply to all contracts, then it would need to be done through legislation.[103] This would be similar to the US approach.

Yet for some the concern remains that 'good faith' needs to be *expressly* (rather than inherently) incorporated into our contract law so that is applicable to all contracts. Finn J has recently bemoaned that, unlike USA and European legal systems, there is no way our common law 'can impose obligations on parties that are contractual in character.'[104] With respect, 'good faith' is already incorporated in contract principles, in particular, in construction of contracts. Sir Anthony Mason's first two elements of 'loyalty to the contract' and a requirement of 'honest'

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97 (1992) 26 NSWLR 234, 263.

98 P Finn, 'Equity and Commercial Contracts: A Comment' [2001] *AMPLA Yearbook* 414, 420.

99 See Elisabeth Peden, *Good Faith in the Performance of Contracts*, 2003, chapter 6.

100 (1992) 26 NSWLR 234, 258. For an example of a case where the implied in fact approach fails see *Christopher John De Pasquale v The Australian Chess Federation Incorporation (AO 1325)* [2000] ACTSC 94, per Gray J. Finn J recently recognised the problems with the implied term approach: *GEC Marconi Systems Pty Ltd v BHP Information Technology Pty Ltd* [2003] FCA 50 (12 February 2003), [918] - [920].

101 See eg *Burger King Corp v Hungry Jack's Pty Ltd* [2001] NSWCA 187 (21 June 2001), [163], suggesting the obligation will 'more readily be implied in standard form contracts'. See also P Finn, 'Equity and Commercial Contracts: A Comment' [2001] *AMPLA Yearbook* 414, 416.

102 Justice Finn once claimed that good faith should be a term implied in law, out of which parties should not be allowed to contract: 'Equity and Commercial Contracts: A Comment' (2001) *AMPLA Yearbook* 414, 418. However, he now seems to appreciate that this is not possible with the current state of the common law: see *GEC Marconi Systems Pty Ltd v BHP Information Technology Pty Ltd* [2003] FCA 40 (12 February 2003), [918] - [920].

103 See eg consumer protection provisions in the *Sale of Goods Act* 1923 (NSW) and corresponding provisions in other state legislation.

104 *GEC Marconi Systems Pty Ltd v BHP Information Technology Pty Ltd* [2003] FCA 40 (12 February 2003), [919].

behaviour[105] are incorporated at the stage of construction of the contract, so express terms are construed to give a meaning that ensures loyalty, and that obligations must be performed honestly. Using good faith as a principle of construction would mean that all obligations would be construed to require parties to have regard to the interests of the other party. The exact content of the obligation would of course depend on the type of contract, the factual matrix and the parties involved etc. The most important consideration in forming the content of the obligation in any case would be the words used by the parties in forming the contract. It may, for example, be very clear that a right has been given to one party, that does not require good faith behaviour, in the sense of having regard to the other party's interests, since the contract allows a self-interested approach, so long as it is loyal and consistent with the contract's objectives and spirit. For example, a particular contract might allow termination for certain breaches, and in the context of the contract as a whole, 'good faith' exercise of this right might allow termination for a trivial breach.[106] In another contract, such termination might not be 'in good faith'. [107]

Such an approach actually has some support in American opinions. For example, Professor Farnsworth has said that many of the uses 'to which the new concept of good faith is put today do not go beyond those to which the traditional techniques of interpretation and gap filling were put in yesteryear'.[108] And this was cited with apparent approval by Gummow J in *Service Station Association Ltd v Berg Bennett and Associates Pty Ltd* [109]

An Australian example of the application of this definition is provided in *Overlook v Foxtel*.[110] Barratt J first looked at the contracts between the parties to determine their character. The contracts concerned the sale of television programs by Overlook to Foxtel, which were then on-sold by Foxtel to subscribers. The dispute arose when Foxtel reduced the subscription price of the channels sold by Overlook, resulting in a reduction in return for Overlook. Overlook argued, inter alia, that by reducing the price of Overlook's product, Foxtel had breached an implied term

105 See discussion above.

106 See *Thiess Contractors Pty Ltd v Placer (Granny Smith) Pty Ltd* (2000) 16 BCL 130, 171 per Templeman J, that there was an absolute discretion to terminate that relieved the party of having regard to the interests of the other side.

107 For a discussion of how lender's rights to repayment on demand might be applied in different situations see Jeannie Marie Paterson, 'Limits on a Lender's Right to Repayment on Demand: Construction, Implication and Good Faith?' (1998) 26 *ABLR* 258.

108 *Contracts*, 2nd ed, 1990, [7.17a].

109 (1993) 117 ALR 393, [36].

110 (2002) Aust Contracts Rep 90-143, [67]. This approach has been followed by other judges. See eg *Commonwealth Development Bank of Australia Pty Ltd v Cassegrain* [2002] NSWSC 965 (22/10/02), per Einstein J,[213]ff; *Mobile Innovations Ltd v Vodafone Pacific Ltd* [2003] NSWSC 166, [616], per Einstein J.

to perform the contract in good faith. While Barratt J felt there was no debate on the existence of the implied term,[111] Overlook's argument failed. Barratt J stated:[112] 'Foxtel did not act in a capricious way: on the contrary, its action was deliberate and reasoned and had both a rational basis and an objective explanation. Furthermore, the action was not purely selfish and destructive of the position of Overlook or such as to cause Overlook's rights to become nugatory, worthless or seriously undermined.' He felt Foxtel's behaviour was honestly designed to increase sales for both parties. The fact that their expectations turned out to be too optimistic did not mean that Foxtel had impugned the integrity of the contract's spirit and therefore there was no breach of the implied obligation.

In effect, Foxtel has a discretion or power to set the price of the products, which needed to be exercised for a proper purpose. As a proper purpose could be explained, there was no breach of contract. There are other examples of such a definition being used, with emphasis on a requirement not to act capriciously or for a purpose extraneous to the contract.[113]

The situation in *Overlook v Foxtel* and similar cases can be contrasted with situations where what a party has been given is not a discretion or power, but rather a 'right', such as the express right of termination, which can be exercised upon the occurrence of certain events. In such situations, the argument that the right must also be exercised with good faith or for a 'proper purpose' seems less convincing.

It is worth considering the effect of such an approach on a few older decisions to see that the effect will not be drastic, but at least clarify and perhaps simplify the position. For example, in *Alcatel Australia Ltd v Scarcella*[114] Sheller JA (with whom Powell and Beazley JJA agreed) accepted an obligation to exercise contractual rights in good faith can be implied in commercial contracts.[115] The facts were that a landlord had commissioned a report from a fire engineer, who reported that work was need for fire safety reasons. At the landlord's invitation the local

111 Barratt J felt there is a term implied in law in every commercial contract that the parties perform in good faith as a result of *Burger King Corp v Hungry Jack's Pty Ltd*: (2002) Aust Contracts Rep 90-143, [62].

112 (2002) Aust Contracts Rep 90-143, [83]. See also *Apple Communications v Optus Mobile Pty Ltd* [2001] NSWSC 635 (26 July 2001), per Windeyer J.

113 See eg *Macintosh & Others v Dylcote Pty Ltd* [1999] NSWSC 230, [16]; *Cubic Transportation Systems Inc v State of New South Wales* [2002] NSWSC 656, [44].

114 (1998) 44 NSWLR 349.

115 (1998) 44 NSWLR 349, 369. This vague and general approach has been adopted in other decisions. See eg *Howtrac Rentals Pty Ltd v Thiess Contractors (NZ) Limited* [2000] VSC 415 (21 December 2000) per Gillard J, [422]-[423], citing *Alcatel Australia Ltd v Scarcella* (1998) 44 NSWLR 349. However, for a less enthusiastic description see *Edensor Nominees Pty Ltd v Anaconda Nickel Ltd* [2001] VSC 502 (18 December 2001), per Warren J, [188].

council inspected the premises and found they did not comply with requirements laid down in legislation and so the tenant would need to vacate the premises. The tenant wanted to challenge the council's findings, but the landlord would not permit the tenant to use its name to sue.

Sheller JA held there was no reason why a duty of good faith should not be implied as part of the lease. However, on the facts, the landlord was not acting unconscionably or in breach of an implied term of good faith, where the landlord merely took steps to ensure that the requirement for fire safety contained in the expert's report should be put in place. Sheller JA stressed the commercial nature of the relationship and said:[116]

> *In a commercial context it cannot be said, in my opinion, that a property owner acts unconscionably or in breach of an implied term of good faith in a lease of the property by taking steps to ensure that the requirements for fire safety advised by an expert fire engineer should be put in place.*

If a broader construction perspective of 'good faith' had been taken, what would the result have been? Clearly, the tenant's interests were that it be allowed to retain possession, and perhaps challenge the council's findings. Could it be said that these interests were completed ignored and the spirit of the contract was thwarted by the landlord? Arguably not. It would be in the interests of the tenant and the landlord that the premises be safe. As the landlord had clear evidence that the premises were unsafe, it was not inappropriate for the landlord to go ahead with the plan to have the work done.

Finally, the case of *Burger King Corp v Hungry Jack's Pty Ltd* [117]should be considered. The complicated facts can be summarised for the purpose of the discussion of the implication of terms of good faith and reasonableness. Burger King franchised its fast-food stores in Australia. The largest franchisee was Hungry Jack's. The franchise agreements were for a term of 15 years (although the term of the later franchise agreements was 20 years) with provision for one renewal of the same term. In 1990 several agreements were entered into by the parties. Under a 1990 agreement, Hungry Jack's had an unrestricted non-exclusive right to develop franchised restaurants throughout Australia, and more specific development obligations in Western Australia, South Australia and Queensland. The agreement was for five years, with renewal provisions. There was a provision for termination for breach, and a provision that a 30 day notice was required to be given in respect of any breach capable of cure.

From at least 1993, Burger King decided to enter the Australian market, possibly by buying out Hungry Jack's or forming a joint venture arrangement. During

116 (1998) 44 NSWLR 349, 369.
117 [2001] NSWCA 187.

1994, the parties entered into discussions with the Shell Oil Company Australia about the feasibility of establishing outlets in Shell service stations under the brand name *Hungry Jack's* as a tripartite venture. However, during the course of these discussions, Burger King began dealing with Shell separately, and concluded an agreement, without Hungry Jack's knowledge. Continuing disputes between the parties intensified from at least 1993 onwards, and from the end of March 1995, Jim Montgomery, Hungry Jack's National Development Manager, began providing Burger King with confidential information about Hungry Jack's, which assisted Burger King in these disputes.

In 1995, Burger King advised Hungry Jack's that it would not approve any further recruitment of third party franchisees, and it withdrew both financial and operational approval. In late 1996, and again in 1997, Burger King served notices of termination on Hungry Jack's. One of the issues was whether these purported terminations were valid and whether Burger King had breached its implied obligations of good faith and reasonableness in the agreement.

Burger King appealed the implication by Rolfe J of three terms, and any breach. First, Rolfe J had implied a term of co-operation (that Burger King would do all that was reasonably necessary to enable Hungry Jack's to enjoy the benefits of the agreement). Secondly, there was an implied term of reasonableness (that Burger King must act reasonably in exercising its powers under the agreement). And thirdly, there was an implied term of good faith (that Burger King must act in good faith in the exercise of its contractual powers).[118] Rolfe J held that these terms had been breached and the consequence was a repudiation by Burger King.[119] He awarded Hungry Jack's over $60 million damages for delay in opening restaurants, loss of opportunity to introduce third party franchisees, loss of service royalties and 'cannibalisation' from allowing Shell to open restaurants in service stations.

The Court of Appeal[120] dismissed Burger King's arguments. The implied term of co-operation was considered uncontroversial, on the basis of the authority of *Mackay v Dick*.[121] The Court of Appeal spent some time discussing the more controversial second and third implied terms. They cited with approval[122] the obiter statement of Priestley JA in *Renard* concerning people's expections of good faith behaviour and his review of the influence of the American UCC and

118 [2001] NSWCA 187, [141].
119 The Court of Appeal quote Rolfe J's expression [142]: Hungry Jack's was "dispensed ... of the necessity to continue performance".
120 Consisting of Sheller, Beazley and Stein JJA.
121 (1881) 6 App Cas 251, 263, per Lord Blackburn.
122 [2001] NSWCA 187, [146].

Restatement (Second) of Contract,[123] and repeated his observation that in America good faith is used as an 'excluder', without expressly agreeing.[124]

In terms of local Australian authority or arguments for the adoption of good faith, the Court of Appeal adopted two sources mentioned by Priestley JA. First, the well documented Australian experience of controlling the operation of general rescission clauses by preventing their use 'for improper and extraneous purposes.'[125] Secondly, they referred[126] to statutory provisions which require reasonable and fair behaviour in a variety of circumstances.

The Court then referred[127] to Sheller JA's judgment in *Alcatel*, where he had accepted that an obligation of good faith could be implied into commercial contracts, both in performing obligations and exercising rights.[128] The Court stated that cases since *Alcatel* have assumed that there may be implied in law terms of good faith and reasonableness.[129] They suggested that terms will more readily be implied in standard form contracts, particularly if such contracts contain a general power of termination.[130]

The Court then proceeded to state the test for implication of terms in law.[131] They conceded that the agreement in question did not fit within any traditional class of contract, such as sale of goods.[132] Therefore, they stated that for a term to be implied it must be reasonable and necessary.[133] This seems to side-step the first element of the test for implication in law, namely, determining the 'type' of

123 Ibid, [147-8].
124 Ibid, [150].
125 Ibid, [151], citing Godfrey *Constructions Pty Limited v Kanagra Park Pty Limited* (1972) 128 CLR 529, 548; *Pierce Bell Sales Pty Limited v Frazer* (1973) 130 CLR 575, 587 per Barwick CJ.
126 Ibid, [151]. See eg *The Money-Lenders and Infants Loan Act* 1905, the *Hire Purchase Agreement Acts* of 1941 and 1960, s 88F of the *Industrial Arbitration Act* 1940 (inserted in 1949 and expanded in 1966), the *Contracts Review Act* 1980, the *Credit Act* 1984 and s 51A of the *Trade Practices Act* 1974 (Cth) (inserted to operate from 1986).
127 Ibid, [155-6].
128 *Alcatel Australia Ltd v Scarcella* (1998) 44 NSWLR 349, 368-369.
129 [2001] NSWCA 187, [159-162], citing as examples *Far Horizons Pty Ltd v McDonalds Australia Ltd* [2000] VSC 310 Byrne J, [120]; *Garry Rogers Motors Aust Pty Limited v Subaru (Aust) Pty Ltd* (1999) ATPR 41-703, 43,014, per Finkelstein J; *Saxby Bridge Mortgages Pty Ltd v Saxby Bridge Pty Ltd* [2000] NSWSC 433, Simos J; *Asia Television Ltd v Yau's Entertainment Pty Ltd* (2000) 48 IPR 283 Gyles J. See also para [164].
130 Ibid, [163].
131 Ibid, [165].
132 Ibid, [166].
133 Ibid, [167].

contract.[134] Before making a conclusion, the Court turned to the meaning of "good faith and reasonableness".

The Court felt there was no difference between the meaning of 'reasonableness' and 'good faith'.[135] They adopted[136] Sir Anthony Mason's three-point concept of good faith and also suggested 'good faith' imposed an obligation 'not to act capriciously'.[137] They also thought that good faith meant a promise to adhere to the spirit of the bargain. Thus, they stated: 'the implied covenant [of good faith] will only aid and further the explicit terms of the agreement and will never impose an obligation `which would be inconsistent with other terms of the contractual relationship'. ... Viewed another way, the implied covenant of good faith is breached only when one party seeks to prevent the contract's performance or to withhold its benefits. ... As a result, it thus ensures that parties to a contract perform the substantive, bargained-for terms of their agreement.'[138]

This supposed definition is more confusing than instructive. There is no precise meaning given, but rather a repetition of well-worn phrases and quotes, without explanation of how and why they fit together. There is furthermore, no explanation of why 'reasonableness' is a justified inclusion in the meaning of good faith, and why it is considered identical to 'good faith'.

Burger King was concerned the implied terms would subvert freedom of contract and would be inconsistent with other express terms, which exhaustively delineated the rights and obligations of the parties.[139] The Court of Appeal saw two fundamental problems with this submission. First, Burger King had 'the sole discretion' in granting approval. If this were read widely, then Burger King could withhold approval 'at its whim'. This would be unacceptable. Secondly, if Burger King were correct, then the exercise of the discretion on facts which without fraud, were determined incorrectly, would be acceptable. The Court of Appeal thought[140] such an interpretation would render the 'enjoyment of the rights conferred by the contract would or could be rendered nugatory, worthless or perhaps seriously undermined'.

The Court of Appeal was convinced by Hungry Jack's argument that there must be an implied term of reasonableness and good faith, as otherwise even minor

134 For a discussion of the legal tests for implication of terms in law see Elisabeth Peden, *Good Faith in the Performance of Contracts*, 2003, chapter 5.
135 Ibid, [169-171], citing *Renard* at 263, 265, per Priestley JA; *Alcatel*, 369 per Sheller JA.
136 Ibid, [171].
137 Ibid, [172] citing *Garry Rogers*, Finkelstein J at 43,014.
138 Ibid, [173] citing *Metropolitan Life Insurance Co v RJR Nabisco Inc* (1989) 716 F Supp 1504, 1517.
139 Ibid, [174]-[175].
140 Ibid, [177].

breaches could result in termination of the contract. For example, clause 4.1 of the agreement required Hungry Jack's to comply with detailed specifications and procedures contained in the Burger King's Manual of Operating Data, relating to every aspect of food handling, cleaning and style of service.[141] Furthermore, Burger King could alter the standards and specifications without providing notice to Hungry Jack's. If no tempering of the right of termination by an obligation of good faith were provided, the Court felt the contract would be uncertain and Hungry Jack's could be robbed of the benefits of the agreement.[142]

The Court stressed that incorporating an implied term that the powers be exercised with good faith and reasonableness did not raise the relationship to a fiduciary level. Thus, the Court said: 'That does not mean that BKC is not entitled to have regard only to its own legitimate interests in exercising its discretion. However, it must not do so for a purpose extraneous to the contract - for example, by withholding financial or operational approval where there is no basis to do so, so as to thwart HJPL's rights under the contract.'[143]

Rolfe J had held that Burger King had breached the implied terms of good faith and reasonableness by:

(i) its conduct in purporting to terminate the Development Agreement; (ii) placing a freeze on the ability of Hungry Jack's to recruit third party franchisees, which was not substantiated by any contractual right, but rather motivated by Burger King's decision to re-enter the Australian market; (iii) withholding financial approval to development under the Development Agreement, which was also without a contractual basis. The reason for withholding approval was Hungry Jack's failure to provide information within an unreasonably short time, which Hungry Jack was under no obligation to provide; and (iv) refusing operational approval under the Development Agreement. The reason Hungry Jack's could not meet its contractual obligations was because Burger King was delayed in making necessary communications and failed to comply with process requirements. This was a clear failure to co-operate and so Burger King could not take advantage of its own inappropriate behaviour.

The Court of Appeal agreed that in effect, the failure to comply with the contract, together with using contractual provisions for illegitimate purposes amounted to a breach of good faith and reasonableness and rendered the purported termination invalid, and in effect a wrongful repudiation, and required compensation through damages.

141 Ibid, [180].
142 Ibid, [181]-[182].
143 Ibid, [185].

Had the alternative approach to the meaning of 'good faith' been adopted and incorporated by construction, the result would not necessarily have been different.[144] The concerns of the Court of Appeal would still have been met. For example, principles of construction are, by their nature, context specific and can be excluded by express terms. Furthermore, it would still have been possible to construe the discretions and powers (in relation to financial and operations approval) given to Burger King as requiring 'good faith', rather than as being unfettered in their nature. However, there is a question of whether the express right to terminate upon breach by Hungry Jack's should have been fettered. This was a clear express right, which could not be exercised at Burger King's discretion, but rather only if certain condition precedents, namely, Hungry Jack's breaches, occurred. Providing the behaviour of Hungry Jack's was correctly assessed to amount to a breach entitling termination, it is unclear why an additional limitation needed to be inserted by the court after the event. And in any case, as the contract expressly provided the situations in which the right to terminate could be exercised, if this were construed requiring 'good faith', there could be no breach if the legitimate purpose expressly provided were relied upon.

Conclusion

The debate in Australia, and even the USA, on the meaning of 'good faith' obligations in contract is not over. It will no doubt take time and a number of higher court decisions to clarify the issue. However, there is little need for Australian courts to look to the USA for definitions of good faith, as it seems that little can be gained from that exercise. Instead, Australian courts should take a careful look at what effect good faith should have in contract law. If it is accepted that good faith has a broad impact across many contract law principles, then it will be quite rare for courts to need to incorporate a separate and autonomous obligation.[145] In fact, most of the cases to date where such an obligation has been implied could be seen as examples of cases of basic construction of contracts, which is informed by good faith.

This is in some ways similar to the approach taken in interpreting legislation that requires certain behaviour to be 'in good faith'.[146] When interpreting legislative

144 For a suggestion that the same conclusion could have been achieved using inherent contractual principles of co-operation, rather than good faith, see C Rickett, "Some Reflections on Open-Textured Commercial Contracting" [2001] *AMPLA Yearbook* 374, 401.

145 See JW Carter and Elisabeth Peden, 'Good Faith in Australian Law' (2003) 19 *JCL* 155.

146 The similarity in interpreting legislation and contractual texts has been drawn on frequently. See eg *Wilson v Anderson* (2002) 190 ALR 313, [8]-9] per Gleeson CJ; The Hon Justice Michael Kirby, "Towards a Grand Theory of Interpretation – The Case of Statutes and Contracts", Clarity and Statute Law Society Joint Conference, Cambridge University, 13 July 2002.

provisions, the courts are looking to give effect to the meaning of the provision consistent with the purpose of the legislation as a whole. If all contractual powers and rights are construed as requiring 'good faith', then the purpose of the contractual provision within the meaning of the contract as a whole must be determined. Obligations and powers should be construed to ensure they give effect to the objective purposes of the contract as a whole. Parties will be required to perform their obligations and exercise their powers within the objective expectations of reasonable parties in their positions at the time of formation, thus, having regard to the interests of the other party, without excluding self-interested behaviour. However, in some contexts, contractual rights may be exercised for a completely self-interested reason, without breaching good faith, as the particular context allows such a construction.