EXPLORING THE RECENT UNCERTAINTY SURROUNDING THE IMPLIED DUTY OF GOOD FAITH IN AUSTRALIAN CONTRACT LAW: THE DUTY TO ACT REASONABLY – ITS EXISTENCE, AMBIT AND OPERATION

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Introduction

1. I have been asked to discuss what we mean in concrete terms when we talk of a duty to act in good faith in the performance or negotiation of a contract. Is there such a duty in Australian law? What do we mean when we say someone is not acting *bona fide*? Is an obligation to act in good faith different from an obligation to act reasonably? If an obligation to act in good faith exists how far does it extend and how does it operate in practice? I do not deal with the enforceability of any agreement to negotiate in good faith.[1]

Background

Roman Law

2. The problem is an old one, no doubt as old as human trade. The traditional view of the common law limiting any obligation to act *bona fide* was expressed in another Latin phrase, *caveat emptor*, "let the buyer beware", but even the Romans were not so sure that was the correct approach.

3. Cicero, the illustrious Roman advocate, gave a useful and still valid example of the area for debate in this passage of his celebrated work on moral philosophy, *De Officiis, (On Obligations* or *Duties),* a work he wrote, ostensibly to his son, not long before he died:[2]

> "[50] Let it be set down as an established principle, then, that what is morally wrong can never be expedient - not even when one secures by

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1 See *Coal Cliff Collieries Pty Ltd v Sijehama Pty Ltd* (1991) 24 NSWLR 1.

2 *De Officiis*, Book III [50]-[53] translated by Walter Miller, Loeb Edition, Cambridge: Harvard University Press, 1913 reproduced at http://www.stoics.com/cicero_book.html and at http://www.thelatinlibrary.com/cicero/off3.shtml in Latin.

means of it that which one thinks expedient; for the mere act of thinking a course expedient, when it is morally wrong, is demoralizing. But, as I said above, cases often arise in which expediency may seem to clash with moral rectitude; and so we should examine carefully and see whether their conflict is inevitable or whether they may be reconciled. The following are problems of this sort: suppose, for example, a time of dearth and famine at Rhodes, with provisions at fabulous prices; and suppose that an honest man has imported a large cargo of grain from Alexandria and that to his certain knowledge also several other importers have set sail from Alexandria, and that on the voyage he has sighted their vessels laden with grain and bound for Rhodes; is he to report the fact to the Rhodians or is he to keep his own counsel and sell his own stock at the highest market price? I am assuming the case of a virtuous, upright man, and I am raising the question how a man would think and reason who would not conceal the facts from the Rhodians if he thought that it was immoral to do so, but who might be in doubt whether such silence would really be immoral.

[51] In deciding cases of this kind Diogenes of Babylonia, a great and highly esteemed Stoic, consistently holds one view; his pupil Antipater, a most profound scholar, holds another. According to Antipater all the facts should be disclosed, that the buyer may not be uninformed of any detail that the seller knows; according to Diogenes the seller should declare any defects in his wares, in so far as such a course is prescribed by the common law of the land; but for the rest, since he has goods to sell, he may try to sell them to the best possible advantage, provided he is guilty of no misrepresentation. "I have imported my stock," Diogenes's merchant will say; "I have offered it for sale; I sell at a price no higher than my competitors - perhaps even lower, when the market is overstocked. Who is wronged?"

[52] "What say you?" comes Antipater's argument on the other side; "it is your duty to consider the interests of your fellow-men and to serve society; you were brought into the world under these conditions and have these inborn principles which you are in duty bound to obey and follow, that your interest shall be the interest of the community and conversely that the interest of the community shall be your interest as well; will you, in view of all these facts, conceal from your fellow-men what relief in plenteous supplies is close at hand for them?" "It is one thing to conceal," Diogenes will perhaps reply; not to reveal is quite a different thing. At this present moment I am not concealing from you, even if I am not revealing to you, the nature of the gods or the highest good; and to know these secrets would be of more advantage to you than to know that the price of wheat was down. But I am under no obligation to tell you everything that it may be to your interest to be told."

[53] "Yea," Antipater will say, "but you are, as you must admit, if you will only bethink you of the bonds of fellowship forged by Nature and existing between man and man." "I do not forget them," the other will reply: but do you mean to say that those bonds of fellowship are such that there is no such thing as private property? If that is the case, we should not sell

> anything at all, but freely give everything away." In this whole discussion, you see, no one says, "However wrong morally this or that may be, still, since it is expedient, I will do it"; but the one side asserts that a given act is expedient, without being morally wrong, while the other insists that the act should not be done, because it is morally wrong."

4. Some people might think that the debate has not advanced terribly far since then. It certainly reminds me of the terms of the debate here about whether and when silence can amount to misrepresentation or misleading or deceptive conduct under the *Trade Practices Act* 1974 (Cth). The views of Diogenes reflect the traditional view of the common law while Antipater could be an advocate from one of the modern civilian systems or America or a proponent of consumer rights in modern Australia.

5. Cicero in notionally deciding this case and another similar example, focussed on what he said was expedient but based on a more subtle world view than the merely practical or greedy:

> "[57] I think, then, that it was the duty of that grain-dealer not to keep back the facts from the Rhodians, and of this vendor of the house to deal in the same way with his purchaser. The fact is that merely holding one's peace about a thing does not constitute concealment, but concealment consists in trying for your own profit to keep others from finding out something that you know, when it is for their interest to know it. And who fails to discern what manner of concealment that is and what sort of person would be guilty of it? At all events he would be no candid or sincere or straightforward or upright or honest man, but rather one who is shifty, sly, artful, shrewd, underhand, cunning, one grown old in fraud and subtlety. Is it not inexpedient to subject oneself to all these terms of reproach and many more besides?"

6. At least from that passage we can conclude that the lawyer's art of using six words when one would do has a long history! But Cicero's point is that the honourable is the expedient and vice versa.

7. Now in case you think I am being unduly antique in taking you back this far in history, let me take you forward to 1817 and some litigation in America arising out of the War of 1812 between the United States and Great Britain. During the war the British had blockaded the port of New Orleans, preventing the export of tobacco and depressing the market price the growers could obtain. Peter

Laidlaw & Co., Louisiana tobacco merchants, learned early on that the war had been concluded and, acting as commission agents, bought 111 hogsheads of tobacco from another merchant, Mr Organ. After the news became available generally and the price of tobacco soared Mr Organ sued. There was evidence available but not admitted that the seller inquired of the buyer if there was any news which was calculated to enhance the value of tobacco, and the buyer remained silent. A retrial was ordered to allow that evidence to go to a Louisiana jury. The judgment itself is brief and not remarkable but the submissions traversed the arguments of Cicero to which I have referred, discussed the relevant passages from *Pothier, Contrat de Vente*, particularly relevant because it was a case from the former French territory of Louisiana whose system is still based on the civil law, and included this passage from the submissions, dear to any common lawyer's heart, if not completely successful in this case at this stage:[3]

> "The only real question in the cause is, whether the sale was invalid because the vendee did not communicate information which he received precisely as the vendor *might* have got it had he been equally diligent or equally fortunate? And, surely, on this question there can be no doubt. Even if the vendor had been entitled to the disclosure, he waived it by not insisting on an answer to his question; and the silence of the vendee might as well have been interpreted into an *affirmative* as a *negative* answer. But, on principle, he was not bound to disclose. Even admitting that his conduct was unlawful, in *foro conscientiae*, does that prove that it was so in the civil forum? Human laws are imperfect in this respect, and the sphere of morality is more extensive than the limits of civil jurisdiction. The maxim of *caveat emptor* could never have crept into the law, if the province of ethics had been co-extensive with it. There was, in the present case, no circumvention or manoeuvre practised by the vendee, unless rising earlier in the morning, and obtaining by superior diligence and alertness that intelligence by which the price of commodities was regulated, be such. It is a romantic equality that is contended for on the other side. Parties never can be precisely equal in knowledge, either of facts or of the inferences from such facts, and both must concur in order to satisfy the rule contended for. The absence of all authority in England and the United States, both great commercial countries, speaks volumes against the reasonableness and practicability of such a rule."

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[3] *Laidlaw & Co. v Organ* (1817) 15 US 178 at 193-194. Both the passage from Cicero and this decision are discussed in Dafydd Walters, *The Concept of Good Faith in Anglo-American Law* in B Glansdorff and ors, *La Bonne Foi*, Cahier No. 10, Centre de Recherches en Histoire du Droit at des Institutions, Facultés Universitaires Saint-Louis Bruxelles 1998 at pp. 131-141.

8. When Cicero wrote about good faith in contracts about 44 BC the idea was not new for Roman lawyers. A modern author dealing with the topic describes the later development of that idea in Roman law after Cicero in terms familiar to common lawyers and students of equity:[4]

> "Out of the mass of decisions based on *bona fides* there slowly crystallised a body of general rules which played a vital role in the reception of Roman law into modern legal systems … Principles such as these continue to influence the modern administration of justice through the general clauses incorporated into the national codifications … However, the legal institutions it [the concept of *bona fides*] had shaped and the finely nuanced considerations to which it had given rise became part and parcel of the civilian heritage on which the modern legal systems are based.
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> In addition, the ethical principles which form the basis of the classical notion of *bona fides* are today enjoying a renaissance. This has to do with the fact that within a framework of general concepts the modern lawyer has to resolve legal issues which have always been measured against the ideals of the *bonus vir* and *bene agere*; i.e. the main pillars of *bona fides* itself."

9. The Roman law background is interesting because it provides an historical context, the factual problems are also familiar and much of the present debate is influenced by modern civilian systems, equitable doctrines, the reception of an obligation of good faith into American commercial law through s. 1-304 of the *Uniform Commercial Code*, under the influence of the partly German educated American realist Professor Karl Llewellyn, the use of the idea of good faith in the draft for the proposed European Civil Code, the Vienna Convention on the International Sale of Goods as well as in the UNIDROIT principles of the law of international commercial contracts. In other words, even if the common law does not admit of an overarching duty of good faith in contracts might some such notion eventually be imported through international commercial law or the application of equitable maxims to the common law?

Civilian Systems

10. The idea of *bona fides* was incorporated into the general clauses of the modern French and German civil codes. Article 1134 of the French *Code Civile* provides that agreements must be performed in good faith. It is the subject of a

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[4] M J Schermaier, *Bona Fides in Roman Contract Law* in R Zimmermann and S Whittaker, *Good Faith in European Contract Law* (Cambridge UP 2000) at 88-89.

significant body of jurisprudence. Similarly in Germany § 242 BGB requires the obligor under a contract to perform in a manner consistent with good faith taking into account accepted practice. Again that has given rise to a considerable body of German law. As Professor Shermaier concluded[5]:

> "The principles of *bona fides*, as incorporated into the general clauses, render a substantial contribution to the adaptation of the codified law to changing social values. They thus contribute, as *Stammler* has said, to the realisation of the social ideal. Without this constant regard for fairness and justice Roman law would not have survived throughout the ages; and the modern codifications, too, would soon have become useless and outdated, had they not provided space for the operation of *bona fides*."

United States

11. In America the idea of an implication of a requirement to act in good faith in a contract antedated the *Uniform Commercial Code* although it was not universally accepted.[6] The performance and enforcement of contracts in good faith became a feature of American commercial law through s. 1-304 of the *Uniform Commercial Code.* It provides that every contract or duty within that Code imposes an obligation of good faith in its performance and enforcement. Section 1-201(b)(20) defines "good faith" as "honesty in fact and the observance of reasonable commercial standards of fair dealing". The involvement of the legal realist Professor Karl Llewellyn in the drafting of that code seems to have been influential in the importation of this approach to "channel the exercise of freedom of contract by creating a market climate which encourages compliance with commercial norms of decency and fairness."[7]

International Instruments

12. The Vienna Convention on the international sale of goods, to which Australia and most of its major trading partners, with the exception of the United

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5 Op. cit. 92.

6 See *Wigand v Bachmann-Bechtel Brewing Co* (1918) 222 NY Rep 272, 277 where the New York Court of Appeals stated that "every contract implies good faith and fair dealings between the parties to it". See also the American Law Institute, *Restatement (2nd) of the Law of Contracts* (1981) s. 205 which provides that every "contract imposes upon each party a duty of good faith and fair dealing in its performance and enforcement." But cf the analysis by Gummow J in *Service Station Association Ltd v Berg Bennett & Associates Pty Ltd* (1993) 45 FCR 84, 91-98.

7 Carolyn Edwards, Article 2 of the Uniform Commercial Code and Consumer Protection: The Refusal to Experiment (2004) 78 St John's Law Review 663, 691-695.

Kingdom and Japan, have adhered, mentions the good faith principle in article 7(1) which requires that Convention to be interpreted having regard to its international character and to the need to promote uniformity in its application and the observance of good faith in international trade. That does not amount to an implied term requiring the parties to exercise good faith in the performance of the contract but it does require interpretation of the convention in conformity with such an idea. The UNIDROIT principles of international commercial contracts in article 1.7(1), however, do require each party to act in accordance with good faith and fair dealing in international trade. Those UNIDROIT principles may be used to interpret or supplement international law instruments and have been used to help arbitrators and some European courts to interpret the Vienna Convention.[8]

13. Again art. 1-201 of the *Principles of European Contract Law*, developed as a possible first step towards a general European Civil Code, provides that "these principles should be interpreted and developed in accordance with their purposes. In particular, regard should be had to the need to promote good faith and fair dealing, certainty in contractual relationships and uniformity of application." The duty may not be excluded or limited. The group developing these principles is a private body modelled on the American Law Institute, responsible for the *Restatements of Americam Law*, but one that is likely to be very influential in the development of the law in Europe.

14. It can be seen from this brief and limited international survey that the idea of interpreting contracts to require good faith in their performance or to require the parties to act in good faith is neither new nor uncommon. Even if it does not form part of Australia's common law, Australian lawyers engaged in international legal transactions will need to be familiar with the idea and its application in practice.

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[8] See Professor Ulrich Magnus, *Remarks on Good Faith* at http://www.cisg.law.pace.edu/cisg/principles/uni7.html#um.

Meaning

15. Sir Anthony Mason has suggested that good faith embraces three notions, an obligation in the parties to cooperate in achieving their contractual objects, compliance with honest standards of conduct and compliance with standards of conduct which are reasonable having regard to the interests of the parties.[9]

16. Such an approach incorporates the obligation to cooperate expressed in *Mackay v Dick*[10] and the normal requirement of honesty. The controversial question is whether an objective standard of reasonable conduct is required, a standard that was not required explicitly, for example in *Meehan v Jones*[11] and a question to which I shall return.

Recent Australian Developments

17. The idea of good faith is familiar to Australian lawyers from its use in statutes,[12] in equity, in insurance contracts, which are contracts of the utmost good faith, and from the concept of a purchaser in good faith.[13] But a requirement that the parties perform a contract by acting in good faith towards one another has not, historically, been regarded as a necessary feature of commercial contracts here. The accepted wisdom has been that parties to such contracts are expected to look after their own interests, *caveat emptor*.[14]

18. The remarks of Priestley JA in *Renard Constructions (ME) Pty Ltd v Minister for Public Works*[15] made significant inroads into that view. His Honour said that "there are many indications that the time may be fast approaching when the idea, long recognised as implicit in many of the orthodox techniques of solving

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9 *Contract and its Relationship with Equitable Standards and the Doctrine of Good Faith*, The Cambridge Lectures, 1993 and *Contract, Good Faith and Equitable Standards in Fair Dealing* (2000) 116 LQR 66. See the discussion in E Peden, *Good Faith in the Performance of Contracts* (LexisNexis Butterworths, 2003) [7.2]-[7.8], pp. 160-170 and the useful discussion of the meaning of the words by Hollingworth J in *Esso Australia Resources Pty Ltd v Southern Pacific Petroleum NL* [2004] VSC 477 [120]-[136].

10 (1881) 6 App Cas 251.

11 (1982) 149 CLR 571.

12 A search for the phrase in Queensland's consolidated statutes on Austlii produces 252 results.

13 Peden, op. Cit. [7.23]-[7.26], pp. 193-198.

14 Although Lord Mansfield had described it in 1766 as "the governing principle … applicable to all contracts and dealings" in *Carter v Boehm* (1766) 3 Burr 1905, 1909; 97 ER 1162, 1164.

15 (1992) 26 NSWLR 234

contractual disputes, will gain explicit recognition in the same way as it has in Europe and in the United States."[16] Especially in New South Wales his views rapidly seemed to become almost the new orthodoxy. They were influential elsewhere also.

19. Within seven years Finkelstein J of the Federal Court was able to say that "recent cases make it clear that in appropriate contracts, perhaps even in all commercial contracts, such a term will ordinarily be implied; not as an ad hoc term (based on the presumed intention of the parties) but as a legal incident of the relationship.[17]

20. The High Court, however, has shown no real enthusiasm to take up the debate. Four years ago it sidestepped the issue in *Royal Botanic Gardens and Domain Trust v South Sydney City Council*.[18] But Kirby J in particular said that a general implied contractual term appeared to conflict with fundamental notions of *caveat emptor* inherent in common law conceptions of economic freedom and to be inconsistent with the law as it has developed in Australia in respect of the introduction of implied terms into written contracts which the parties have omitted to include.[19] The High Court has not revisited the debate since then.

21. The reluctance of the High Court to enter into the debate unless a case that raises the issue clearly comes before it may also reflect the views of Gummow J. While still a member of the Federal Court his Honour decided *Service Station Association v Berg Bennett & Associates Pty Limited.*[20] His detailed reasons there leave little scope for the implication of a general term of good faith in the performance of commercial contracts in Australian law.[21] His Honour

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16 See at 263-264. His Honour had written extrajudicially on the topic in greater detail; *Contract – the Burgeoning Maelstrom* (1988) 1 JCL 15.

17 *Garry Rogers Motors (Aust) Pty Ltd v Subaru (Aust) Pty Ltd* (1999) ATPR 41-703 at 43,014 [34], referred to in this context by TM Carlin, *The Rise (and Fall?) of Implied Duties of Good Faith in Contractual Performance in Australia* (2002) 25 UNSW Law Journal 99, 100-101.

18 (2002 76 ALJR 436 [40], [86]-[87] and [155].

19 At [87]

20 (1993) 45 FCR 84.

21 See at 91-98, but cf the views of the New South Wales Court of Appeal in *Alcatel Australia Ltd v Scarcella* (1998) 44 NSWLR 349, 363-369.

concluded after a lengthy, learned discussion about the development and use of the doctrine in the United States as follows:[22]

> "Anglo-Australian contract law as to the implication of terms has heretofore developed differently, with greater emphasis upon specifics, rather than the identification of a genus expressed in wide terms. Equity has intervened in matters of contractual formation by the remedy of rescission, upon the grounds mentioned earlier. It has restrained freedom of contract by inventing and protecting the equity of redemption, and by relieving against forfeitures and penalties. To some extent equity has regulated the quality of contractual performance by the various defences available to suits for specific performance and for injunctive relief. In some, but not all, of this, notions of good conscience play a part. But it requires a leap of faith to translate these well-established doctrines and remedies into a new term as to the quality of contractual performance, implied by law."

22. In a useful critique of the decisions since *Renard Constructions*, Mr Tyrone Carlin drew attention to the fact that the real question raised in that case involved the extent to which the exercise of powers expressly conferred by contract can be tempered by the implication of a term requiring reasonableness in their exercise, not an implied duty of good faith in contractual performance.[23] Priestley JA also noted that his discussion of good faith did not form part of his reasons for judgment.[24] Mr Carlin also argues persuasively that Priestley JA's comments have been taken out of context and treated as authoritative when they were not.[25]

23. Even though *Renard Constructions* continues to be relied upon to argue that a general implied term of good faith in contractual performance exists in Australia in spite of Gummow J's reservations,[26] such discussion as there was in the High Court in *Royal Botanic Gardens* does not encourage the conclusion that it will

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22 (1993) 45 FCR 84, 96- 97.

23 Op. cit. at 104. Note how the case was treated by the Queensland Court of Appeal in *Gold Coast Waterways Authority v Salmead Pty Ltd* [1997] 1 Qd R 346 also.

24 See *Renard* at 271.

25 As to the reluctance of other judges to go as far as Priestly JA went; see *GSA Group Pty Ltd v Siebe PLC* (1993) 30 NSWLR 573, 579 and *Service Station Association Ltd v Berg Bennett & Associates Pty Ltd* at 97-98.

26 See *Alcatel Australia Ltd v Scarcella* and the other cases listed in fn 128 of Carlin op. cit. But cf *Vodafone Pacific Ltd v Mobile Innovations Ltd* [2004] NSWCA 15, [189]-[191] and *Australian Hotels Assn (NSW) v TAB Ltd* [2006] NSWSC 293 [69]-[80] which indicate a renewed reluctance in New South Wales to recognise that commercial contracts are a class of contracts that, as a legal incident, have an implied obligation of good faith. There is now more of a focus on implication of such a term in particular classes of contracts.

soon imply such a general term in Australian contracts. That is the apparent position in Queensland and Victoria too.[27]

Implication of such a term in particular contracts

24. Is it possible to imply such a term in particular factual circumstances rather than by operation of the law generally? That appears to have been done in *News Ltd v Australian Rugby Football League*[28] because of the special nature of the relationship between the Australian Rugby League and the teams affiliated with its competition. The reasons for such an implication were not elaborated at any great length in that case.

25. The next significant decision was that of Finn J in *Hughes Aircraft International v Air Services Australia* (1997) 76 FCR 151, 191-194 where his Honour expressed his personal preference for the views of Priestley J in *Renard Constructions* while noting the decision of Gummow J in *Service Station Association.* His Honour decided the issue before him on the basis that the implication of such a duty was a legal incident of the particular class of contract with which he was dealing. That case dealt with pre-award contracts dealing with procurement from a Government authority and his Honour found a duty to act fairly appeared to have been accepted in other British Commonwealth jurisdictions. As his Honour said at 194:

> "If the purpose of a tender process contract is to be accomplished, if contractor-tenderers are to be given an effective opportunity to enjoy the fruits of the bid and not to have that opportunity destroyed by the unfair dealing of the other party to the contract, a duty such as I have described would appear to me to be a presupposition of such a contract. In the tender process context such a duty seems little more than an appropriate adaptation of the duty to cooperate recognised in *Butt v M'Donald* (1896) 7 QLJ 68 at 70-71."

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27 See *Gold Coast Waterways Authority v Salmead Pty Ltd* [1997] 1 Qd R 346, *Laurelmont Pty Ltd v Stockdale & Leggo (Queensland) Pty Ltd* [2001] QCA 212 and *Re Zurich Australian Insurance Ltd* [1999] 2 Qd R 203, 213-219 [34]-[82]. There is no great desire to leap into the fray either; *Re Kendells (NSW) Pty Ltd (In Liq)* [2005] QSC 064 [58]-[60] where Muir J surveys the cases helpfully and *Highmist Pty Ltd v Tricare Australia Ltd* [2005] QSC 115 at [43]. In Victoria see *Essa Australia Resources Pty Ltd v Southern Pacific Petroleum NL* [2005] VSCA 228 [3]-[4], [25].

28 (1996) 58 FCR 447, 540-541.

26. Similar arguments have been advanced in respect of franchise relationships many of which would, in any event, be covered by the unconscionability provisions of the *Trade Practices Act* 1974 (Cth) in s. 51AC. There is, nonetheless, an increasing tendency for an obligation of good faith to be treated as arising in particular cases.[29]

27. One of the problems associated with implying such a term in a particular factual context is whether that conforms with the traditionally accepted tests for the implication of terms, a point made by Kirby J in *Royal Botanic Gardens*, or with the traditionally accepted obligations of parties to such contracts.[30]

Interpretation and drafting of express terms - reasonableness

28. If there is an express term requiring the parties to perform the obligations of the contract in good faith it would need, on general principles, to be interpreted in context and not to override other express terms giving particular contractual rights to the parties.[31] In other words if a contract gives a right to terminate if certain conduct occurs it is difficult to argue convincingly that a duty to perform the contract in good faith could override such an express provision. If one wishes to incorporate an express term of good faith in a contract it seems to me that it would be most desirable to express that obligation in a particular context to give it real meaning. As Elisabeth Peden says "broad definitions of good faith based on general moral standards of cooperation, fairness and justice, can seem uncertain and vague and too much the exercise of judicial discretion."[32]

29. For example, an agreement might include an arbitration clause leaving it up to the parties to agree on who should be nominated as an arbitrator should a disagreement arise in the performance of a contract. The incorporation of an obligation in each party to act in good faith in the choice of an arbitrator would probably be so vague as to be anodyne. The wise solicitor may find it prudent to amplify the obligation of good faith by reference to objective standards of

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29 See E Peden, *Good Faith in the Performance of Contracts* (LexisNexis Butterworths, 2003) at [6.10] p. 130.

30 See the comments of Chesterman J in *Re Zurich Australian Insurance Ltd* above.

31 See the discussion in Peden, op. cit., at [6.18].

32 Op. cit. at [7.2] p. 159.

qualification and independence of a possible arbitrator to ensure good faith is exercised in fact as well as in theory and to avoid the problem the courts face at present of deciding whether conduct incorporating objective standards of reasonableness is required by parties to such contracts.

30. It seems to me that a role for an express obligation of good faith in the performance of a contract is likely to arise where the contract's provisions give a discretion to a party to act in one of a number of ways. If such an obligation is to have a practical effect it should focus on requiring the party to exercise the discretion by reference to those virtues of cooperation, honesty and reasonableness spoken of by Sir Anthony Mason. To make this explicit would be desirable given the distinction the High Court has made, for example, between requiring honesty if not reasonableness in the determination of whether satisfactory efforts have been made by a purchaser to obtain finance in a "subject to finance" conveyancing transaction.[33]

31. In other words it will be desirable, if drafting such a clause, to include an obligation in the purchaser to act in good faith in seeking to obtain finance for the purchase by acting both honestly and reasonably in seeking the finance and by using his or her best endeavours to cooperate with the vendor in achieving the object of the contract.

32. I hesitate to give any drafting examples but do suggest that a focus on achieving objective standards of reasonableness in the behaviour of parties to a contract is the most useful general approach to achieving the general effect of a "good faith" clause as the need to act honestly and to cooperate in achieving the contractual objects are terms already effectively implied in Australian contracts.

33. In the absence of such an approach to drafting one needs to come to grips with the meaning of the third principle discussed by Sir Anthony Mason: what is compliance with standards of conduct which are reasonable having regard to the interests of the parties? It seems to me that this may be something different from objectively reasonable conduct. It does not go so far as a fiduciary duty

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[33] See *Meehan v Jones* (1982) 149 CLR 571, 581, 590-591, 597-598.

where the beneficiary has a legitimate expectation that the fiduciary will act in the beneficiary's interest.[34] Nor should it prevent one party from engaging in conduct in reliance on a contractual right where the interests of the parties are opposed. Perhaps it means that when a party makes a decision under a contract it should be mindful of the other party's position and act reasonably taking that position into account.

34. A useful discussion of such an idea, particularly in the insurance context, by Chesterman J in *Re Zurich Australian Insurance Ltd* [35] may help:

> "[84] The central problem remains. What is "due regard" for the interests of the insured? The passage I have quoted from the *American Law Reports* points to the failure of the courts of that country to formulate any satisfactory test to decide what is an appropriate level of consideration for the insured's interests. One can say with confidence that due regard will depend upon the nature of the right being exercised and the circumstances in which it comes to be exercised but that is not to say very much. To my mind an important factor is that the parties have agreed by formal written contract to confer on one of them, the insurer, a discretion, the exercise of which will or may occur in circumstances where their interests are opposed. In other words, as Mr Hawke puts it (at p. 97), the contract indicates a mutual intention that the insured be placed, to a certain extent, in the insurer's hands in relation to the exercise of the power.
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> [85] Importantly the implied limitation that an insurer will exercise rights with due regard for the interests of the insured has little application with respect to a condition which operates only as between the insurer and the insured. Condition 3 expressly confers upon the insurer the right to act in a way which can only be inimical to the insured's interests. An implied term can scarcely overcome this express agreement by the insured that the insurer may act to its detriment.
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> [86] The situation is different, as the cases illustrate, where an insurer is empowered by the policy to deal with third parties either by way of compromising or defending claims or bringing suits against them. The interests of insurer and insured, which may be different, are affected by the outcome of the action or defence. One can readily see how the insurer should be mindful of its insured's position when defending, suing or compromising. But the capacity of the insurer to injure the interests of the insured pursuant to a term that only operates between

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34 Sir Anthony Mason, op. cit. (2000) 116 LQR at 84.

35 [1999] 2 Qd R 203, 219, [84]-[86].

> insurer and insured and which expressly authorises the conduct is of a wholly different category. It seems to me the implied limitation cannot have any application to Zurich's reliance on Condition 3."

Can any implied duty be excluded?

35. The answer to this question must depend greatly on the nature of any implied duty that is eventually found to exist under Australian laws. If an implied duty of the type recognised under the civilian systems were to be "created" by a decision of the High Court as one applying to all contracts, such as the obligation to cooperate deriving from *Mackay v Dick* requiring each party to do that which was necessary for the performance of the contract, then there would seem to be little scope for excluding the duty by agreement.

36. There is also an argument that "good faith" is inherent in all common law contractual principles and that an attempt to imply an independent term requiring good faith is unnecessary.[36] The authors who propound that theory argue good faith is inherent in all aspects of contract law because good faith is the essence of contract. They develop their argument by analysing typical steps in the formation and performance of an agreement. It is an interesting argument but not one that convinces me, partly because of the debate as to whether the law requires both honesty and reasonableness in performing obligations under a contract or merely honesty. If those authors are correct, however, then the argument against the ability to exclude such an implied obligation of good faith would be stronger.

37. If, however, the obligation is one found to arise only in particular contracts or by implication from particular facts then there should be no reason in theory why such an implied implication might not be excluded just as fiduciary obligations that might otherwise arise may be excluded by agreement.

38. In practical terms it is difficult to imagine an attractively drafted term seeking to exclude an obligation of good faith. It would certainly ring alarm bells for the other party to the negotiations. Perhaps it could be phrased more palatably if it

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[36] See JW Carter and E Peden, Good Faith in Australian Contracts Law (2003) 19 JCL 155.

were expressed in terms that a party to a contract be at liberty to consult only its own interests in making a particular decision under the contract but, again, that should serve only to alarm a prospective party to the contract.

Construing the contract so there is an expectancy of good faith

39. The construction of a contract consistently with obligations of good faith can be achieved in the exercise of the courts' equitable jurisdiction as Lord Hoffmann, originally trained in the Roman-Dutch system in South Africa, said in *O'Neill v Phillips*:[37]

> "An example of such equitable principles in action is *Blisset v. Daniel* (1853) 10 Hare 493 to which Lord Wilberforce referred in *In re Westbourne Galleries Ltd.* at p. 381. Page-Wood V.-C. held that upon the true construction of the articles, two-thirds of the partners could expel a partner by serving a notice upon him without holding any meeting or giving any reason. But he held that the power must be exercised in good faith. He said that "the literal construction of these articles cannot be enforced" and, after citing from the title "De Societate" in Justinian's *Institutes*, went on:
>
> > 'It must be plain that you can neither exercise a power of this description by dissolving the partnership nor do any other act for purposes contrary to the plain general meaning of the deed, which must be this, that the power is inserted, not for the benefit of any particular parties holding two-thirds of the shares but for the benefit of the whole society and partnership . . ."
>
> In the Australian case of *In re Wondoflex Textiles Pty. Ltd.* [1951] V.L.R. 458, 467, Smith J. also contrasted the literal meaning of the articles with the true intentions of the parties:
>
> > 'It is also true, I think, that, generally speaking, a petition for winding up, based upon the partnership analogy, cannot succeed if what is complained of is merely a valid exercise of powers conferred in terms by the articles. . . . To hold otherwise would enable a member to be relieved from the consequences of a bargain knowingly entered into by him. . . . But this, I think, is subject to an important qualification. Acts which, in law, are a valid exercise of powers conferred by the articles may nevertheless be entirely outside what can fairly be regarded as having been in the contemplation of the parties when they became members of the company; and in such cases the fact that what has been done is not in excess of power will not necessarily be an answer to a claim for winding up. Indeed, it may be said that one purpose of [the

[37] [1999] 1 WLR 1092, 1100-1101.

> just and equitable provision] is to enable the court to relieve a party from his bargain in such cases.'

I cite these references to "the literal construction of the articles" contrasted with good faith and "the plain meaning of the deed" and "what the parties can fairly have had in contemplation" to show that there is more than one theoretical basis upon which a decision like *Blisset v. Daniel* can be explained. 19th century English law, with its division between law and equity, traditionally took the view that while literal meanings might prevail in a court of law, equity could give effect to what it considered to have been the true intentions of the parties by preventing or restraining the exercise of legal rights. So Smith J. speaks of the exercise of the power being valid 'in law' but its exercise not being just and equitable because contrary to the contemplation of the parties. This way of looking at the matter is a product of English legal history which has survived the amalgamation of the courts of law and equity. But another approach, in a different legal culture, might be simply to take a less literal view of 'legal' construction and interpret the articles themselves in accordance with what Page-Wood V.-C. called 'the plain general meaning of the deed.' *Or one might, as in Continental systems, achieve the same result by introducing a general requirement of good faith into contractual performance.* These are all different ways of doing the same thing. I do not suggest there is any advantage in abandoning the traditional English theory, even though it is derived from arrangements for the administration of justice which were abandoned over a century ago. On the contrary, a new and unfamiliar approach could only cause uncertainty. So I agree with Jonathan Parker J. when he said in *In re Astec (B.S.R.) Plc.* [1998] 2 B.C.L.C. 556, 588:

> 'in order to give rise to an equitable constraint based on 'legitimate expectation' what is required is a personal relationship or personal dealings of some kind between the party seeking to exercise the legal right and the party seeking to restrain such exercise, such as will affect the conscience of the former.'

This is putting the matter in very traditional language, reflecting in the word "conscience" the ecclesiastical origins of the long-departed Court of Chancery. As I have said, I have no difficulty with this formulation. But I think that one useful cross-check in a case like this is to ask whether the exercise of the power in question would be contrary to what the parties, by words or conduct, have actually agreed. Would it conflict with the promises which they appear to have exchanged? In *Blisset v. Daniel* the limits were found in the "general meaning" of the partnership articles themselves. In a quasi-partnership company, they will usually be found in the understandings between the members at the time they entered into association. But there may be later promises, by words or conduct, which it would be unfair to allow a member to ignore. Nor is it necessary that such promises should be independently enforceable as a matter of contract. A promise may be binding as a matter of justice and equity although for one reason or another (for

> example, because in favour of a third party) it would not be enforceable in law." (My emphasis.)

Conclusion

40. This passage from the decision of Lord Hoffman reminds me of the attitude expressed in a colloquium on good faith organised by the University of Brussels by the French-speaking editor: "The mistrust of Anglo-Saxon jurists for the general concept of good faith is equalled only by the imagination which they put towards multiplying particular concepts which lead to the same results."[38] The author takes the view that the English legal tradition in seeking to avoid imposing a general obligation of good faith includes many other concepts designed to achieve the same end.

41. The use of equity rather than the law to achieve a "good faith" construction of a contract also helps form a bookend to the examples given at the start of this paper drawn from Cicero. As the praetors later introduced actions based on *bona fides* to supplement and correct pre-existing Roman civil law so did the chancellor use equitable ideas to reform the English common law.[39]

42. As Lord Justice Bingham said in *Interfoto Picture Library v Stiletto Visual Programme* [1989] QB 433, 439:

> "In many civil law systems, and perhaps in most legal systems outside the common law world, the law of obligations recognises and enforces an overriding principle that in making and carrying out contracts parties should act in good faith. This does not simply mean that they should not deceive each other, a principle which any legal system must recognize; its effect is perhaps most aptly conveyed by such metaphorical colloquialisms

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38 Prof. Jacques-Henri Michel in *La Bonne Foi*. at (x):
"L'apport du droit anglo-saxon à la réflexion qui nous est proposée est tout aussi instructif. Je le résumerais volontiers en une phrase. La méfiance des jurists anglo-saxons à l'égard de la notion générale de bonne foi n'a d'égale que l'imagination qu'ils ont mise à multiplier les concepts particuliers qui en tiennent lieu tout en aboutissant aux mêmes resultats. Aujourd'hui, les besoins nés des échanges internationaux à dimension de la planète amènent les jurists de la tradition continentale et ceux de la *common law* à confronter leurs habitudes les plus enracinées pour en tirer les nécessaries conciliations exigées par la pratique. A lire la dernière contribution de notre volume, on s'apercoit que le travail est d'ores et déjà entrepris et il y a tout lieu de penser que la voie est ainsi ouverte à des contacts fructueux qui, un jour sans doute, autoriseront une nouvelle synthèse."

39 M J Shermaier, op. cit. at 65-66.

> as 'playing fair', 'coming clean' or 'putting one's cards face upwards on the table'. It is in essence a principle of fair and open dealing...
>
> English law has, characteristically, committed itself to no such overriding principle but has developed piecemeal solutions in response to demonstrated problems of unfairness. Many examples could be given. Thus equity has intervened to strike down unconscionable bargains. Parliament has stepped in to regulate the imposition of exemption clauses and the form of certain hire-purchase agreements. The common law also has made its contribution, by holding that certain classes of contract require the utmost good faith, by treating as irrecoverable what purport to be agreed estimates of damage but are in truth a disguised penalty for breach, and in many other ways."

43. In other words, our legal system normally achieves the result that parties should act fairly in performing a contract even if the common law does not imply a term that they act in good faith explicitly in every contract.

44. See also in South Africa:

Southernport Developments (Pty) Ltd v Transnet Ltd (440/03) [2004] ZASCA 94 (29 September 2004)

SUPREME COURT OF APPEAL
OF SOUTH AFRICA

http://www.saflii.org/cgi-saflii/disp.pl/za/cases/ZASCA/2004/94.html

Also South African Law Commission

Paper at

http://www.saflii.org/cgi-saflii/disp.pl/za/other/zalc/report/1998/3/1998%5f3%2dCHAPTER.html

and

http://www.saflii.org/cgi-saflii/disp.pl/za/other/zalc/report/1998/3/1998%5f3%2dCHAPTER%2d2.html

2.5.2.23 Lord Johan Steyn[199] observes that whereas the principle of **good faith** is gaining ground in the rest of the world, English layers remain hostile to the idea of the incorporation of **good faith** principles into English law.[200] He considers since English law serves the international market place it cannot remain impervious to ideas of **good faith**, or of fair dealing. He states that his impression is that the basis of the hostility is suspicion about the meaning of **good faith**. He is of the view if **good faith** were a wholly subjective notion, one could understand the scepticism and if it were an impractical and open-ended way of fastening contractual liability onto parties, it would not deserve a place in international trade. Lord Steyn remarks that this is however not the case. He considers that **good faith** has a subjective requirement entailing basically that the party must act honestly and an objective requirement entailing the observance of reasonable commercial standards of fair dealing in the conclusion and performance of the transaction concerned. He considers that it is surprising that the House of Lords held in the case of *Walford v Miles*[201] that an express agreement that parties must negotiate in **good faith** is unenforceable. Lord Steyn notes that it was held that the concept of a duty to carry on negotiations in **good faith** is inherently repugnant to the adversarial process of the parties when involved in negotiations. He notes that the court did not consider in *Walford v Miles* that where a party negotiates in bad faith not intending to reach an agreement with the

other party he is liable for losses caused to the other party. Lord Steyn states that he hopes that the concept of **good faith** would not be rejected out of hand if it were to arise again with the benefit of fuller argument. He considers that since the concept of **good faith** is practical and workable there is no need for hostility to the concept.

2.5.2.24 Lord Steyn further draws attention to the fact that the *Unfair Terms in Consumer Contracts Regulations* treats consumer transactions within its scope as unfair when they are contrary to **good faith** and that it is likely to influence domestic English law. He considers that given the needs of the international market place, and the primacy of European Union law, English lawyers cannot avoid grappling with the concept of **good faith**. Lord Steyn explains that he has no heroic suggestion for the introduction of a general duty of **good faith** in the English contract law since it is unnecessary. He suggests that as long as the English courts always respect the reasonable expectations of parties the English contract law can satisfactorily be left to develop in accordance with its pragmatic traditions and where in specific contexts **good faith** are imposed on parties the English law system can readily accommodate such a well-tried notion.

45. Note also the case in Natal c. 1900 McPherson JA mentioned to me re coal supplied in appropriate for fuelling ships and failure to disclose that.