

# IMPLIED FETTERS ON THE EXERCISE OF DISCRETIONARY CONTRACTUAL POWERS

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*Long-term commercial contracts commonly grant one of the parties a discretionary power to vary the contract in particular respects. In Australia, the exercise of discretionary contractual powers may be fettered by a general duty of good faith in contract performance. In England, the exercise of discretionary contractual powers may be fettered by a number of more specific implied duties. This paper considers the content of these duties. The paper argues that the substance of the duty of good faith implied by Australian courts is similar to the specific duties implied in England. It argues that the duties need not be unduly disruptive to commercial certainty or party autonomy. In fettering the exercise of discretionary contractual powers, courts have drawn on principles governing the judicial review of administrative action, namely requirements that a discretionary power should not be exercised for an 'extraneous' purpose or unreasonably. Moreover, Australian courts have repeatedly recognised that the implied duties fettering the exercise of discretionary contractual powers will not prevent parties from acting to preserve their legitimate interests. Courts have also been cautious in applying the duties to fetter the exercise of contractual powers to terminate.*

## I INTRODUCTION

While a contractual power will be illusory if the grantee of the power has an unfettered discretion whether to perform,<sup>1</sup> courts have accepted that a party may be granted a power to determine the manner of performance of particular obligations.<sup>2</sup> Consistently with this distinction, long-term commercial contracts commonly grant one of the parties a discretionary power to vary the rights and obligations of the other party under the contract in particular respects.<sup>3</sup> For example, a lender may be granted a discretionary power to vary the interest rates applicable to its borrowers. An employer may be granted a discretionary power to award bonus payments to employees. A franchisor may be granted a discretionary power to change the operating standards of the franchise.

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1 *Placer Development Ltd v Commonwealth* (1969) 121 CLR 353, 356. See also *Thorby v Goldberg* (1964) 112 CLR 597, 605.

2 *Thorby v Goldberg* (1964) 112 CLR 597, 605. See also *Godecke v Kirwan* (1973) 129 CLR 629, 642.

3 See Mark Gergen, 'The Use of Open Terms in Contract' (1992) 92 *Columbia Law Review* 997; Victor Goldberg, 'Discretion in Long-Term Open Quantity Contracts: Reining in Good Faith' (2002) 35 *University of California Davis Law Review* 319.

The grant of a discretionary contractual power gives the grantee of the power a degree of flexibility in responding to the various contingencies which may affect performance of the contract.<sup>4</sup> For the party subject to the exercise of the power, the grant of a discretionary contractual power must necessarily carry the risk that the power will be exercised in a way that makes performance of the contract more burdensome than was originally the case. The grant of a discretionary power also carries the risk that the power will be exercised in a manner that is not consistent with the intended purpose of the power or is otherwise unreasonable.<sup>5</sup> For example, a lender may use its discretionary power to vary interest rates for the purpose of responding to changes in market conditions or to pressure an individual borrower who is not in default to terminate the loan contract in circumstances where the lender has no direct power to terminate. An employer may use a discretionary power to award bonus payments to ensure that bonus payments are commensurate with the employee's performance or to deny a well-performing employee any bonus payment at all. A franchisor may use a discretionary power to change franchise operating standards for the purpose of improving the franchise system or to appropriate the territory of a successful franchisee.

Courts in both Australia and England have responded to the risk of abuse of discretionary contractual powers by being prepared to imply duties fettering the exercise of such powers. At one level, the approaches have been quite different. In Australia, intermediate courts have held that the exercise of discretionary contractual powers may be fettered by a general duty of good faith in contract performance. In England, courts have relied on a number of specific duties to fetter the exercise of discretionary contractual powers. English courts have stressed that these duties do not express some generalised notion of good faith or fair dealing. Nonetheless, it is suggested in this paper that the English and Australian approaches are similar in substance. Australian courts have suggested that an implied duty of good faith should preclude parties from exercising contractual powers for 'extraneous' or 'improper' purposes and it also requires the exercise of the powers to be 'reasonable'.<sup>6</sup> In England, the duties implied by courts to fetter the exercise of discretionary contractual powers prohibit the exercise of the powers for an 'improper purpose' or 'unreasonably'.<sup>7</sup> Courts in both jurisdictions have held that discretionary contractual powers must be exercised honestly and have raised the possibility of a duty to make inquiries before exercising such powers.

Particularly when described as applications of a duty of 'good faith', implied duties fettering express contractual powers inevitably raise concerns about commercial

4 See also Robert Hillman, *The Richness of Contract Law: An Analysis and Critique of Contemporary Theories of Contract Law* (1996) Ch 7.

5 See generally Hugh Collins, 'Discretionary Powers in Contracts' in David Campbell, Hugh Collins and John Wightman (eds), *Implicit Dimensions of Contract: Discrete, Relational and Network Contracts* (2003) 219, 240.

6 See generally Jeannie Marie Paterson, 'The Standard of Good Faith Performance: Reasonable Expectations or Community Standards?' in Michael Bryan (ed), *Private Law in Theory and Practice* (2007).

7 Collins, above n 5.

certainty and freedom of contract. Thus, in *Esso Australia Resources Pty Ltd v Southern Pacific Petroleum NL*,<sup>8</sup> Warren CJ commented that:

the current reticence attending the application and recognition of a duty of good faith probably lies as much with the vagueness and imprecision inherent in defining commercial morality. The modern law of contract has developed on the premise of achieving certainty in commerce. If good faith is not readily capable of definition then that certainty is undermined.<sup>9</sup>

This paper argues that the duties implied by Australian and English courts to fetter the exercise of discretionary contractual powers need not be unduly disruptive to commercial certainty or party autonomy. Courts have not subjected the merits of the decisions of contracting parties to critical review by reference to vague standards of commercial morality. Rather, courts have drawn on principles familiar in the context of judicial review of the exercise of administrative power, to require contracting parties to conform to basic standards of good decision-making. The extent to which parties may contract out of the implied duties fettering the exercise of discretionary contractual powers is uncertain. However, Australian courts have recognised that the implied duties will not prevent parties from acting to preserve their legitimate business interests. Moreover, at least in practice, courts have been unwilling to impose substantial fetters on the exercise of contractual powers to terminate.

In exploring these issues, Part II of the paper compares the approaches of courts in England and Australia in fettering the exercise of discretionary contractual powers. Part III considers the duties implied by courts in both jurisdictions: honesty, not to use a power for an extrinsic or improper purpose, not to exercise a power in a manner that is unreasonable and, possibly, to make inquiries about the circumstances relevant to the exercise of the power. Part IV considers the role of a party's legitimate interests in acting as a defence to a claim that a discretionary contractual power was exercised in a manner contrary to the implied duties fettering that power. Part V considers whether parties can contract out of the duties. Part VI considers the role of the duties in fettering discretionary powers to terminate a contract.

## **II AUSTRALIAN AND ENGLISH RESPONSES TO DISCRETIONARY CONTRACTUAL POWERS COMPARED**

### **A Australia**

In *Royal Botanic Gardens v South Sydney City Council*<sup>10</sup> the High Court left open the issue of whether Australian law should recognise a duty of good faith

8 [2005] VSCA 228 (Unreported, Warren CJ, Buchanan JA and Osborn AJA, 15 September 2005) ('*Esso*').

9 *Ibid* [3].

10 (2002) 186 ALR 289.

in contract performance.<sup>11</sup> Intermediate courts have been prepared to recognise a duty of good faith fettering the exercise of discretionary contractual powers,<sup>12</sup> although there are few examples of actual breach of the duty.<sup>13</sup> The character and the requirements of the duty are not altogether certain. In terms of character, it has been suggested that the duty of good faith is a principle of construction inherent in all contracts.<sup>14</sup> While there may be considerable merit in this suggestion, most courts have treated the duty as an implied term.<sup>15</sup> Generally, good faith has been treated as a term implied in law<sup>16</sup> rather than a term implied in fact.<sup>17</sup> As Steytler J commented in *Central Exchange Ltd v Anaconda Nickel Ltd*,<sup>18</sup> '[the] preference for implication as a matter of law is no doubt due to the difficulty of complying with the criteria for an implication in fact'.<sup>19</sup>

It has been suggested that the duty of good faith should be characterised as a 'universal' term expressing 'the standard of conduct to which all contracting parties

- 11 Ibid 301 (Gleeson CJ, Gaudron, McHugh, Gummow and Hayne JJ), 327 (Callinan J), see also, 312 (Kirby J).
- 12 See, eg, *Renard Constructions (ME) Pty Ltd v Minister for Public Works* (1992) 26 NSWLR 234, 263–8 ('*Renard Constructions*'); *Hughes Aircraft Systems International v Airservices Australia* (1997) 76 FCR 151, 191–3; *South Sydney District Rugby League Football Club Ltd v News Ltd* (2000) 177 ALR 611; *Far Horizons Pty Ltd v McDonald's Australia Ltd* [2000] VSC 310 (Unreported, Byrne J, 18 August 2000); *CBFC Ltd v Edwards* [2001] SADC 40 (Unreported, Lee J, 28 March 2001); *Central Exchange Ltd v Anaconda Nickel Ltd* (2002) 26 WAR 33 [16], [55]; *Expectation Pty Ltd v Pinnacle VRB Ltd* [2002] WASCA 160 (Unreported, Steytler, Miller and Hasluck JJ, 19 June 2002). See also *Laurelmont Pty Ltd v Stockdale & Leggo (Queensland) Pty Ltd* [2001] QCA 212 (Unreported, McPherson, Williams JJA and Dutney J, 5 June 2001) ('*Laurelmont*'). Cf *Service Station Association Ltd v Berg Bennett & Associates Pty Ltd* (1993) 45 FCR 84, 91–8.
- 13 See, eg, *Burger King Corporation v Hungry Jack's Pty Ltd* (2001) 69 NSWLR 558 ('*Burger King*'); *Pacific Brands Sport & Leisure Pty Ltd v Underworks Pty Ltd* [2005] FCA 288 (Unreported, Finn, Sundberg and Emmett JJ, 23 March 2006) ('*Pacific Brands*') (issue not decided on appeal in *Pacific Brands Sport & Leisure Pty Ltd v Underworks Pty Ltd* (2006) 149 FCR 395, 423 [119]).
- 14 See Elisabeth Peden, 'Incorporating Terms of Good Faith in Contract Law in Australia' (2001) 23 *Sydney Law Review* 223, 230; Elisabeth Peden, 'Co-operation in English Contract Law: To Construe or Imply' (2000) 16 *Journal of Contract Law* 56; Elisabeth Peden, *Good Faith in the Performance of Contracts* (2003); Elisabeth Peden, 'Implicit Good Faith: Or Do We Still Need an Implied Term of Good Faith' (2009) 25 *Journal of Contract Law* 50.
- 15 See, eg, *Vodafone Pacific Ltd v Mobile Innovations Ltd* [2004] NSWCA 15 (Unreported, Sheller, Giles and Ipp JJA, 20 February 2004) [206] ('*Vodafone Pacific*'); *CGU Workers Compensation (NSW) Ltd v Garcia* (2007) 69 NSWLR 680, 704–5; *Australian Hotels Association (NSW) v TAB Ltd* [2006] NSWSC 293 (Unreported, Bergin J, 19 April 2006) [78]; *Insight Oceania Pty Ltd v Philips Electronics Australia Ltd* [2008] NSWSC 710 (Unreported, Bergin J, 23 July 2008) [168]–[185]; *Esso* [2005] VSCA 228 (Unreported, Warren CJ, Buchanan JA and Osborn AJA, 15 September 2005) [25].
- 16 See, eg, *Alcatel Australia Ltd v Scarcella* (1998) 44 NSWLR 349, 369 ('*Alcatel*'); *Garry Rogers Motors (Aust) Pty Ltd v Subaru (Aust) Pty Ltd* [1999] ATPR ¶41–703, 43–014 ('*Garry Rogers Motors*'); *Burger King* (2001) 69 NSWLR 558, 569; *Commonwealth Bank of Australia Ltd v Spira* (2002) 174 FLR 274, [140]; *Commonwealth Development Bank of Australia Pty Ltd v Cassegrain* [2002] NSWSC 965 (Unreported, Einstein J, 22 October 2002) [210].
- 17 But see, treating good faith as implied in fact, *Renard Constructions* (1992) 26 NSWLR 234; *GSA Group Pty Ltd v Siebe plc* (1993) 30 NSWLR 573, 580; *News Ltd v Australian Rugby Football League Ltd* (1996) 58 FCR 447, 541; *Hughes Aircraft Systems International v Airservices Australia* (1997) 76 FCR 151. See also *South Sydney District Rugby League Football Club Ltd v News Ltd* (2000) 177 ALR 611; *Overlook Management BV v Foxtel Management Pty Ltd* (2002) ATPR ¶46–219; *De Pasquale v The Australian Chess Federation Inc* [2000] ACTSC 94 (Unreported, Gray J, 20 October 2000) [17].
- 18 (2002) 26 WAR 33.
- 19 Ibid [52].

are to be expected to adhere throughout the lives of their contracts'.<sup>20</sup> However, courts subsequently have distanced themselves from such general statements.<sup>21</sup> At this stage, it appears that good faith will be implied into particular classes of commercial contract rather than into all contracts. A duty of good faith fettering the exercise of broad contractual powers has been implied in a range of commercial contracts including: the power of a building principal to make decisions about the consequences of breach,<sup>22</sup> the power of a franchisor to approve new franchise sites proposed by a franchisee,<sup>23</sup> the power of a franchisor to vary franchise conditions,<sup>24</sup> and the power of a principal to set sales targets for a distributor.<sup>25</sup>

The various descriptions of the standard of conduct required by the implied duty of good faith have been described by one court as 'bewildering'.<sup>26</sup> However, the cases indicate some core content to the duty. Primarily, the duty of good faith in contract performance precludes parties from exercising contractual powers 'capriciously' or for an 'extraneous purpose'.<sup>27</sup> Obligations of honesty<sup>28</sup> and to inquire<sup>29</sup> have arisen in some cases. Courts have sometimes also stated that the duty of good faith incorporates a standard of reasonableness in the exercise of discretionary contractual powers,<sup>30</sup> although this standard has rarely been applied.

## B England

The classic description of the duties implied by English courts to fetter the exercise of discretionary contractual powers is found in the statement of Leggatt LJ in *Abu Dhabi National Tanker Co v Product Star Shipping Ltd (No 2)*:<sup>31</sup>

Where A and B contract with each other to confer a discretion on A, that does not render B subject to A's uninhibited whim. In my judgment,

20 *Hughes Aircraft Systems International v Airservices Australia* (1997) 76 FCR 151, 193 (Finn J). See also *Garry Rogers Motors* [1999] ATPR ¶41–703, 43 014; *Alcatel* (1998) 44 NSWLR 349, 366.

21 See, eg, *CGU Workers Compensation (NSW) Ltd v Garcia* (2007) 69 NSWLR 680, 704–5; *Australian Hotels Association (NSW) v TAB Ltd* [2006] NSWSC 293 (Unreported, Bergin J, 19 April 2006) [78]; *Insight Oceania Pty Ltd v Philips Electronics Australia Ltd* [2008] NSWSC 710 (Unreported, Bergin J, 23 July 2008).

22 *Renard Constructions* (1992) 26 NSWLR 234, 263–8.

23 *Burger King* (2001) 69 NSWLR 558.

24 *J F Keir Pty Ltd v Priority Management Systems Pty Ltd* [2007] NSWSC 789 (Unreported, Rein AJ, 24 July 2007) ('*J F Keir*'). See also *Garry Rogers Motors* [1999] ATPR ¶41–703.

25 *Apple Communications Ltd v Optus Mobile Pty Ltd* [2001] NSWSC 635 (Unreported, Windeyer J, 26 July 2001).

26 *Council of the City of Sydney v Goldspar Australia Pty Ltd* (2006) 230 ALR 437, 498 [166]. See also *Esso* [2005] VSCA 228 (Unreported, Warren CJ, Buchanan JA and Osborn AJA, 15 September 2005).

27 See *Alcatel* (1998) 44 NSWLR 349, 368; *Garry Rogers Motors* [1999] ATPR ¶41–703; *Far Horizons Pty Ltd v McDonald's Australia Ltd* [2000] VSC 310 (Unreported, Byrne J, 18 August 2000) [115]; *Burger King* (2001) 69 NSWLR 558, 573. See also *Vodafone Pacific* [2004] NSWCA 15 (Unreported, Sheller, Giles and Ipp JJA, 20 February 2004).

28 See, eg, *Thiess Contractors Pty Ltd v Placer (Granny Smith) Pty Ltd* [2000] WASCA 102 (Unreported, Ipp, Steytler and Wheeler JJ, 14 April 2000) [36]; rev'd (on other grounds) (2003) 196 ALR 257.

29 See, eg, *Renard Constructions* (1992) 26 NSWLR 234.

30 *Ibid.*

31 [1993] 1 Lloyd's Rep 397 ('*The Product Star*').

the authorities show that not only must the discretion 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.<sup>32</sup>

Although the matter is not entirely clear, it appears that the duties are terms implied in fact on the basis that they 'go without saying'.<sup>33</sup> Examples of cases in which courts have been prepared to imply the duties fettering the exercise of a discretionary contractual power include: the power of a master or owner of a ship under a charter-party to determine whether any port to which the vessel was ordered was dangerous,<sup>34</sup> the power of an insurer to approve settlement of an insurance claim,<sup>35</sup> the power of a lender to set interest rates,<sup>36</sup> the power of an employer to pay employees under bonus, option and other incentive schemes,<sup>37</sup> the power of a property owner to approve new licensees or tenants<sup>38</sup> and the power of a building principal to make decisions about changes in the works.<sup>39</sup>

English courts have not traditionally recognised an implied duty of reasonableness or good faith fettering the exercise of contractual powers, or a doctrine of abuse of rights.<sup>40</sup> Where English courts have implied terms to resolve disputes they have generally preferred relatively specific duties over general standards. As Steyn J has observed:

Compared to the civil law, English law shows a considerable hospitality to implied terms. In civil law countries the existence of a generalised duty of good faith in the performance of contracts reduces the need for the implication of terms. In the absence of a doctrine of good faith English law has to resort to the implication of the terms by reason of the nature of the contract (eg an implied duty to cooperate where the contract cannot be performed without cooperation, as in *Mackay v Dick* (1881) 6 App Cas 251) or by reason of special circumstances of a particular contract.<sup>41</sup>

32 Ibid 404.

33 *Gan Insurance Co Ltd v Tai Ping Insurance Co Ltd* [2001] EWCA Civ 1047 (Unreported, Mance, Latham LJ and Sir Christopher Staughton, 3 July 2001) [67] ('*Gan Insurance*'); *Paragon Finance plc v Staunton* [2002] 2 All ER 248, 260 ('*Paragon Finance*').

34 *The Product Star* [1993] 1 Lloyd's Rep 397, 404. See also *Tillmanns & Co v SS Knutsford Ltd* [1908] 2 KB 385.

35 *Gan Insurance* [2001] EWCA Civ 1047 (Unreported, Mance, Latham LJ and Sir Christopher Staughton, 3 July 2001).

36 *Paragon Finance* [2002] 2 All ER 248.

37 *Mallone v BPB Industries plc* [2002] EWCA Civ 126 (Unreported, Rix, Waller LJ and Wilson J, 19 February 2002); *Horkulak v Cantor Fitzgerald International* [2004] EWCA Civ 1287 (Unreported, Potter, Carnwath LJ and Bodey J, 14 October 2004) ('*Horkulak*').

38 *Lymington Marina Ltd v MacNamara* [2006] EWHC 704 (Ch) (Unreported, Patten J, 4 April 2006). See also *Price v Bouch* (1986) 53 P & CR 257.

39 *Balfour Beatty Civil Engineering Ltd v Docklands Light Railway Ltd* (1996) 78 BLR 42.

40 *Allen v Flood* [1898] AC 1.

41 Johan Steyn, 'The Role of Good Faith and Fair Dealing in Contract Law: A Hair-Shirt Philosophy' (1991) *Denning Law Journal* 131, 133. See also John O'Connor, *Good Faith in English Law* (1991) 19.

Consistently with this statement, English courts have emphasised that the duties implied to fetter the exercise of discretionary contractual powers are not an expression of a general duty of good faith or fair dealing in contract performance.<sup>42</sup> Nonetheless, the duties implied by English courts may perform a similar function to a duty of good faith. As discussed above, Australian courts striving to give content to a duty of good faith in contract performance have, like English courts, drawn on a requirement not to exercise the power for an improper purpose. Proponents of a general duty of good faith in English law might argue that explicit recognition of the role of good faith in contracting would allow courts to better articulate the policy and values behind their judgments.<sup>43</sup> On the other hand, it might be argued that the vagueness and uncertainty associated with a duty of good faith in Australian law might be avoided through the use of the more specific duties implied by English courts to fetter discretionary contractual powers.

### **C Why Fetter Discretionary Contractual Powers?**

In *Gan Insurance Co Ltd v Tai Ping International Co Ltd*<sup>44</sup> (*Gan Insurance*) Mance LJ said that the breadth of a discretionary contractual power was not of itself a sufficient reason to imply a term fettering that discretion. Lord Justice Mance explained that:

the authorities do not justify any automatic implication [of a term], whenever a contractual provision exists putting one party at the mercy of another's exercise of discretion. It all depends on the circumstances.<sup>45</sup>

Nonetheless, it appears that the main trigger for courts to imply duties fettering the exercise of broad discretionary contractual powers is concern about the consequences of leaving such powers unfettered. In *Paragon Finance Plc v Staunton*<sup>46</sup> (*Paragon Finance*) the Court of Appeal implied a term that a lender's 'discretion to vary interest rates should not be exercised dishonestly, for an improper purpose, capriciously, or arbitrarily'.<sup>47</sup> Dyson LJ could not accept that the power could be completely unfettered because that would leave the lender free to specify interest rates at an exorbitant level.<sup>48</sup> Somewhat similarly, in *Burger King Corporation v Hungry Jack's Pty Ltd*<sup>49</sup> (*Burger King*), Sheller, Beazley

42 *The Product Star* [1993] 1 Lloyd's Rep 397, 404; See also *Horkulak* [2004] EWCA Civ 1287 (Unreported, Potter, Carnwath LJJ and Bodey J, 14 October 2004) [30].

43 Roger Brownsword, 'Two Concepts of Good Faith' (1994) 7 *Journal of Contract Law* 197; Sir Anthony Mason, 'Contract, Good Faith and Equitable Standards in Fair Dealing' (2000) 116 *Law Quarterly Review* 66; Robert Summers, 'Good Faith in General Contract Law and the Sales Provisions of the Uniform Commercial Code' (1968) 54 *Virginia Law Review* 195, 198–9; Raphael Powell, 'Good Faith in Contracts' (1956) 9 *Current Legal Problems* 16, 26.

44 [2001] EWCA Civ 1047 (Unreported, Mance, Latham LJJ and Sir Christopher Staughton, 3 July 2001).

45 *Ibid* [62].

46 [2002] 2 All ER 248.

47 *Ibid* 260.

48 *Ibid* 259.

49 (2001) 69 NSWLR 558.

and Stein JJA of the New South Wales Court of Appeal expressed concern that, without a duty of good faith fettering the discretionary powers of a franchisor, the franchisor could, 'for the slightest of breaches, bring to an end the very valuable powers which [the franchisee] had under the [franchise contract]'.<sup>50</sup>

Courts appear to regard unfettered discretionary contractual powers as inconsistent with the expectations of the parties. *Horkulak v Cantor Fitzgerald International*<sup>51</sup> ('*Horkulak*') concerned the construction and application of a contractual 'discretionary' bonus clause in the employment contract of the claimant/respondent. Potter LJ concluded that:

While, in any such situation, the parties are likely to have conflicting interests and the provisions of the contract effectively place the resolution of that conflict in the hands of the party exercising the discretion, it is presumed to be the reasonable expectation and therefore the common intention of the parties that there should be a genuine and rational, as opposed to an empty or irrational, exercise of discretion.<sup>52</sup>

Where one party is granted a discretionary power over some aspect of contract performance it is foreseeable that the exercise of that power will make performance more onerous for the party subject to the power and that party can be presumed to have accepted this risk. However, the institution of contracting requires some level of cooperation between contracting parties and a shared commitment to performance of the contract. Accordingly, courts will not normally presume that parties would have consented to a discretionary contractual power being exercised for reasons contrary to the purposes for which the power was granted or in an unreasonable and arbitrary manner.

### III THE DUTIES IMPLIED

#### A *Honesty*

The duty of good faith is generally agreed to require honesty from contracting parties.<sup>53</sup> The requirement is of relatively narrow application.<sup>54</sup> Strictly, the honesty of the grantee of a discretionary contractual power will only be relevant where the contract requires some belief to be held by the grantee. For example, where a right to terminate a contract is made conditional on the principal not being satisfied with the explanation given by the contractor as to the reason why the contract should not be terminated, then the principal must be honestly dissatisfied

50 Ibid 573. See also *Renard Constructions* (1992) 26 NSWLR 234, 258.

51 [2004] EWCA Civ 1287 (Unreported, Potter, Carnwath LJJ and Bodey J, 14 October 2004).

52 Ibid [30].

53 See, eg, *Thiess Contractors Pty Ltd v Placer (Granny Smith) Pty Ltd* [2000] WASCA 102 (Unreported, Ipp, Steytler and Wheeler JJ, 14 April 2000) [36]; rev'd (on other grounds) (2003) 196 ALR 257.

54 See, eg, Allan Farnsworth, *Farnsworth on Contracts* (1990) vol 2, 331; See also Allan Farnsworth, 'Good Faith in Contract Performance' in Jack Beatson and Daniel Friedmann (eds), *Good Faith and Fault in Contract Law* (1995) 153.



before the power can be exercised. In such a case, the requirement of honesty will be inherent in the condition.<sup>55</sup> A principal cannot be either satisfied, or dissatisfied, unless the judgment as to satisfaction is honestly made. By contrast, where a contractual power is not conditioned on the grantee of the power having a particular state of mind, no issue of honesty can arise. For example, if a franchisor is granted a power to change the standards under which the franchise is operated, the honesty of the franchisor will not be relevant to the exercise of the power, although, as discussed below, the franchisor's purpose may be.<sup>56</sup>

Establishing dishonesty on the part of the grantee of a discretionary contractual power may be difficult simply because evidence about the grantee's actual reasons for exercising the power may not be available. Nonetheless, the difficulty need not be insurmountable.<sup>57</sup> In other areas of the law courts have considered themselves capable of dealing with questions about a party's state of mind.<sup>58</sup> There may be evidence of the grantee's subjective intentions in the form of written memoranda. An inference of dishonesty might be drawn where the decision was made for an improper purpose<sup>59</sup> or was unreasonable.<sup>60</sup>

In *Deemcope Pty Ltd v Cantown Pty Ltd*<sup>61</sup> a purchaser of commercial property had a right to avoid the contract where an amended plan of subdivision was not completed to its 'reasonable satisfaction' by a given date. The purchaser purported to exercise this right on the basis that the amended plan did not reflect an oral agreement about the position of a stairway. In the Supreme Court of Victoria, Coldrey J held that the purchaser had not exercised the right in accordance with its terms. His Honour concluded that the purchaser's rejection of the plan was neither honest nor reasonable. Rather, the purchaser 'used his purported dissatisfaction as a further weapon in his endeavour to avoid the contract'.<sup>62</sup> Coldrey J identified a number of factors as relevant to his decision. His Honour considered that no specific agreement had ever been reached between the parties as to the position of the stairway. Nor had the issue been discussed in any great detail at the relevant time.<sup>63</sup> It was also conceded by the purchaser that he was seeking a way to avoid the contract, which he now considered worth less than the agreed purchase price.<sup>64</sup>

55 See also *Meehan v Jones* (1982) 149 CLR 571, 597 (implying the word 'honest' to a condition of satisfaction adds nothing).

56 See below text at n 74.

57 James Brook, 'Conditions of Personal Satisfaction in the Law of Contracts' (1981) 27 *New York Law School Law Review* 103, 115–19.

58 *Meehan v Jones* (1982) 149 CLR 571, 578. See generally *Edginton v Fitzmaurice* (1885) 29 Ch D 459, 483 (Bowen LJ).

59 See *The Product Star* [1993] 1 Lloyd's Rep 397, 405; See also *Williams v Hirshorn* (1918) 91 NJL 419. Cf *Gold Coast Waterways Authority v Salmead Pty Ltd* [1997] 1 Qd R 346.

60 See *Ee v Kahar* (1979) 40 P & CR 223, 230; *Freedom v AHR Constructions Pty Ltd* [1987] 1 Qd R 59, 61; *VL Credits Pty Ltd v Switzerland General Insurance Co Ltd (No 2)* [1991] 2 VR 311, 315. See also *Grobarchik v Nasa Mortgage & Inv Co* (1936) 186 A 433, 434.

61 [1995] 2 VR 44.

62 *Ibid* 59 (Coldrey J).

63 *Ibid*.

64 *Ibid*.

## B Improper or Extraneous Purpose

In England<sup>65</sup> and Australia,<sup>66</sup> as well as in Canada<sup>67</sup> and the United States,<sup>68</sup> courts have repeatedly held that discretionary contractual powers should not be exercised for an ‘improper’ or ‘extraneous’ purpose. In Australia, the requirement is part of the duty of good faith. Thus, in *Alcatel v Scarcella*<sup>69</sup> (*Alcatel*) Sheller JA (with whom Powell and Beazley JJA agreed), in discussing the implied duty of good faith, said:

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, conclude that the powers are being exercised in a capricious or arbitrary manner or for an extraneous purpose, which is another way of saying the same thing.<sup>70</sup>

In England, a duty not to exercise a discretionary contractual power for an improper purpose is implied in its own right. A good example is *Gan Insurance*.<sup>71</sup> The case concerned a reinsurance contract which contained a clause providing that no settlement or compromise of a claim could be made, or liability admitted by the insured, without the prior approval of the reinsurers. Mance LJ (with whom Latham LJ agreed) said:

I would therefore accept, as a general qualification, that any withholding of approval by reinsurers should take place in good faith after consideration of and on the basis of the facts giving rise to the particular claim and not

65 See, eg, *Shearson Lehman Hutton v Maclaine Watson & Co* [1989] 2 Lloyd’s Rep 570, 629 (*‘Shearson’*); *The Product Star* [1993] 1 Lloyd’s Rep 397, 404; *Gan Insurance* [2001] EWCA Civ 1047 (Unreported, Mance, Latham LJJ and Sir Christopher Staughton, 3 July 2001) [67]; *Paragon Finance* [2002] 2 All ER 248, 262. See also *Weinberger v Inglis* [1919] AC 606; *Price v Bouch* (1986) 53 P & CR 257.

66 See, eg, *Alcatel* (1998) 44 NSWLR 349, 368; *Blackler v Felpure Pty Ltd* [1999] NSWSC 958, (Unreported, Bryson J, 24 September 1999) [32]; *Garry Rogers Motors* [1999] ATPR ¶41–703, 43–014; *Far Horizons Pty Ltd v McDonald’s Australia Ltd* [2000] VSC 310 (Unreported, Byrne J, 18 August 2000) [115]; *Burger King* (2001) 69 NSWLR 558, 573; *Overlook Management BV v Foxel Management Pty Ltd* (2002) ATPR ¶46–219 [73]; *Wenzel v Australian Stock Exchange Ltd* (2002) 118 FCR 505, 526–7.

67 See, eg, *McKinlay Motors Ltd v Honda Canada Inc* (1989) Nfld & PEIR 200; *Gateway Realty Ltd v Arton Holdings Ltd (No 3)* (1991) 106 NSR (2d) 180; *Mesa Operating Limited Partnership v Amoco Canada Resources Ltd* (1994) AR 187, 191. See also *Houle v Canadian National Bank* (1990) 74 DLR (4th) 577, 610.

68 See, eg, *Shor-Line Rambler Inc v American Motors Sales*, 543 F 2d 601 (7th Cir, 1976); *Photovest Corp v Fotomat Corp*, 606 F 2d 704, 728 (7th Cir, 1979), cert denied 445 US 917 (1980); *Tymshare Inc v Covell*, 727 F 2d 1145 (DC Cir, 1984); *Valentine v Mobil Oil Corp*, 789 F 2d 1388, 1392 (9th Cir, 1986); *Fox Motors v Mazda Distributors (Gulf) Inc*, 806 F 2d 953 (10th Cir, 1986); *Brattleboro Auto Sales Inc v Subaru of New England Inc*, 633 F 2d 649, 652 (2nd Cir, 1980); *KMC Co v Irving Trust Co*, 757 F 2d 752, 759 (6th Cir, 1985); *American Mart Corp v Joseph E Seagram & Sons*, 824 F 2d 733, 734 (9th Cir, 1987); *Schott Motorcycle Supply Inc v American Honda Motor Co Inc*, 976 F 2d 58, 63–4 (1st Cir, 1992). See also Gillian Hadfield, ‘Problematic Relations: Franchising and the Law of Incomplete Contracts’ (1990) 42 *Stanford Law Review* 927, 980–5.

69 (1998) 44 NSWLR 349.

70 Ibid 368.

71 [2001] EWCA Civ 1047 (Unreported, Mance, Latham LJJ and Sir Christopher Staughton, 3 July 2001).

with reference to considerations wholly extraneous to the subject matter of the particular reinsurance.<sup>72</sup>

In the context of judicial review of the exercise of administrative action, it is well established that where a ‘decision-maker has a wide discretion, the court is frequently driven to implying fetters on the power by reference to the Act’s subject matter, scope and objects’.<sup>73</sup> Courts may be seen as employing a similar concept in the implied duties that fetter the exercise of contractual discretionary power. In the contractual context, courts refer to the presumed intentions of the parties in making their contract to determine limits on the purposes for which the power may be exercised.

## 1 *Assessing an Improper Purpose*

Although the matter has not been analysed by the courts, in principle, assessing whether a contractual power was exercised for an improper or extraneous purpose should involve a two stage inquiry. First, the legitimate purposes of the power should be determined. This is a matter of construction of the contract, in the light of the surrounding circumstances, to determine the proper purposes of the power on the basis of the presumed intentions of the parties. Second, the motive of the grantee of the power in exercising the power should be considered to determine whether that motive was consistent with the power’s purposes. The inquiry into motive would be somewhat similar to the assessment of honesty, as discussed above.<sup>74</sup>

## 2 *Illustrations of an Improper Purpose*

One of the most straightforward examples of the exercise of a discretionary contractual power for an improper purpose is where the contract gives a list of considerations relevant to the exercise of the power and the grantee of the power acts for a purpose that is inconsistent with those considerations. In such a case, the court will have reasonably secure grounds for distinguishing between proper and improper purposes for the exercise of the power. In *Burger King*<sup>75</sup> a franchisee was required to develop a certain number of new franchise restaurants each year, subject to the franchisor’s approval. The franchisor refused to give the approval needed for the franchisee to comply with this requirement. The franchise agreement specified three types of approval as necessary conditions for the franchisor to allow further development. The agreement gave the franchisor the ‘sole discretion’ in deciding whether or not to grant these approvals, and outlined the factors relevant to the approvals. The factors all related to the efficacy of the proposed new business.

72 Ibid [67].

73 Mark Aronson, Bruce Dyer and Matthew Groves, *Judicial Review of Administrative Action* (4<sup>th</sup> ed, 2009) [5.180]. See, eg, *Sydney Municipal Council v Campbell* [1925] AC 338.

74 See above text at n 56.

75 (2001) 69 NSWLR 558.

The Court of Appeal of New South Wales considered that the franchisor's discretionary power to approve new franchise outlets was subject to an implied duty of good faith which prevented the franchisor from exercising the power for a purpose extraneous to the contract.<sup>76</sup> The Court considered that the franchisor's refusal to give the approvals was not in fact based on the specified factors<sup>77</sup> but was instead directed at preventing the franchisee from performing its obligations under the agreement. The court approved the conclusion of the trial judge that the franchisor was acting as part of a 'deliberate plan to prevent [the franchisee] expanding'<sup>78</sup> and instead to enable the franchisor itself 'to develop the Australian market [that is, through operating its own outlets] unhindered by its contractual arrangements with [the franchisee]'.<sup>79</sup> Accordingly, the court considered that the franchisor had acted in breach of its duty of good faith.<sup>80</sup>

Where the contract does not expressly identify the considerations relevant to the exercise of a discretionary power, the court may be able to delineate the proper purposes of the power by reference to the nature and terms of the contract. In particular, courts have found that a discretionary contractual power was exercised for an extraneous or improper purpose where the power related to an aspect of contract performance but was instead used to prompt termination of the contract in circumstances where there was no direct power to terminate. In such cases it may be found that the power was used for an extraneous purpose because there was a clear disjunction between the purpose of the power (aspects of performance) and the focus of its exercise (termination).

In *Burger King*, the discretionary power to approve franchise outlets was used to prompt termination of the contract where no such right would otherwise exist. A concern with the use of a power to change some aspect of contract performance to prompt termination of the contract was also apparent in *Paragon Finance*.<sup>81</sup> The case concerned the power of a lender to vary interest rates. The Court of Appeal held that the power of the lender to set interest rates from time to time was fettered by an implied term. Dyson LJ (with whom Astill J and Thorpe LJ agreed) said: 'I would hold that there were terms to be implied in both agreements that the rates of interest would not be set dishonestly, for an improper purpose, capriciously or arbitrarily'.<sup>82</sup> Dyson LJ explained that:

An example of an improper purpose would be where the lender decided that the borrower was a nuisance (but had not been in breach of the terms

76 *Ibid* 573 [185].

77 *Burger King Corporation v Hungry Jack's Pty Ltd* [2001] NSWCA 187 (Unreported, Sheller, Beazley and Stein JJA, 21 June 2001) [223], [250], [306], [307], [368].

78 *Ibid* [310].

79 *Ibid*.

80 *Ibid* [224], [308], [316], [368].

81 [2002] 2 All ER 248. See also *Gan Insurance* [2001] EWCA Civ 1047 (Unreported, Mance, Latham LJ, and Staughton J, 3 July 2001) [67]; *Lymington Marina Ltd v MacNamara* [2006] EWHC 704 (Ch) (Unreported, Patten J, 4 April 2006) [88].

82 *Paragon Finance* [2002] 2 All ER 248, 262.

of the agreement) and, wishing to get rid of him, raised the rate of interest to a level that it knew he could not afford to pay.<sup>83</sup>

It might be argued that the discretion to change interest rates is granted to a lender for a range of reasons. The decision that a borrower is a nuisance might be related to the risk assessment of that borrower as a client of the bank. For example, a borrower's irrational and aggressive behaviour towards the bank might signal that the borrower carries a significant risk of default due to the likelihood of this type of behaviour affecting the borrower's decision-making abilities generally. On the other hand, it might be argued that if a lender wanted a power to terminate the relationship due to its assessment of the risks associated with a borrower, it should have sought a power to do so directly or entered into a different type of loan with the borrower, for example, an overdraft payable on demand.

A variant on this type of case is *J F Keir Pty Ltd v Priority Management Systems Pty Ltd*<sup>84</sup> (*J F Keir*). In this case the franchise contract provided that the franchisor could, 'from time to time' prescribe 'specifications, standards and procedures' for the operation of the franchise.<sup>85</sup> The contract stated that these specifications standards and procedures were to 'enhance the reputation and goodwill' of the franchise and that they were to be 'reasonable and consistent' with the contract.<sup>86</sup> The franchise contract also did not reserve exclusive territory for franchisees. The franchisor introduced new policies that gave to another franchisee, controlled by an officer of the franchisor, exclusive control of territories in which the plaintiff franchisee operated.

Rein AJ held that the new policy 'infringed the requirement of reasonableness and consistency with the franchise agreement'.<sup>87</sup> Even if, contrary to this view, the express terms of the franchise contract permitted the policy, Rein AJ held that:

a strong case can be mounted that the Policy was itself introduced for ulterior motives extraneous to the interests of [the franchisor] and inimical to the reasonable expectations of [the franchisee], and hence in breach of [the franchisor's] duty of good faith.<sup>88</sup>

This conclusion may be explained on the basis that a discretionary power to vary franchise standards is very different from a grant of exclusive territory, a topic that would normally be the subject of an express provision.

Another factor that may indicate the exercise of a contractual power for an improper purpose is discriminatory treatment, namely singling out one contracting partner for special treatment unrelated to any special features or circumstances affecting that contracting partner. Courts are unlikely to accept that a discretionary

83 Ibid 261.

84 [2007] NSWSC 789 (Unreported, Rein AJ, 24 July 2007).

85 Ibid [14].

86 Ibid.

87 Ibid [75].

88 Ibid.

contractual power would have been granted for such a purpose. A concern with discriminatory treatment was also apparent in *Paragon Finance*.<sup>89</sup> In Australia in *Kellcove Pty Ltd v Australian Motor Industries Ltd*<sup>90</sup> Woodward J suggested that good faith requires a franchisor not to discriminate against a particular dealer for no good reason and not to act with reckless indifference towards the needs of any particular dealer.<sup>91</sup> In *Laurelmont Pty Ltd v Stockdale & Leggo (Queensland) Pty Ltd*<sup>92</sup> ('*Laurelmont*') Williams JA in the Queensland Court of Appeal considered that a duty to cooperate might prevent a franchisor from preferring one franchisee in an area over others.<sup>93</sup> In *J F Keir*<sup>94</sup> one of the factors indicating an improper purpose was the discriminatory nature of the changes introduced by the franchisor, with the changes primarily affecting only one franchisee.

## C Reasonableness/Unreasonableness

### 1 Reasonableness

Australian courts have often equated the standard of conduct required by a duty of good faith with reasonableness.<sup>95</sup> In the leading case of *Renard Constructions (ME) v Minister for Public Works*<sup>96</sup> ('*Renard Constructions*') Priestley JA was prepared to imply a duty of reasonableness tempering the powers of a principal to terminate a construction contract. His Honour considered that this duty of reasonableness had 'much in common' with a duty of good faith.<sup>97</sup> It is unclear whether the standard would be based on the views of a reasonable person or on reasonable industry practice, a standard applied in the United States.<sup>98</sup>

In practice, courts implying a duty of good faith have tended to focus on the aspect of the duty requiring parties not to act for an improper purpose rather than on the requirement of reasonableness. In *Renard Constructions* itself, although Priestley JA explained a duty of good faith by reference to a duty of reasonableness, the judgment was based primarily on the much narrower question of the quality of the decision, including a failure to make inquiries, discussed further below.<sup>99</sup>

89 See text above at n 81.

90 (Unreported, Federal Court of Australia, Woodward J, 6 July 1990) discussed in Stephen Giles, Michael Redfern and Andrew Terry, *Franchising Law & Practice: Seminar Papers* (Leo Cussen Institute, 1998).

91 *Ibid.* See also *Autohaus Brugger Inc v Saab Motors Inc*, 567 F 2d 901, 912 (9th Cir, 1978); *Fox Motors v Mazda Distributors (Gulf) Inc*, 806 F 2d 953 (10th Cir, 1986); *American Mart Corp v Joseph E Seagram & Sons Inc*, 824 F 2d 733 (9th Cir, 1987).

92 [2001] QCA 212 (Unreported, McPherson, Williams JJA and Dutney J, 5 June 2001).

93 *Ibid* [8].

94 See text above at n 84.

95 *Renard Constructions* (1992) 26 NSWLR 234, 263–5; *Burger King* (2001) 69 NSWLR 558, 570; *Jobern Pty Ltd v BreakFree Resorts (Victoria) Pty Ltd* [2007] FCA 1066 (Unreported, Gordon J, 23 July 2007) [157]. See also Mason, above n 43, 69.

96 (1992) 26 NSWLR 234.

97 *Ibid* 263. See also *Alcatel* (1998) 44 NSWLR 349, 368; *Garry Rogers Motors* [1999] ATPR ¶41–703.

98 On the role of trade standards in the United States, see Farnsworth, *Farnsworth on Contracts*, above n 54, 331.

99 See text below at n 112.

Given its lack of real application, it is arguable that the concept of reasonableness should be dropped from its association with good faith.<sup>100</sup>

## 2 Unreasonableness

English courts have held that discretionary contractual powers must not be exercised in a manner that is unreasonable.<sup>101</sup> In administrative law, qualitative review of a decision is primarily achieved through the concept of unreasonableness. Unreasonableness in administrative law is commonly associated with ‘something so absurd that no sensible person could ever dream that it lay within the powers of the authority’.<sup>102</sup> English courts have expressly invoked the public law principle of *Wednesbury* unreasonableness<sup>103</sup> in explaining the nature of the duty not to exercise a discretionary contractual power in an unreasonable way. Because the duty is expressed in a negative form, precluding only those decisions ‘no reasonable person would make’, it is less intrusive than a standard of reasonableness on the decision-making processes of parties to commercial contracts.<sup>104</sup>

English courts have indicated that the implied term precluding an unreasonable decision may not be ‘materially’ different from the term precluding decisions made for an improper purpose.<sup>105</sup> In *Gan Insurance*, Mance LJ explained that the prohibition on an unreasonable decision:

will not ordinarily add materially to the requirement that the reinsurer should form a genuine view as to the appropriateness of settlement or compromise without taking into account considerations extraneous to the subject-matter of the reinsurance.<sup>106</sup>

In *Paragon Finance*<sup>107</sup> Dyson LJ, with whom Thorpe LJ and Astill J agreed, suggested that an example of a lender using a capricious reason for exercising this power would be ‘where the lender decided to raise the rate of interest because its manager did not like the colour of the borrower’s hair’.<sup>108</sup> This is an example of a decision that is both unreasonable and made for an improper purpose. No

100 See also Jane Stapleton, ‘Good Faith in Private Law’ (1999) 52 *Current Legal Problems* 1, 8.

101 *The Product Star* [1993] 1 Lloyd’s Rep 397, 404; *Gan Insurance* [2001] EWCA Civ 1047 (Unreported, Mance, Latham LJJ and Staughton J, 3 July 2001) [73]; *Paragon Finance* [2002] 2 All ER 248, 261. See also *Weinberger v Inglis* [1919] AC 606; *West of England Shipowners Mutual Insurance Association (Luxembourg) v Cristal Ltd* [1996] 1 Lloyd’s Rep 370 (‘*The Glacier Bay*’).

102 *Associated Provincial Picture Theatres Ltd v Wednesbury Co* [1948] 1 KB 223, 229–30. See also Aronson, Dyer and Groves, above n 73, [6.175].

103 See, eg, *Paragon Finance* [2002] 2 All ER 248, 261; *Lymington Marina Ltd v MacNamara* [2006] EWHC 704 (Ch) (Unreported, Patten J, 4 April 2006) [86]; *Socimer International Bank Ltd v Standard Bank London Ltd (No 2)* [2008] 1 Lloyd’s Rep 558 (Unreported, Laws, Rix and Lloyd LJJ, 22 February 2008) [36].

104 *Clark v Nomura International plc* [2000] IRLR 766 HC (Unreported, Burton J, 6 September 2000) [40].

105 *Gan Insurance* [2001] EWCA Civ 1047 (Unreported, Mance, Latham LJJ and Staughton J, 3 July 2001) [73]. See also *Paragon Finance* [2002] 2 All ER 248, 263.

106 *Gan Insurance* [2001] EWCA Civ 1047 (Unreported, Mance, Latham LJJ and Staughton J, 3 July 2001) [73]. See also *Paragon Finance* [2002] 2 All ER 248, 261.

107 See text above at n 81.

108 *Paragon Finance* [2002] 2 All ER 248, 261.

reasonable person would base such a decision on the hair colour of a borrower. Moreover, the power cannot be contemplated as authorising discriminatory treatment of borrowers, that is, treatment based on characteristics unrelated to their status as borrowers. The purposes for which a power to change interest rates is granted must be presumed to relate to commercial considerations.

In principle, it is possible to distinguish between the implied duty not to exercise discretionary contractual powers for an improper purpose and the duty not to exercise such powers unreasonably. The duty precluding unreasonable decisions covers the situation where the subjective motives of the grantee of the power were legitimate (ie the decision was made for a proper purpose) but the decision was objectively unreasonable (ie no reasonable person would have made the decision).<sup>109</sup> In practice, the duty not to exercise discretionary contractual powers unreasonably is likely to have most independent application in cases where a highly egregious decision may have been motivated by an improper purpose but evidence about the motive of the grantee of the power is not available.

In *Mallone v BPB Industries plc*<sup>110</sup> the plaintiff was employed as managing director of a subsidiary of the defendant. The defendant operated a senior executive share option scheme. The aim of the scheme was to provide long-term incentives to selected key executives. Options were granted each year by a resolution of the directors and could not be exercised for three years from the date they were granted. An option held for three years became a 'mature' option. When the plaintiff was dismissed, he held three years of mature options. When the plaintiff sought to exercise his options he was told that the directors had passed a resolution under which his share options had been cancelled in full. The rules of the scheme provided that where an executive ceased to be employed by the Group (other than where dismissed for misconduct) the executive might still exercise his options in certain circumstances in a proportion which was effectively determined by the directors in their 'absolute discretion'.

The directors did not give reasons for their decision. Thus, it was difficult to determine whether the power was exercised for an improper purpose, for example depriving an otherwise well-performing executive of participation in the option scheme or for the proper purpose of what the directors considered necessary to preserve an incentive among executives to high standards of performance. The Court of Appeal held that the High Court judge was entitled to find that the committee of the defendants' directors acted irrationally in cancelling the claimants' mature share options when he left their employment. The contract provided some guidance on the exercise of the discretion and suggested that after 36 months service, when the option became mature the appropriate proportion was 36/36. The committee had apparently not given any regard to the fact that the 'options were granted at a time when [the executive's] performance was clearly

109 *Mallone v BPB Industries plc* [2002] EWCA Civ 126 (Unreported, Waller, Rix LJJ and Wilson J, 19 February 2002) [38]–[39].

110 [2002] EWCA Civ 126 (Unreported, Waller, Rix LJJ and Wilson J, 19 February 2002).



regarded as excellent'.<sup>111</sup> Rix LJ (with whom Waller LJ and Wilson J agreed) commented that the scheme should not be treated as a 'mirage':

whereby the executive is welcomed as a participant, encouraged to perform well in return for reward, granted options in recognition of his good performance, led on to further acts of good performance and loyalty, only to learn at the end of his possibly many years of employment, when perhaps the tide has turned and his powers are waning, that his options, matured and vested as they may have become, are removed from him without explanation.<sup>112</sup>

## D A Duty to Inquire?

There is some suggestion in both English and Australian cases that the grantee of a discretionary contractual power may be under a duty to make some inquiries before exercising that power.<sup>113</sup> It may be seen as unreasonable and capricious for the grantee of a discretionary contractual power to make a decision that significantly affects the interests of the other party to the contract without at least taking some reasonable steps to ascertain the facts relevant to that decision.

*The Product Star*<sup>114</sup> concerned a charter party under which the master and the owners had discretion in determining whether any port to which the vessel was ordered was dangerous. The owners directed the charter to avoid a port even though the conditions pertaining to the port were known at the outset of the voyage and had not changed subsequently. Leggatt LJ, with whom the other members of the court agreed, held that proper exercise of the power required 'a proper consideration of the matter after making any necessary inquiries'.<sup>115</sup> In this case the owner was found to have been 'almost entirely ignorant of the previous history of hostilities ... in the region'<sup>116</sup> and the decision was held to be unreasonable and capricious.

In *Renard Constructions* the contract granted the principal under a building contract several powers in relation to the work following default by the contractor. The right to exercise these powers was fettered by a 'show cause' clause. The clause provided that, on default, the contractor was entitled to 'show cause' why the powers should not be exercised and that the principal was only entitled to exercise the powers if it was not satisfied with the cause shown. Following a breach by the contractor, the principal exercised its powers to take over the work and exclude the contractor from the site. The arbitrator found that in exercising its powers the principal had acted on 'misleading, incomplete, and prejudicial information'.<sup>117</sup>

111 Ibid [42].

112 Ibid [44].

113 *The Product Star* [1993] 1 Lloyd's Rep 397, 404; *Gan Insurance* [2001] EWCA Civ 1047 (Unreported, Mance, Latham LJ and Staughton J, 3 July 2001); *Paragon Finance* [2002] 2 All ER 248; *Burger King* (2001) 69 NSWLR 558; *Renard Constructions* (1992) 26 NSWLR 234.

114 [1993] 1 Lloyd's Rep 397, 404.

115 Ibid.

116 Ibid 405.

117 *Renard Constructions* (1992) 26 NSWLR 234, 276.

The New South Wales Court of Appeal held that the principal had not acted in accordance with the clause. Handley and Priestley JJA held that the principal was subject to an obligation to act reasonably in considering whether or not the contractor had shown cause to the principal's satisfaction and, where the contractor failed to satisfy the principal, to act reasonably in considering whether or not the powers should be exercised.<sup>118</sup> Meagher JA held that the powers conferred by the clause could only be properly exercised where the principal understood what it was doing.<sup>119</sup> The only way that the principal could have acted reasonably in making its decision (as required by Priestley JA) or properly understood what it was doing (as required by Meagher JA) was to have made some inquiries about the veracity of the information on which its decision would be based.<sup>120</sup> These inquiries would have ensured that the decision was not based on 'incomplete and prejudicial' information.

Any duty to make inquiries before exercising a discretionary contractual power may not be overly onerous. In *Hughes Bros Pty Ltd v Trustees of the Roman Catholic Church for the Archdiocese of Sydney*<sup>121</sup> Priestley JA commented that 'it will not be difficult in ordinary circumstances for the principal to fulfil the reasonableness obligation'<sup>122</sup> which, as discussed above, seems to include a duty to inquire. It may be that the duty would only extend to facts readily ascertainable by the decision-maker.<sup>123</sup>

#### IV LEGITIMATE BUSINESS INTERESTS

Australian courts have repeatedly stated that the implied duty of good faith will not prevent a party from having regard to its own 'legitimate interests'.<sup>124</sup> Thus, in *South Sydney District Rugby League Football Club Ltd v News Ltd*<sup>125</sup> Finn J explained that good faith will 'not operate so as to restrict decisions and actions, reasonably taken, which are designed to promote the legitimate interests

118 Ibid 257, 263, 279.

119 Ibid 275–6.

120 See also *Hughes Bros Pty Ltd v Trustees of the Roman Catholic Church for the Archdiocese of Sydney* (1993) 31 NSWLR 91 ('*Hughes Bros*'); *Burger King* (2001) 69 NSWLR 558, 572.

121 (1993) 31 NSWLR 91.

122 Ibid 101. See also *Renard Constructions* (1992) 26 NSWLR 234, 259–60.

123 Cf *Prasad v Minister for Immigration and Ethnic Affairs* (1985) 6 FCR 155, 169–70.

124 See, eg, *Bridgestone Australia Ltd v GAH Engineering Pty Ltd* [1997] 2 Qd R 145, 151; *Alcatel* (1998) 44 NSWLR 349; *Garry Rogers Motors* (1999) ATPR ¶41–703; *Automasters Australia Pty Ltd v Bruness Pty Ltd* [1999] WASC 39 (Unreported, McKechnie J, 21 May 1999); *Burger King* (2001) 69 NSWLR 558, 573; *South Sydney District Rugby League Football Club Ltd v News Ltd* (2000) 177 ALR 611, 696; *Commonwealth Bank of Australia v Renstel Nominees Pty Ltd* [2001] VSC 167 (Unreported, Byrne J, 8 June 2001) [96]; *Laurelmont* [2001] QCA 212 (Unreported, McPherson, Williams JJA and Dutney J, 5 June 2001) [29]; *Commonwealth Bank of Australia Ltd v Spira* [2002] NSWSC 905 (Unreported, Gzell J, 21 November 2002) [155], appeal dismissed without comment on this point *Spira v Commonwealth Bank of Australia* (2003) 57 NSWLR 544; *Wenzel v Australian Stock Exchange Ltd* [2002] FCA 95 (Unreported, Sundberg J, 15 February 2002) [42]. See also *Philips Electronique Grand Public SA v British Sky Broadcasting Ltd* [1995] EMLR 472. See also *Trade Practices Act 1974* (Cth) s 51AC(3)(b).

125 (2000) 177 ALR 611.

of a party and which are not otherwise in breach of an express contractual term'.<sup>126</sup> Perhaps, echoing a similar sentiment, in *Shearson Lehman Hutton v Maclaine Watson & Co*<sup>127</sup> ('*Shearson*') Webster J said:

Again and again it is laid down that powers must be exercised reasonably and in good faith. But in this context 'in good faith' means merely 'for legitimate reasons'. Contrary to the natural sense of the words, they impute no moral obliquity.<sup>128</sup>

In the United States, a common explanation of the standard of conduct required by the duty of good faith implied under the general law is that a party must have a 'legitimate business reason' for the exercise of its powers under the contract.<sup>129</sup> Hadfield suggests that the test has been interpreted as the corollary of the rule precluding acting for an improper purpose.<sup>130</sup> Thus, in *David R McGeorge Car Co Inc v Leyland Motor Sales Inc*<sup>131</sup> a car manufacturer had not breached its duty of good faith in failing to renew its dealership contract with a dealer where the manufacturer had a 'reasonable belief that its business welfare required'<sup>132</sup> the decision it had taken.

In *Dickey v Philadelphia Minit-Man Corp*<sup>133</sup> a lessee discontinued part of its business which resulted in reduced rental payable to the lessor. The lessee was held not to have breached its duty of good faith because its decision to discontinue part of the business was not 'taken other than in good faith and in the exercise of legitimate business judgment'.<sup>134</sup>

It is suggested that the existence of a legitimate business reason for the decision to exercise a discretionary contractual power may assist the grantee of the power

126 Ibid 696. See also *Burger King* (2001) 69 NSWLR 558, 573. The concept has also been embraced by commentators: see, eg, Roger Brownsword, above n 43; John Carter and Michael Furmston, 'Good Faith and Fairness in the Negotiation of Contracts: Part 1' (1994) 8 *Journal of Contract Law* 1; John Carter and Michael Furmston, 'Good Faith and Fairness in the Negotiation of Contracts: Part 2' (1994) 8 *Journal of Contract Law* 93; Paul Finn, 'The Fiduciary Principle' in Timothy Youdan (ed), *Equity, Fiduciaries and Trusts* (1989) 1; Sir Anthony Mason, above n 43; Dennis Patterson, 'Good Faith, Lender Liability, and Discretionary Acceleration: Of Llewellyn, Wittgenstein and the Uniform Commercial Code' (1989) 68 *Texas Law Review* 169, 199–203; Elisabeth Peden, 'The Meaning of Contractual Good Faith' (2002) 22 *Australian Bar Review* 235; B J Reiter, 'Good Faith in Contracts' (1983) 17 *Valparaiso University Law Review* 705, 714.

127 [1989] 2 Lloyd's Rep 570.

128 Ibid 629.

129 Hadfield, above n 68, 980–5; Lee Rau, 'Implied Obligations in Franchising: Beyond Terminations' (1992) 47 *The Business Lawyer* 1053, 1072–4. See, eg, *David R McGeorge Car Co Inc v Leyland Motor Sales Inc*, 504 F 2d 52, 56 (4<sup>th</sup> Cir, 1974); *Brattleboro Auto Sales Inc v Subaru of New England Inc*, 633 F 2d 649, 652 (2nd Cir, 1980); *Moody v Amoco Oil Co*, 734 F 2d 1200, 1217 (7<sup>th</sup> Cir, 1984); *KMC Co v Irving Trust Co*, 757 F 2d 752, 759 (6<sup>th</sup> Cir, 1985); *American Mart Corp v Joseph E Seagram & Sons*, 824 F 2d 733, 734 (9<sup>th</sup> Cir, 1987); *General GMC Inc v Volvo White Truck Corp*, 918 F 2d 306, 309 (1<sup>st</sup> Cir, 1987); *Schott Motorcycle Supply Inc v American Honda Motor Co Inc*, 976 F 2d 58, 63–4 (1<sup>st</sup> Cir, 1992); *US Genes v Vial*, 143 Or App 552, 559 (1996). See also *Gallagher v Pioneer Concrete (NSW) Pty Ltd* (1993) 113 ALR 159, 190–1; *Houle v Canadian National Bank* [1991] 74 DLR (4<sup>th</sup>) 577, 610.

130 Hadfield, above n 68, 982.

131 504 F 2d 52 (4<sup>th</sup> Cir, 1974).

132 Ibid 57.

133 105 A 2d 580 (Pa, 1954).

134 Ibid 556.

in showing that the exercise of that power was made in good faith or is otherwise reasonable and made for a proper purpose.<sup>135</sup> This is because the existence of a legitimate business reason, consistent with the purpose of a power, suggests that the power was not exercised for a prohibited reason.

In Australia, the role of legitimate business reasons for a decision in defending a claim of bad faith is evident in *Alcatel*.<sup>136</sup> In *Alcatel* a landlord had commissioned a report from a fire engineer, who reported that works on the leased premises were needed for fire safety reasons. At the landlord's invitation, the local council inspected the premises and found that they did not comply with fire safety requirements. The council specified particular work which it required to be carried out. Under the lease the tenant was obliged to observe and perform all lawful requirements pursuant to State legislation. The tenant argued that:

because [the landlord] had pressured the council into imposing stricter and unreasonable fire requirements, it was not obliged to comply with [the relevant provision] of the lease. This result flowed from an implied term of good faith or reasonableness in the [landlord's] performance of their lease obligations or exercise of their lease rights which bound [it] to co-operate in a reasonable way to ensure that the [tenant] was not subjected to the expense and impact of an unreasonable fire order.<sup>137</sup>

The New South Wales Court of Appeal accepted that a duty of good faith, requiring cooperation, could be implied as a part of the lease but did not consider that the duty had been breached. The lessee had not demonstrated that the requirements of the fire order were unreasonable. Giving judgment for the court, Sheller JA explained that:

In a commercial context it cannot be said, in my opinion, that a property owner acts unconscionably or in breach of an implied duty 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.<sup>138</sup>

*Garry Rogers Motors (Aust) Pty Ltd v Subaru (Aust) Pty Ltd*<sup>139</sup> ('*Garry Rogers Motors*') indicates that the role of 'legitimate interests' in defending a claim of bad faith may extend beyond a party's immediate commercial interests to include consideration of the ongoing relationship with the other party to the contract. The case concerned a car dealership. The supplier implemented a new marketing program aimed at improving the image of its dealers in the marketplace. The dealer did not comply, and indicated that it was unwilling to comply, with the program. As a result, the supplier gave notice of termination of the dealership in accordance with a term under the contract. The dealer then indicated that it was

135 See, eg, *Overlook Management BV v Foxtel Management Pty Ltd* [2002] NSWSC 17 (Unreported, Barret J, 31 January 2002) [83]. See also *Advance Fitness Corp Pty Ltd v Bondi Diggers Memorial & Sporting Club Ltd* [1999] NSWSC 264 (Unreported, Austin J, 30 March 1999).

136 (1998) 44 NSWLR 349.

137 *Ibid* 363.

138 *Ibid* 369–70.

139 [1999] ATPR ¶41–703.

willing to comply with the program. However, the supplier was not willing to withdraw its notice of termination.

Finkelstein J in the Federal Court accepted that a duty of good faith might be implied to fetter the exercise of the supplier's right to terminate. However, Finkelstein J also held that this duty would not operate 'so as to restrict actions designed to promote the legitimate interests'<sup>140</sup> of the supplier. In *Garry Rogers Motors*, Finkelstein J held that there was no breach of any duty of good faith<sup>141</sup> and that the conduct of the dealer in refusing to adopt the program 'could reasonably be regarded by the [supplier] as an indication that the [dealer] was not willing to act in the best interests ... of the dealership group as a whole'.<sup>142</sup> This situation was not remedied by the dealer's subsequent indication that it would comply with the program. Finkelstein J concluded that the dealer's conduct had 'no doubt' led to the supplier losing confidence in the dealer and that this loss would not necessarily be overcome by a change in the attitude on the part of the dealer. Finkelstein J then explained that:

Many relationships can only operate satisfactorily if there is mutual confidence and trust. Once that confidence and trust has broken down the position is not easily restored. It is not unconscionable to terminate a relationship where that trust and confidence has been undermined.<sup>143</sup>

## V CONTRACTING OUT

### A Good Faith Cannot Be Excluded

Courts have been wary of asserting that parties cannot exclude at all the duty of good faith or the more specific duties fettering the exercise of discretionary contractual powers.<sup>144</sup> Such an approach would be inconsistent with the traditional emphasis in the law of contract on respecting the 'will' of contracting parties. The point was recognised in *Pacific Brands*,<sup>145</sup> where Finkelstein J said:

For the purposes of this case it is necessary to find, as I do, that the duty of good faith is an incident (not an ad hoc implied term) of every commercial contract, unless the duty is either excluded expressly or by necessary

140 Ibid [37].

141 Ibid [39].

142 Ibid [46].

143 Ibid.

144 *Alcatel* (1998) 44 NSWLR 349, 368; *Burger King* (2001) 69 NSWLR 558, 574–5. See also *Central Exchange Ltd v Anaconda Nickel Ltd* [2002] WASC 94 (Unreported, Malcolm CJ, Wallwork and Steytler JJ, 23 April 2002) [64]. Cf Governing Council of the International Institute for the Unification of Private Law, *UNIDROIT Principles for International Commercial Contracts 2004* Art 1.7(2) states: 'The parties may not exclude or limit this duty'; Ole Lando, Hugh Beale (eds) and Commission on European Contract Law, *Principles of European Contract Law* (2000–03) 53; Article 1.106 'Good Faith and Fair Dealing' states: '(1) In exercising his rights and performing his duties each party must act in accordance with good faith and fair dealing. (2) The parties may not exclude or limit this duty.'

145 [2005] FCA 288 (Unreported, Finkelstein J, 24 May 2005).

implication. The duty cannot override any express or unambiguous term which is to a different effect.<sup>146</sup>

On the other hand, it is unclear what will be required of parties in order to exclude the implied duties fettering the exercise of discretionary contractual powers. There is little discussion of the issue in the English cases. In Australia, courts have expressed different views on the issue.<sup>147</sup>

## **B Entire Agreement Clause**

In a number of decisions, Australian courts have held that an entire agreement clause – which states that the contract represents the entire agreement of the parties – may not be sufficient to exclude a duty of good faith in contract performance.<sup>148</sup> This is not altogether surprising. The effectiveness of an entire agreement clause in excluding implied terms generally is doubtful. In *Hart v MacDonald*<sup>149</sup> Isaacs J stated that an entire agreement clause:

excludes what is extraneous to the written contract: but it does not in terms exclude implications arising on a fair construction of the agreement itself, and in the absence of definite exclusion, an implication is as much a part of a contract as any term couched in express words.<sup>150</sup>

## **C Exclusion of All Implied Terms**

In *Vodafone Pacific Ltd v Mobile Innovations Ltd*<sup>151</sup> (*Vodafone Pacific*) the contract provided that '[t]o the full extent permitted by Law and other than as expressly set out in this Agreement the parties exclude all implied terms'.<sup>152</sup> Giles JA, with whom Ipp and Sheller JJA agreed, held that this provision was sufficient to exclude the implication of a duty of good faith.<sup>153</sup> Nonetheless, the guidance provided by this decision is limited. The court expressly confined its decision to certain uses of the duty discussed by the trial judge and, in particular, the duty to

<sup>146</sup> *Ibid* [64].

<sup>147</sup> See generally Bill Dixon, 'Can the Common Law Obligation of Good Faith Be Contractually Excluded?' (2007) 35 *Australian Business Law Review* 110.

<sup>148</sup> See *Commonwealth Bank of Australia Ltd v Spira* [2002] NSWSC 905 (Unreported, Gzell J, 21 November 2002) [144], appeal dismissed without comment on this point in *Spira v Commonwealth Bank of Australia* [2003] NSWCA 180; *GEC Marconi Systems Pty Ltd v BHP Information Technology Pty Ltd* (2003) 128 FCR 1, 208–9; *Insight Oceania Pty Ltd v Philips Electronics Australia Ltd* [2008] NSWSC 710 (Unreported, Bergin J, 23 July 2008) [158]. Cf *NT Power Generation Pty Ltd v Power and Water Authority* (2001) 184 ALR 481. On entire agreement clauses: see generally Catherine Mitchell, *Interpretation of Contracts: Current Controversies in Law* (2007) Ch 5.

<sup>149</sup> (1910) 10 CLR 417.

<sup>150</sup> *Ibid* 430. See also *Johnson Matthey Ltd v A C Rochester Overseas Corp* (1990) 23 NSWLR 190, 196. Cf *Hope v RCA Photophone of Australia Pty Ltd* (1937) 59 CLR 348, 358, 363, 365, 368.

<sup>151</sup> [2004] NSWCA 15 (Unreported, Sheller, Giles and Ipp JJA, 20 February 2004).

<sup>152</sup> *Ibid* [198].

<sup>153</sup> *Ibid*.

act reasonably.<sup>154</sup> The court left open the issue as to ‘whether or when an implied term of good faith so far as it precludes arbitrariness, capriciousness or abuse of a power can be excluded’.<sup>155</sup>

If the duty of good faith, and/or the more specific duties fettering the exercise of discretionary contractual powers, cannot be excluded by a provision aimed at all implied terms, it appears that the duties do not have the character of terms implied by law or fact. The duties would seem instead to have the character of ‘universal terms’, a possibility raised in some earlier cases but not clearly embraced by the courts.<sup>156</sup> The idea is not entirely far-fetched. If the duties not to exercise a contractual power unreasonably or for an improper purpose are implied on the basis that they are in some sense fundamental to the institution of contracting and to good decision making in a contractual context, it would follow that they could not easily be excluded by the parties.

### **D Exclusion by the Grant of a Broad Discretion**

The use of broad words to describe a discretionary contractual power may not be sufficient to exclude entirely the implied duties fettering the exercise of that power. The use of broad words to describe a discretionary contractual power must indicate that the parties intended to authorise the exercise of the power for a broad range of purposes. In such a case, the range of improper purposes for which the power cannot be exercised must be limited. However, other aspects of the case may justify some limits on the scope of the power.

In *Vodafone Pacific* the contract granted Vodafone a power to set the sales levels for its distributor Mobile. The power was expressed to be ‘in the sole discretion’ of Vodafone. The New South Wales Court of Appeal held that the discretion was not limited by an implied duty of good faith. Giles JA, with whom Ipp and Sheller JJA agreed, held that the words ‘sole discretion’ ‘can not be passed over, and they weigh against the implied obligation of good faith and reasonableness in the exercise of the power’.<sup>157</sup> In reaching this decision, Giles JA was influenced by other provisions in the contract under which a discretionary power was expressly fettered by an obligation to act reasonably.<sup>158</sup> As already noted, Giles JA did not consider whether that aspect of good faith requiring the power not to be exercised for an improper purpose would be excluded by the broad words used to describe the power.

The matter was considered in *Burger King*.<sup>159</sup> This case concerned the right of a franchisor to determine matters relating to renewal of a franchise ‘in its sole

154 Ibid [193].

155 Ibid [194] (Giles JA).

156 See above n 20 and accompanying text.

157 *Vodafone Pacific* [2004] NSWCA 15 (Unreported, Sheller, Giles and Ipp JJA, 20 February 2004) [195] (Giles JA).

158 Ibid [197] (Giles JA).

159 (2001) 69 NSWLR 558 (Sheller, Beazley and Stein JJA).

discretion'.<sup>160</sup> The New South Wales Court of Appeal rejected a submission that a duty of good faith would be inconsistent with express terms of the contract in delineating the obligations of the parties.<sup>161</sup> The nature of the contract in *Burger King* arguably invited qualifications to the so-called 'sole discretion'. The contract contained a list of factors relevant to the exercise of the discretion and thus the power might be read as meaning the franchisor had 'sole discretion' to consider the relevance of the specified factors.

English and United States courts have also been prepared to fetter a 'sole discretion'.<sup>162</sup> In *Tymshare Inc v Covell*<sup>163</sup> Covell worked for Tymshare and received a salary plus commissions on all sales in excess of designated annual sales quotas, which Tymshare could modify at its 'sole discretion'. Covell helped Tymshare to win a major contract. Shortly after, Tymshare modified Covell's commission plan and then terminated Covell's employment. The effect of this conduct was to deny Covell the significant commissions he had been expecting as a result of his assistance with the major contract. Covell sued Tymshare for breach of contract, including breach of the duty of good faith.

The District Court granted Covell's motion for summary judgment. The appellate court accepted that Tymshare may have breached its duty of good faith, which would exclude acting for certain unauthorised purposes.<sup>164</sup> The issue depended on the nature of the power in question. Scalia J accepted that there were some express powers for which an implied limitation could not be contemplated. An example was a loan of money in exchange for a promise to repay on demand.<sup>165</sup> By contrast, the power in this case could not be understood as absolute. Scalia J said that:

Where what is at issue is the retroactive reduction or elimination of a central compensatory element of the contract – a large part of the *quid pro quo* that induced one party's assent – it is simply not likely that the parties had in mind a power quite as absolute as [Tymshare] suggests. In the present case, agreeing to such a provision would require a degree of folly on the part of these sales representatives we are not inclined to posit where another plausible interpretation of the language is available. It seems to us that the 'sole discretion' intended was discretion to determine the existence or nonexistence of the various factors that would reasonably justify alteration of the sales quota ... But the language need not (and therefore can not reasonably) be read to confer discretion to reduce the quota for

160 Ibid 573.

161 Ibid.

162 *Clark v BET plc* [1997] IRLR 348; *Mallone v BPB Industries Ltd* [2002] EWCA Civ 126 (Unreported, Waller, Rix LJ, and Wilson J, 19 February 2002). See also *Ludgate Insurance Co Ltd v Citibank NA* [1998] Lloyd's Rep IR 2.

163 727 F 2d 1145 (1984). See also *Greenberg v Meffert* (1985) 18 DLR (4th) 548; leave to appeal refused (1985) 30 DLR (4th) 768.

164 *Tymshare Inc v Covell*, 727 F 2d 1145, 1153 (1984).

165 See Paterson, above n 6.



any reason whatever – including what Covell has alleged here, a simple desire to deprive an employee of the fairly agreed benefit of his labors.<sup>166</sup>

The case was remanded to the lower court for the purpose of determining whether, in varying the quota plan and terminating the contract, Tymshare had acted for legitimate purposes envisioned by the contract or for the bad faith purpose of considerably reducing the commissions due to Covell.

### **E Express Exclusion of the Specific Duties**

In principle, the duties fettering the exercise of a discretionary power might be excluded by words directed specifically at these duties. Direct exclusion of the duties would leave a court in no doubt as to the parties' intentions. In practice, such provisions may rarely be utilised. In *GEC Marconi Systems Pty Ltd v BHP Information Technology Pty Ltd*<sup>167</sup> Finn J noted that 'it is, perhaps, difficult to envisage an express provision authorising dishonesty'.<sup>168</sup> It also seems unlikely that parties would agree to a term authorising a discretionary power to be exercised unreasonably or for an improper purpose.

## **VI FETTERING POWERS TO TERMINATE**

The willingness of courts to imply duties fettering the exercise of discretionary contractual powers leads to the question of whether these duties will also be implied to fetter the exercise of contractual powers to terminate the contract. Termination powers differ from the discretionary powers thus far discussed in that they concern the power to bring the contract to an end rather than to vary some aspect of contract performance. In both England and Australia, the termination powers have not traditionally been fettered by requirements of reasonableness or fairness.<sup>169</sup> Courts have also been cautious in the use of the equitable doctrine of relief against forfeiture to not unduly fetter the exercise of a contractual power to terminate. In *Union Eagle Ltd v Golden Achievement Ltd*<sup>170</sup> Lord Hoffmann noted the 'obvious merit of allowing the court to impose what it considers to be

<sup>166</sup> *Tymshare Inc v Covell*, 727 F 2d 1145, 1154 (1984).

<sup>167</sup> (2003) 128 FCR 1.

<sup>168</sup> *Ibid* 209.

<sup>169</sup> See, eg, *White and Carter (Councils) Ltd v McGregor* [1962] AC 413, 430 (but see also comments on the scope of the 'legitimate interest' exception in John Carter, 'Shipbuilding Contracts: The Interaction of Contractual Powers and Common Law Remedies' (1997) 12 *Journal of Contract Law* 65, 75); *Wood Hall Ltd v Pipeline Authority* (1979) 141 CLR 443; *Biotechnology v Pace* (1988) 15 NSWLR 130, 132–3; *Blackpool and Flyde Aero Club Ltd v Blackpool Borough Council* [1990] 1 WLR 1195, 1202; *Comco Constructions Pty Ltd v Westminster Properties Pty Ltd* (1990) 2 WAR 335, 346; *Canberra Advance Bank Ltd v Benny* (1992) 38 FCR 427, 433; *Vroon BV v Foster's Brewing Group* [1994] 2 VR 32, 95–6. A similar sentiment may also be expressed in the general rule that a party can justify its termination or rescission of a contract by reference to grounds not taken at the relevant time: *Boston Deep Sea Fishing & Ice Co v Ansell* (1888) 39 Ch D 339; *Shepherd v Felt and Textiles of Australia Ltd* (1931) 45 CLR 359, 262; *Sunbird Plaza Pty Ltd v Maloney* (1988) 166 CLR 245.

<sup>170</sup> [1997] AC 514 ('*Union Eagle*').

a fair solution in the individual case'.<sup>171</sup> However, Lord Hoffmann also explained that there were practical as well as doctrinal considerations against the principle that 'equity will restrain the enforcement of legal rights when it would be unconscionable to insist upon them'.<sup>172</sup> Lord Hoffmann referred in particular to the need for certainty in commercial transactions.<sup>173</sup> In Australia, in *Romanos v Pentagold Investments Pty Ltd*<sup>174</sup> the High Court of Australia noted that 'equity does not intervene to reshape contractual relations in a form the court thinks more reasonable or fair'.<sup>175</sup>

By contrast, Australian courts recognising a duty of good faith in contract performance have indicated that the duty will apply to powers to terminate.<sup>176</sup> In *Burger King*, Sheller, Beazley and Stein JJA said that the case law indicated 'obligations of good faith and reasonableness will be more readily implied in standard form contracts, particularly if such contracts contain a general power of termination'.<sup>177</sup> A particular concern has been with the possibility of termination for an improper purpose. In *Mangrove Mountain Quarries Pty Ltd v Barlow*<sup>178</sup> Windeyer J stated that '[a]cting in good faith means that a party to a contract should not pretend to rely upon breaches of no importance to him or her to achieve a collateral but desired result of bringing the contractual relationship to an end'.<sup>179</sup> This approach has antecedents in earlier case law. In *Godfrey Constructions Pty Ltd v Kanangra Park Pty Ltd*<sup>180</sup> there are statements that a general termination clause cannot be used 'for improper and extraneous purposes'<sup>181</sup> and in *Pierce Bell Sales Pty Ltd v Frazer*<sup>182</sup> there are statements that a general termination clause should not be exercised where 'it would be unconscionable in the circumstances to do so'.<sup>183</sup> However, despite judicial statements that a duty of good faith may apply to fetter the exercise of contractual powers to terminate, there are few examples of the duty actually having been breached in this context.

171 Ibid 519.

172 Ibid.

173 Ibid.

174 (2003) 217 CLR 367.

175 Ibid 375 (commenting on *Tanwar Enterprises Pty Ltd v Cauchi* (2003) 217 CLR 315).

176 See, eg, *Garry Rogers Motors* (1999) ATPR ¶41-703, 43-014. Also in relation to termination for convenience, see *GEC Marconi Systems Pty Ltd v BHP Information Technology Pty Ltd* (2003) 128 FCR 1, 171-4. See also Elisabeth Peden, 'When Common Law Trumps Equity: The Rise of Good Faith and Reasonableness and the Demise of Unconscionability' (2005) 21 *Journal of Comparative Law* 226.

177 (2001) 69 NSWLR 558, 569. See also *The Original Great American Chocolate Chip Cookie Company Incorporated v River Valley Cookies Limited*, 970 F 2d 273, 280 (7th Cir, 1992); *Bamco Villa Pty Ltd v Montedeen Pty Ltd* [2001] VSC 192 (Unreported, Mandie J, 20 June 2001) [162]-[167]; *Paragon Finance* [2002] 2 All ER 248, 261.

178 [2007] NSWSC 492 (Unreported, Windeyer J, 17 May 2007).

179 Ibid [28].

180 (1972) 128 CLR 529.

181 Ibid 548 (Stephen J).

182 (1973) 130 CLR 575.

183 Ibid 587 (Barwick CJ).

One of the few cases in which bad faith termination was successfully argued is *Pacific Brands*.<sup>184</sup> In this case Finkelstein J was concerned that a sub-licence was terminated not because of the harm caused to Pacific Brands by the breach, but because the sub- licensee refused to comply with the demands of Pacific Brands to enter into a direct licence.<sup>185</sup> Finkelstein J explained that:

Despite the pressure to which it was subjected, Underworks refused to enter into a direct licence agreement with Pacific Brands. When that pressure failed to achieve its objective, Pacific Brands decided to get rid of Underworks at the first available opportunity. It was willing to make life as difficult as possible for Underworks in an endeavour to lead it into a breach of the sub-licence. It was then willing to act on any breach, however trivial.<sup>186</sup>

Finkelstein J considered this behaviour was contrary to good faith:

In England such conduct would not be unacceptable. As Professor Goode has said, there the motive for terminating an agreement is irrelevant. Fortunately that view has now been rejected in Australia. Pacific Brands' conduct was reprehensible, being motivated as it was by bad faith and it would be unjust and oppressive to Underworks to permit Pacific Brands to terminate the sub-licence in the circumstances which prevailed.<sup>187</sup>

The issue of termination was not decided on appeal<sup>188</sup> and the decision was subsequently described as 'adventurous'.<sup>189</sup>

As Finkelstein J's statement suggests, it might be argued that the exercise of a power to terminate a contract in response to a merely trivial breach indicates the grantee of the power had an improper purpose in terminating, namely that the grantee's reasons for terminating related not to the quality of the other party's performance of the contract, but to some other collateral purpose. The difficulty with this approach is that there will commonly be a range of reasons motivating a party to terminate beyond the quality of the other party's performance of the contract. Professor Waddams explains:

The motive of a party seeking to terminate a contract almost always includes a large element of self interest. Suppose a contract provides that the party to whom a payment is due may give notice, and on failure of payment within ten days, may terminate the contract. The motive of the party terminating under such a clause is almost always that the contract is unprofitable. Can such a motive be described as bad faith, or, putting the question another way, is there any principled reason why the party (apparently) entitled to terminate should not do so? ... It would scarcely

184 [2005] FCA 288 (Unreported, Finkelstein J, 24 May 2005).

185 Ibid [66].

186 Ibid.

187 Ibid. See also *Mangrove Mountain Quarries Pty Ltd v Barlow* [2007] NSWSC 492 (Unreported, Windeyer J, 17 May 2007) [28].

188 *Pacific Brands Sport & Leisure Pty Ltd v Underworks Pty Ltd* (2006) 149 FCR 395.

189 *Council of the City of Sydney v Goldspar Australia Pty Ltd* (2006) 230 ALR 437 [166] (Gyles J).

be a workable rule that the party to whom payment was overdue could terminate only if her true motive were love of punctuality.<sup>190</sup>

A power to terminate will be commonly expressed in broad terms precisely in order to allow the grantee of the power a flexible response to the events triggering the right to terminate.<sup>191</sup> Even where the immediate consequences of the event triggering the right to terminate may not be serious, they have longer term implications for the grantee of the power. For example, the grantee of the power may consider that a breach triggering the right to terminate indicates a lack of commitment or competence on the part of the other party to the contract. Another possibility is that the grantee may place value on its right to terminate as a signal to other contracting partners of its commitment to strict performance of the contract. A power to terminate may also be included in a contract for the purpose of allowing the grantee of the power to terminate for any reason whatsoever.

The wide range of purposes for which a termination power may have been included in a contract were recognised in *Apple Communications Ltd v Optus Mobile Pty Ltd*.<sup>192</sup> In this case, the parties had entered into a distribution agreement on 23 November 2000 for a term of three years. Optus, the supplier, could terminate the agreement for any reason on 30 days notice. Notice of termination was served on Apple, the distributor, on 28 June 2001. The reason for the termination was that Optus had decided to change its method of distribution which involved reducing the number of distributors. Apple argued that the termination was arbitrary or capricious or for an extraneous purpose contrary to good faith because the termination reason had nothing to do with the performance of Apple. This argument was rejected by Windeyer J in the New South Wales Supreme Court. His Honour said that:

If a contract allows for termination for any reason then it does not seem to me to be unreasonable to terminate it for a reason unconnected with conduct of a contracting party. If a system of operation is decided to be inappropriate, that would be a proper reason for changing that system.<sup>193</sup>

A similar point was made in *Reda v Flag Ltd*.<sup>194</sup> In this case the employer exercised an express power to dismiss his employees without cause. The Privy Council confirmed the decision of the Court of Appeal of Bermuda that the appellants' employment was lawfully terminated, albeit the motive of the employer was to prevent the appellants from participating in a stock option plan about to be introduced. It was held that the very nature of a power to dismiss without cause

190 Stephen Waddams, 'Good Faith, Unconscionability and Reasonable Expectations' (1995) 9 *Journal of Contract Law* 55, 63.

191 See also *Esso* [2005] VSCA 228 (Unreported, Warren CJ, Buchanan JA and Osborn AJA, 15 September 2005) [23] (Warren CJ); *Hoy Mobile Pty Ltd v Allphones Retail Pty Ltd (No 2)* [2008] FCA 810 (Unreported, Rares J, 30 May 2008) [397].

192 [2001] NSWSC 635 (Unreported, Windeyer J, 26 July 2001).

193 *Ibid* [17]. See also *Dickson Property Management Services Pty Ltd v Centro Property Management (Vic) Pty Ltd* (2000) 180 ALR 485; *Thiess Contractors Pty Ltd v Placer (Granny Smith) Pty Ltd* (2000) 16 BCL 130; *aff'd* (2000) 16 BCL 255.

194 [2002] UKPC 38 (Unreported, Lords Nicholls, Mackay, Hope, Hutton and Millett, 11 July 2002).

was that its exercise did not have to be justified. Accordingly, there was no scope for an argument that the right to terminate was fettered by an implied term of trust and confidence.<sup>195</sup>

## VII CONCLUSION

Both English and Australian courts have implied duties fettering the exercise of discretionary contractual powers. While in Australia these duties have been treated as applications of a general duty of good faith, they probably fulfil similar functions to the more specific duties implied by English courts. In both jurisdictions, courts have held that parties may not exercise a discretionary contractual power for reasons contrary or extrinsic to the purposes of the power. Courts in Australia have generally not subjected the exercise of contractual power to review by reference to a standard of reasonableness. It may be that the duty implied by English courts not to exercise a discretionary contractual power in a manner that is unreasonable would better reflect the courts' concern in this regard. Courts have been sensitive to the need for parties to commercial contracts to preserve their own interests.<sup>196</sup> Indeed, courts are likely to recognise that some contractual powers, particularly powers to terminate, may be exercised for a broad range of reasons.

The best advice to contracting parties including discretionary powers in their contracts is to realise that the powers must be exercised for sound business reasons rather than egregious or overreaching outcomes. Any considerations included in the contract as relevant to the exercise of the power should be respected. The power should not be used in a discriminatory manner or to prompt termination of the contract in circumstances where no direct power to terminate exists. Put this way, the duties need not introduce unmanageable uncertainty in contracting nor represent an unreasonable imposition on freedom of contract. The implied duties fettering the exercise of discretionary contractual powers should instead be seen as articulating simple and fundamental principles of good decision making.

<sup>195</sup> *Ibid* [45].

<sup>196</sup> See, eg, *Eso* [2005] VSCA 228 (Unreported, Warren CJ, Buchanan JA, Osborn AJA, 15 September 2005); *Pioneer Park Pty Ltd v ANZ Banking Group Ltd* [2006] NSWSC 883 (Unreported, Einstein J, 20 September 2006) [79].