

Issues of good faith and contract

By Patrick Mugliston

A cornerstone of contract law is certainty. Ultimately one might ask whether the interests of certainty in contractual activity should be interfered with without qualification, or perhaps only when the relationship between the parties is unbalanced and one party is at a substantial disadvantage, or is particularly vulnerable.

The difficulty in applying a general duty to act in good faith and reasonableness to all contracts is that parties can be advantaged for no reason at all. If one party to a contract is shrewder and strikes a massive contractual advantage over the other party, it is difficult to see why the latter should have greater protection.

Whether an obligation to act in good faith and reasonableness in the performance of contractual obligations should be implied in all commercial contracts is awaiting decision by the High Court of Australia. While it remains to be seen whether Australian courts will embrace the American civil law concept – that each contracting party should show good faith in the performance of contractual obligations – some have clearly stated that they will not do

so. For instance in *CSA Group Ltd v Siebe*,¹ Rogers CJ said he was not persuaded to accept that commercial interests should be required to act in good faith towards each other. He stated, specifically:

‘Why should contractual entities each with strong bargaining power, not be permitted to drive the best bargain they can, provided that they act within the law ... the courts should not be too eager to interfere in the commercial conduct of the parties, especially where the parties are all wealthy, experienced, commercial entities able to attend to their own interests.’

An obligation of good faith and reasonableness may be legally implicit as a matter of course in a commercial contract.² However, whether such an obligation should be implied as an incident to all commercial contracts has yet to be decided by the High Court.

The concept of acting in good faith is entrenched in certain discrete areas of contract. For instance, the common law imposes a duty of good faith in insurance contracts. This is based on what the insured knows and the insurer

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does not know, and cannot know, except if disclosed by the insured. As an extension of this concept, an insurer who settles a claim against a limited liability policy, must act in good faith towards the insured and have regard to his or her interests when defending the action against the insured and in their settlement.

The decisions in *Alcatel*³ and *Burger King Corporation* are significant, because they deal with the question of terms being implied as a matter of law on the basis of the intention of the parties. The question as to whether a term 'to act in good faith' can be imported into all transactions was not decided in those two decisions.

Kirby J, in his judgment in *Royal Botanic Gardens and Domain Trusts v South Sydney City Council*⁴ made the following comments:

'However, in Australia, such an implied term appears to conflict with fundamental notions of caveat emptor that are inherent (statute and equitable intervention apart) in common law conceptions of economic freedom. It also appears to be inconsistent with the law as it has developed in this country in respect of the introduction of implied terms into written contracts which the parties have admitted to include.'⁵

Those comments fall short of indicating support for the notion of the existence of such an implied term. The facts in *Royal Botanic Gardens* concerned a public corporation that was required by its statute to pursue commercial objectives. As Kirby J pointed out, 'it was not therefore entitled, without restraint, to pursue its own selfish, commercial, economic interest'.

In *Renard Constructions Pty Ltd v Minister of Public Works*,⁶ Priestley JA made significant comments regarding a clause in the building contract that empowered the principal to take over the whole or any part of the work or to cancel the contract if the contractor failed to comply with any direction given by the principal, however minor. Priestley JA held that the power so conferred on the principal must be exercised reasonably. His Honour said that notwithstanding recent decisions separating 'implication in fact' and 'implication by law', the former (referred to as implication *ad hoc*) are really an implication by the judge based on the judge's view of the actual intention of the parties drawn from the surrounding circumstances of the particular contract. The rules governing such implications were to be found in *BP Refinery (Western Port) Pty Ltd v Hastings Shire Council*⁷ and *Secured Income Real Estate (Australia) Ltd v Saint Martins Investment Pty Ltd*.⁸ Priestley JA said:

'Those rules are that the implied term must be reasonable and equitable; necessary to give business efficacy to the contract, so that no term will be implied if the contract is effective without it; so obvious that it "goes without saying"; capable of clear expression; and must not contradict any express term of the contract.'⁹

Further, Priestley JA implied 'reasonableness in performance' in the exercise of the contractual power to take over or cancel the contract. His Honour said:

'The kind of reasonableness I have been discussing seems to me to have much in common with the notions of good

faith which are regarded in any of the civil law systems of Europe and in all states in the United States as necessarily implied in many kinds of contract. Although this implication has not yet been accepted to the same extent in Australia as part of Australian contract law, there are many indications that the time may be fast approaching when the idea, long recognised as implicit in many of the orthodox techniques of solving contractual disputes, will gain explicit recognition in the same way it has in Europe and in the United States.'¹⁰

Sir Anthony Mason said in his 1993 Cambridge lecture that he thought it probable that the concept of 'good faith' embraced three related notions:

1. an obligation on the parties to co-operate in achieving the contractual objects;
2. compliance with the standards of conduct; and
3. compliance with standards of conduct that are reasonable, having regard to the interests of the party.

More recent cases indicate a change in judicial attitudes with regard to acceptance of an implied good faith in contracts. During the last three or four years, cases indicate that courts are increasingly wary of embracing the concept of a general duty of good faith. In the NSW Court of Appeal decision of *Vodafone Pacific v Mobile Innovations Ltd*,¹¹ Giles JA said that an obligation of good faith and reasonableness in the performance of a contractual obligation, or the exercise of contractual power, may be implied as a matter of law as a legal instant of a commercial contract. However, he made a point of stating that the law had not gone so far as to say that commercial contracts are a class of contracts carrying the implied terms as a legal incident. As for the distinction between implying a term as a matter of law and implying a term in order to give business efficacy to a contract one should have regard to the approach of McHugh and Gummow JJ in *Byrne v Australian Airlines Ltd*¹² where they explain it in this way:

'However, the more modern and better view is that these rules of construction are not rules of law so much as terms implied, in a sense of attributed to the contractual intent of the parties, unless the contrary appears on a proper construction of their bargain. There is force in the suggestion that what now would be classified as terms implied by law in particular classes of a case had their origin as implications based on the intention of the parties, but therefore became so much a part of the common understanding as to be imported into all transactions of the particular description.'¹³

In his reasons for his decision, Giles J refers to *Australia Media Holdings Pty Ltd v Telstra Corporation Ltd*¹⁴ as



supportive of the proposition that, as he puts it, 'at the end of the day, it is to be remembered that terms implied at law do not depend upon the intention of the parties'.

Yet Samuels JA, in *Simonrus Vischer & Co v Holt and Thompson*,¹⁵ stated:

'The imposition of terms as a matter of law amounts to no more than the imposition of legal duties in cases where the law thinks that policy requires it.'

Giles J in *Vodafone Pacific* went on to conclude in his reasons for decision that, while an obligation of good faith and reasonableness in performance of a contractual obligation implied as a matter of law is a legal incident of a commercial contract, similarly its application of the term as a matter of law may be precluded by expression of a contrary intent. *Vodafone* was cited by McDougall J with approval in *Tomlin v Ford Credit Australia*¹⁶ in support of the proposition that there is no general implication to exercise powers given under the contract in good faith. McDougall J said he would not find an implied obligation constraining the relevant powers to act reasonably or in good faith in the course of exercising the powers but the powers may be 'vitiating by conscious bad faith'.¹⁷

McDougall J went on to find that there was no implied term in the bailment agreements requiring Ford Credit to act in good faith.

In *Esso Australia Resources Pty Ltd v Southern Pacific Petroleum*,¹⁸ the Victorian Court of Appeal refused to accept that an implied duty of good faith applies generally to commercial contracts. Buchanan JA said that he was reluctant to conclude that a commercial contract class carries an implied term to act in good faith as a legal incident.¹⁹ He was not prepared to conclude that an obligation of good faith applies indiscriminately to all the rights and powers conferred by commercial contract. He did, however, say 'it may, however, be appropriate in a particular case to import such an obligation to protect a vulnerable party from exploited conduct which was the original purpose for which the contract was made'.²⁰ His Honour dealt with the issues before him in this context in the following way:

'The attack in this case mounted on appeal against the proposed deed of arrangement was aimed at a proposal

which, while it attended the assignment, was not a necessary part of it. The liquidation of SPP could have taken place independently of the assignment, and would have been open to the same objection raised against it as a term of the proposed arrangement, namely, that it deprived Esso of the advantages of a continuing guarantee and the presence of an original participant in the joint venture.

In this case it is not necessary to determine whether a term requiring the exercise of good faith is to be implied in the agreement, for even if such an obligation was imposed upon SPP, in my opinion it was not breached'.²¹ To rule that there is a standard of contractual conduct that is implicit in all commercial contracts rather than on an ad hoc basis may well be an attempt to introduce judicially commercial morality into contracts where parties may never have thought of so doing. Though one must be cautious about entering into contracts where it is assumed that each party is entitled, without restraint, to pursue its own selfish, commercial, economic interest, there is at least certainty in such a view as it accords more with commercial reality. There is much weight to the suggestion that the application of a doctrine of a duty of good faith will in itself bring uncertainty. ■

Notes: 1 (1993) *ATPR* ¶41-240 at ¶41-260. 2 *Burger King Corporation v Hungry Jack's Pty Limited* [2001] *NSWCA* 187 at para 159, the court said 'courts in various Australian jurisdictions have, for the most part, proceeded upon an assumption that there may be implied, as a legal incident of a commercial contract, terms of good faith and reasonableness'. 3 *Alcatel Australia Limited v Scarcella & Ors* [2001] *NSWCA* 401. 4 *Royal Botanic Gardens and Domain Trusts v South Sydney City Council* [2002] *HCA* 5. 5 *Ibid.*, at 88. 6 (1992) 26 *NSWLR* 234 at 255. 7 (1977) 52 *ALJR* 20; 16 *ALR* 363 (decision of the Privy Council). 8 (1979) 144 *CLR* 596. 9 *Renard Constructions* at 256. 10 *Ibid.*, at 263-4. 11 [2004] *NSWCA* 15. 12 (1995) 185 *CLR* 410. 13 *Ibid.*, at 449. 14 (1988) 43 *NSWLR* 104. 15 (1979) 2 *NSWLR* 322 at 348. 16 [2005] *NSWSC* 540. 17 *Ibid.*, at para 121. 18 [2005] *VSCA* 228. 19 *Ibid.*, at para 25. 20 *Ibid.* 21 *Ibid.*, at paragraphs 26 and 27.

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