



Asia Pacific Projects Update

EXERCISING A CONTRACTUAL DISCRETION AND THE OBLIGATION TO ACT IN GOOD FAITH

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GOOD FAITH & CONTRACTUAL DISCRETION

When parties agree to include discretionary rights in their agreement, one party will have the right to determine the outcome of some matter in prescribed circumstances. It is well established, however, that the courts have sought to influence the operation of discretionary provisions by imposing obligations of good faith on commercial players in certain situations. The key questions to be considered, are: when will courts impose an obligation of good faith, what does "good faith" mean, and how can parties create commercial certainty.

This update looks at the landscape of good faith in the context of discretionary provisions as a matter of contract law in an attempt to provide readers with the necessary background to approach this area of law. The law is unsettled and can change from State to State - an understanding of the state of play will enable parties to be fully informed when entering into contractual arrangements.

DISCRETIONARY PROVISIONS

Discretionary provisions can take a number of forms - key words alluding to the fact one party will have a contractual discretion in a contract include: "consent", "waiver", "approval", "election", "may", "right to terminate" and of course "discretion" itself. These types of words, and the discretions they confer, are used in a wide variety of circumstances. Some commonly used discretionary provisions are in respect of contract renewal, termination, valuations, variation, assignment and change of control.

Exercising a discretion is not always what it seems, though. Irrespective of the express words of an agreement, a party can sometimes be restricted in what it thought was a matter subject only to its (absolute) discretion. But when will this occur? And, just as important, can the imposition of further impediments to a contractual discretion be avoided in the name of certainty?

CERTAINTY

The law in this area can be adequately managed if the parties are aware of the current state of law in the various States - or otherwise, well advised. If the document expressly provides as much, good faith can be excluded from (or on the other hand be specifically applied to) the exercise of a discretionary provision.

The courts will not imply a term that requires good faith to be observed, if doing so would be inconsistent with the

express terms of the agreement. In *Sundararajah v Teachers Federation Health Ltd* Foster J said:

The courts will not imply an obligation of good faith unless it operates as an aid and in furtherance of the explicit terms of the contract and will never impose such an obligation if it would be inconsistent with other terms of the contractual relationship.¹

In short, a discretionary provision can be unfettered if the parties expressly set out as much in their agreement. A good example is the entire agreement clause. On its own, a standard clause of this type will not be effective to exclude an implied term (including an implied duty of good faith). However, if the provision is extended, simply by including the words (for example) "the parties agree no terms are to be implied into this agreement to the extent permitted by law", then the clause should be sufficient for the courts to give effect to the parties' intention.

The courts have also refused to impose a fetter on discretionary provisions where the drafting shows an intention not to interfere with its exercise. Descriptions such as "sole discretion" and "absolute discretion" have met this test.² Clauses which allow one party the right to terminate after a given notice period (often referred to as "termination for convenience clauses") have also been endorsed by the courts.³

GOOD FAITH & DISCRETIONARY PROVISIONS

For many reasons, it may not be possible to exclude good faith from the operation of a discretionary provision. It is of course commercially unrealistic in most contracts to expressly provide that the parties are not required to act in good faith. This would be inconsistent with the intention of most parties at the time of entering into a contract. Contracts are also likely to have the courts imply a term of good faith if one of the counterparties is at a disadvantage or particularly vulnerable.

GOOD FAITH IN AUSTRALIA

The process of implying good faith into contracts in Australia is unsettled and subject to much debate. What is certain is that there is an expectation that principles of good faith and reasonableness will be applied by the courts - it is what the community expects.⁴

Good faith has been identified as part of certain contracts on the basis of (i) contractual interpretation (that is, on the basis of interpretation of the express words of the contract, in the context of the agreement), (ii) implication at law (whereby the courts impose a term of good faith to ensure the contract operates effectively) and (iii) implication in fact (a term implied in fact will reflect what the court

presumes to have been the intention of the parties, but which the parties did not set out explicitly in their agreement).

GOOD FAITH IMPLIED IN FACT

The Privy Council in *BP Refinery (Westernport) Pty Ltd v Shire of Hastings*⁵ formulated five criteria for the implication of a contractual term. Such terms must (a) "be reasonable and equitable", (b) "be necessary to give business efficacy to the contract, so that no term will be implied if the contract is effective without it", (c) be so obvious that it "goes without saying", (d) "be capable of clear expression" and (e) "not contradict any express term of the contract".

Many Australian courts have followed the Privy Council's approach, however as we will see below, in the majority of States the courts favour implication of good faith as a matter of law.

GOOD FAITH IMPLIED AT LAW

Implication of contractual terms as a matter of law is not concerned with the parties' intention, but rather with ensuring the contract can operate, and that the rights under the contract are capable of enjoyment. The question posed, is whether the agreement falls within a class of contracts for which such a term is necessary.

The weight of judicial opinion suggests "commercial contracts" is too broad a description to constitute a class of contract, although some commercial contracts may of course fall within a class.

In conjunction with the "class" requirement set out above, the "test of necessity" must also be satisfied before a term can be implied at law. The question is whether or not implying the term would, or could, cause "the enjoyment of the rights conferred by the contract... [to] be rendered nugatory, worthless, or, perhaps, be seriously undermined".⁶

Some commercial contracts recognised as implying a term of good faith at law include government contracts, construction contracts, franchise agreements, business development agreements and commercial leases.

GOOD FAITH AS A MATTER OF CONTRACTUAL INTERPRETATION

Supporters of this approach submit good faith is inherent in contract law, and can be implemented by careful interpretation of a contract's express terms. The words of a contract are provided a meaning obtained from the circumstances, and the nature of the transaction.

Although taken up by some academics, this approach only has some support in the courts, with the majority of the decisions favouring an implied term of good faith.

WHAT IS GOOD FAITH

It goes without saying that the crux of any term of good faith, whether implied or incorporated as a matter of construction, is the concept of good faith itself. In the context of exercising a contractual discretion, what "good faith" means is fundamental - parties need to be aware of the parameters within which to act. Unfortunately, this area of law is unsettled, as reflected by the comments of Giles JA in *Vodafone Pacific Ltd v Mobile Innovations Ltd* when he referred to the "regrettable lack of uniformity in the cases".⁷

McDougall J has provided some guidance in this area which is worth repeating:

I do not think that it is fruitful to enquire, in some a priori way, as to the content of the concept of "good faith" in a contractual context. It is necessary to look at the particular contract, to see what might be comprehended as a particular expression of the general concept of good faith, and then to enquire whether that particular term, or a term having that particular content, should be implied, or whether is excluded by express terms or necessary implication from them.⁸

In practice, the following statement of law adopted by Hodgson JA,⁹ and which was taken from Sir Anthony Mason's "Cambridge Lectures",¹⁰ seems to reflect the view widely held by the judiciary that good faith encompasses:

- an obligation on the parties to co-operate in achieving the contractual objects;
- compliance with honest standards of conduct; and
- compliance with standards of conduct which are reasonable having regard to the interests of the parties.

The phrase "honest standards of conduct" has been the subject of some discussion, and so it is useful to note Finkelstein J's thoughts in *Pacific Brands Sport & Leisure Pty Ltd v Underworks Pty Ltd* on this point. His Honour refers to conduct allegedly carried out in good faith, and asks:

Was [it] motivated by bad faith, or was [it] for an ulterior motive or, if it be any different, [did] the defendant [act] arbitrarily or capriciously. It may also be proper to investigate whether the impugned act was oppressive or unfair in its result.¹¹

Importantly, Hodgson JA also clarified in whose interests good faith should operate:

... a contractual obligation of good faith does not require a party to act in the interests of the other party or to subordinate its own legitimate interest

to the interests of the other party; although it does require it to have due regard to the legitimate interests of both parties.¹²

SURVEYING THE LANDSCAPE

The jurisdictions have not been uniform in their approach to good faith, and the High Court has not yet provided guidance on the matter. As a consequence, how a discretionary provision should be exercised can be guided only by cases at first instance and appellate decisions. What follows is a brief synopsis of the current state of the law in each of the six States and federally.

NEW SOUTH WALES

The formative case on the implied term of good faith is the New South Wales case of *Renard Constructions (ME) Pty Limited v Minister for Public Works*.¹³

Insofar as the applicable technique for implication is concerned, a close reading of the case identifies that either implication in fact, or a "hybrid" approach, was originally adopted. This uncertainty was resolved in subsequent cases in which a term of good faith was implied by the courts at law. Regardless of some divergence in the New South Wales cases implication at law is still the favoured approach.

Recent case law has tended towards a cautious approach in which neither the class nor necessity requirement are discussed at length. The outcome in practice being courts merely asking whether a contract contains provisions inconsistent with implying a term of good faith. For instance, Hammerschlag J stated in *Solution 1 Pty Ltd v Optus Networks Pty Limited*:

I propose... to assume that unless excluded by express provision or because inconsistent with the terms of the Agreement, Optus was under an implied obligation to act in good faith in exercising its power.¹⁴

SOUTH AUSTRALIA

The Supreme Court of South Australia recently discussed good faith in the case of *Alstom Ltd v Yokogawa Australia Pty Ltd*.¹⁵ While the court chose to imply good faith at law, it elected not to discuss the relevant two limbs ("class" and "necessity"), and instead provided that every commercial contract contained a good faith provision implied at law, subject only to inconsistency with the express terms of the agreement.¹⁶

WESTERN AUSTRALIA

The Court of Appeal in Western Australia recently noted:

whether... there is an implied term of good faith remains an open question in Australia and the law in that respect is still to be determined.¹⁷

The Supreme Court has, however, assumed (without deciding the point) that the approach in New South Wales represents the law with respect to implying terms of good faith.¹⁸

QUEENSLAND

In Queensland the courts have been reluctant to make findings in respect of an implied term of good faith. However, the Queensland courts have gone on to discuss the position of the New South Wales courts, including implication of good faith as a matter of law, and have assumed that approach is correct for the purpose of considering submissions from parties alleging breach of the implied.¹⁹

VICTORIA

The Victorian courts, taking *Renard* as the building blocks for this area of law, have developed jurisprudence along different lines to New South Wales. Flowing directly from judicial statement in the leading case of *Esso Australia Resources Pty Limited v Southern Pacific Petroleum*,²⁰ the Victorian courts support the implication of good faith as a matter of fact.

Interestingly though, the courts have also identified a blending of sorts between implication in fact, and good faith as a product of contractual interpretation. For example, in *Network Ltd v Speck*²¹ Pagone J held a good faith requirement came about from the "language of the provisions themselves".²²

Another interesting comment made by the Victorian courts is in respect of bargaining power. Warren CJ in *Esso* has questioned whether it is appropriate to imply a term of good faith where the parties were "commercial leviathans", and had the nous and resources to look after their own interests.

TASMANIA

Tasmania's Supreme Court endorses the Victorian approach in *Esso*. A term requiring good faith is recognised as capable of being implied in fact as opposed to at law, and the court has stated "good faith is not a necessary legal incident of all commercial contracts".²³ There is recognition that what it means to act in "good faith" is unsettled.

FEDERAL

The Federal Court now looks to have acknowledged that an obligation of good faith can be imposed on contracts, although it has shied away from setting out definitive principles with respect to the technique for their inclusion. In fact, some judges have suggested there is no universal implied term of good faith, whilst others have considered and applied both techniques in respect of implication (in fact and at law). In other cases, it has been suggested good faith is "an incident (not an ad hoc implied term) of every commercial contract".²⁴

WRAP-UP

The law of good faith and its implication into contracts, and the flow on effect on the exercise of discretionary provisions, is unsettled and inconsistent. What is certain, is that the parties can to a large extent determine how their agreements will be interpreted if they turn their mind to the implied term of good faith prior to signing. Broad and express language should be used to exclude unwritten obligations on the parties, or alternatively, specific language should be utilised to set the boundaries of any good faith obligations that will need to be performed. Finally, it is noted that even if good faith obligations are effectively excluded, acting dishonestly, capriciously or arbitrarily could potentially give rise to liability in a range of legal actions such as misleading and deceptive conduct under statute, liability for which cannot be excluded.

¹ [2011] FCA 1031 at [66] referring to *Metropolitan Life v RJR Nabisco* (1989) F Supp 1504 at 517 and *Hoppers Crossing Club Ltd v Tattersalls Gaming Pty Ltd* [2005] VSC 114 at [24].

² See for example *Solution 1 Pty Ltd v Optus Networks Pty Limited and Ors* [2010] NSWSC 1060.

³ *Ibid*.

⁴ *Renard Constructions (ME) Pty Limited v Minister for Public Works* (1992) 26 NSWLR 234 at 268.

⁵ *BP Refinery (Westernport) Pty Ltd v Shire of Hastings* (1977) 52 ALJR 20.

⁶ *Byrne v Australian Airlines Ltd* (1995) 185 CLR 410 at 450 (McHugh and Gummow JJ); *Breen v Williams* (1996) 186 CLR 71 at 103 (Gaudron and McHugh JJ), 124 (Gummow J).

⁷ *Vodafone Pacific Ltd v Mobile Innovations Ltd* [2004] NSWCA 15 at [192].

⁸ Robert McDougall, *The Implied Duty of Good Faith in Australian Contract Law* http://www.lawlink.nsw.gov.au/lawlink/Supreme_Court/ll_sc.nsf/vwPrint1/SCO_mcdougall210206 at 9 October 2013.

⁹ *Macquarie International Health Clinic Pty Ltd v Sydney South West Area Health Service* [2010] NSWCA 268 at 146.

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- ¹⁰ Sir Anthony Mason, *Contract and its Relationship with Equitable Standards and the Doctrine of Good Faith*, The Cambridge Lectures, 1993 (8 July 1993).
- ¹¹ *Pacific Brands Sport & Leisure Pty Ltd v Underworks Pty Ltd* [2005] FCA 288 at [65].
- ¹² *Macquarie International Health Clinic Pty Ltd v Sydney South West Area Health Service* [2010] NSWCA 268 at 147.
- ¹³ *Renard Constructions (ME) Pty Limited v Minister for Public Works* (1992) 26 NSWLR 234.
- ¹⁴ *Solution 1 Pty Ltd v Optus Networks Pty Limited and Ors* [2010] NSWSC 1060 at 61.
- ¹⁵ *Alstom Ltd v Yokogawa Australia Pty Ltd and Anor* (No 7) [2012] SASC 49.
- ¹⁶ *Ibid.*
- ¹⁷ *Acton Real Estate Pty Ltd v Shemiran Pty Ltd* [2011] WASCA 33 at [14].
- ¹⁸ *Trans Petroleum (Australia) Pty Ltd v White Gum Petroleum Pty Ltd* [2012] WASCA 165 at [152].
- ¹⁹ *Kosho Pty Ltd and Anor v Trilogy Funds Management Ltd* [2013] QSC 135.
- ²⁰ *Eso Australia Resources Pty Limited v Southern Pacific Petroleum* [2005] VSCA 228.
- ²¹ *Network Ltd v Speck* [2009] VSC 235.
- ²² *Ibid.*, 21.
- ²³ *Driveforce Pty Ltd v Gunns Ltd* (No 3) [2010] TASSC 38 at [12].
- ²⁴ *Pacific Brands Sport and Leisure Pty Ltd v Underworks Pty Ltd* [2005] FCA 288 at [64].

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