Good Faith in Contract: Why Australian Law is Incoherent*

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1. Context

(a) Introduction

As an underlying concept, good faith plays a crucial role in the law of contract. However, on the basis that good faith *ought* to be more than that, over the past 20 years some Australian courts have given good faith a more overt role in the resolution of contractual disputes. Unfortunately, these 'good faith cases' have produced much confusion and uncertainty. The law is incoherent.

This paper focuses on the two areas in which implied terms have been used to implement the new understanding of the role of good faith: contract performance and the exercise of express rights. Although regularly raised as an issue, only rarely in the reported cases has the decision turned on the new understanding. From that perspective, the main contribution of the good faith cases has been to litigation costs.[1] Analysis of express terms of 'good faith' has occurred mainly in the context of good faith negotiation clauses. I am not concerned with those.[2]

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1 Cf E A Farnsworth, 'Good Faith in Contract Performance' in Jack Beatson and Daniel Friedmann, eds, *Good Faith and Fault in Contract Law*, Clarendon Press, Oxford, 1995, p 169.

2 However, it might be mentioned that although the cases on exercise of express rights have tended to equate good faith with 'reasonableness', that has not occurred in the context of express good faith negotiation clauses. See *United Group Rail Services Ltd v Rail Corporation of New South Wales* (2009) 74 NSWLR 618; [2009] NSWCA 177; *Strzelecki Holdings Pty Ltd v Cable Sands Pty Ltd* (2010) 41 WAR 318; [2010] WASCA 222. Another oddity is that when it comes to implying terms, courts claim to know exactly what good faith means. However, in the leading case on express good faith negotiation clauses (*Coal Cliff Collieries Pty Ltd v Sijehama Pty Ltd* (1991) 24 NSWLR 1) the provision was struck down because the court could give it no meaning.

There are three principal cases. The first is *Renard Constructions (ME) Pty Ltd v Minister for Public Works*,[3] where Priestley JA held that 'reasonableness' was an implied term of a termination clause in a standard form building contract. Although he alone took that view, Priestley JA's judgment included an extended discussion of the good faith concept. In many subsequent cases that discussion has been treated as legitimising the search for an implied term giving effect to good faith.[4] In the second case, *Burger King Corp v Hungry Jack's Pty Ltd*,[5] it was held that good faith justified three terms which were implied in law in a complex franchising transaction between sophisticated parties: a co-operation term; and 'terms of good faith and reasonableness'.

Neither case has been approved by the High Court. In fact, *dicta* from two members of the court in *Royal Botanic Gardens and Domain Trust v South Sydney City Council*[6] point in the opposite direction. Kirby J said[7] that a general implied term of 'good faith and fair dealing' would 'conflict with fundamental notions'. And Callinan J referred[8] to the 'far-reaching contentions' for which certain cases stood as authority. He included *Hungry Jack's*. Nevertheless, emboldened by that decision, *Renard* and other cases,[9] some courts assumed that a term of 'good faith' is implied in all contracts,[10] or at least all commercial contracts.[11] Given that only the High Court

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3 (1992) 26 NSWLR 234 ('*Renard*').

4 See, eg *Hungry Jack's v Burger King Corp* [1999] NSWSC 1029 per Rolfe J, affirmed *sub nom Burger King Corp v Hungry Jack's Pty Ltd* (2001) 69 NSWLR 558; [2001] NSWCA 187 (source for implied term of 'good faith and reasonableness'); *Far Horizons Pty Ltd v McDonald's Australia Ltd* [2000] VSC 310 at [120] per Byrne J (source for implied term of 'good faith and fair dealing').

5 (2001) 69 NSWLR 558; [2001] NSWCA 187 ('*Hungry Jack's*').

6 (2002) 240 CLR 45; 186 ALR 289; [2002] HCA 5.

7 (2002) 240 CLR 45 at 75; 186 ALR 289; [2002] HCA 5 at [88].

8 (2002) 240 CLR 45 at 94; 186 ALR 289; [2002] HCA 5 at [156].

9 See *Hughes Aircraft Systems International v Airservices Australia* (1997) 146 ALR 1; *Alcatel Australia Ltd v Scarcella* (1998) 44 NSWLR 349.

10 See, eg *Central Exchange Ltd v Anaconda Nickel Ltd* (2002) 26 WAR 33; [2002] WASCA 94; *Pacific Brands Sport & Leisure Pty Ltd v Underworks Pty Ltd* [2005] FCA 288 per Finkelstein J (affirmed without deciding the point (2006) 149 FCR 395; 230 ALR 56; [2006] FCAFC 40). Compare *Jenkins v NZI Securities Australia Ltd* (1994) 124 ALR 605 at 619 per the Full Federal Court.

11 See, eg *Garry Rogers Motors (Australia) Pty Ltd v Subaru (Australia) Pty Ltd* [1999] FCA 903 at [34] per Finkelstein J; *NT Power Generation Pty Ltd v Power and Water Authority* (2001) 184 ALR 481 at 574; [2001] FCA 334 at [395] per Mansfield J.

can create new rules of law,[12] this was somewhat surprising. However, in the third case, *CGU Workers Compensation (NSW) Ltd v Garcia*,[13] it was held that 'good faith' is not a term 'to be inserted into every contract or even into every aspect of a particular contract'.[14] That decision binds all Australian courts other than the High Court.[15] It follows any good faith term must satisfy the rules which govern implications in particular contracts, or particular classes of contract.

(b) Kinds of Incoherence

However well-intentioned the efforts of the courts over the past 20 years in the good faith cases, the plain fact is that the law is in an unsatisfactory state. From one perspective at least it is self-evident that Australian Law is incoherent. As Giles JA said in *Vodafone Pacific Ltd v Mobile Innovations Ltd*,[16] there is a 'regrettable lack of uniformity in the cases'. That is the result of differences of opinion as to whether good faith is a distinct concept, when (and how) it can be called upon, and what good faith 'means'. Similarly, good faith is variously described as a 'duty', 'requirement', 'obligation', and so on. In addition, commitment to the overt concept has varied not

12 See, eg *Garcia v National Australia Bank Ltd* (1998) 194 CLR 395; 155 ALR 614; *Farah Constructions Pty Ltd v Say-Dee Pty Ltd* (2007) 230 CLR 89; 236 ALR 209; [2007] HCA 22; *Narain v Euroasia (Pacific) Pty Ltd* (2009) 26 VR 387 at 396; [2009] VSCA 290 at [44] per Nettle JA (with whom Bongiorno JA and Byrne AJA agreed).

13 (2007) 69 NSWLR 680; [2007] NSWCA 193 ('*CGU*').

14 (2007) 69 NSWLR 680 at 704; [2007] NSWCA 193 at [132] per Mason P (with whom Hodgson and Santow JJA agreed); see also (2007) 69 NSWLR 680 at 710; [2007] NSWCA 193 at [168] per Santow JA, with whom Hodgson JA agreed ('no general contractual term, implied in law, requiring the exercise of good faith in contractual performance'). To the same effect see *Esso Australia Resources Pty Ltd v Southern Pacific Petroleum NL* [2005] VSCA 228 at [4] per Warren CJ, [25] per Buchanan JA (with whom Warren CJ and Osborn AJA agreed); *Vodafone Pacific Ltd v Mobile Innovations Ltd* [2004] NSWCA 15 at [189], [191] per Giles JA (with whom Sheller and Ipp JJA agreed) and the decision of the Singapore Court of Appeal in *Ng Giap Hon v Westcomb Securities Pte Ltd* [2009] 3 SLR(R) 518; [2009] SGCA 19.

15 See *Farah Constructions Pty Ltd v Say-Dee Pty Ltd* (2007) 230 CLR 89; 236 ALR 209; [2007] HCA 22; *Narain v Euroasia (Pacific) Pty Ltd* (2009) 26 VR 387 at 396; [2009] VSCA 290 at [44] per Nettle JA (with whom Bongiorno JA and Byrne AJA agreed); *CAL No 14 Pty Ltd v Motor Accidents Insurance Board* (2009) 239 CLR 390 at 411-12; 260 ALR 606 at 621; [2009] HCA 47 at [49] per Gummow, Heydon and Crennan JJ (with whom Hayne J agreed).

16 [2004] NSWCA 15 at [192] ('*Vodafone*'). Sheller and Ipp JJA agreed. See also *Council of the City of Sydney v Goldspar Australia Pty Ltd* (2006) 230 ALR 437 at 498; [2006] FCA 472 at [166] per Gyles J ('bewildering variety of opinions').

just from court to court but also from judge to judge.[17] All of this has contributed to a general lack of internal coherence.

A second kind of incoherence relates to methodology. As noted above, good faith has been promoted through implied terms. There is a lack of uniformity of rationale, and in term formulation. In some cases courts have been content to imply a term of 'good faith', if only as a matter of assumption. In others specific implications have been arrived at, usually formulated in terms of 'reasonableness'. And in some cases courts have taken a 'two for the price of one' approach, as in 'good faith and reasonableness' or 'good faith and fair dealing'. As they all derive from the concern to promote good faith overtly, 'good faith term' is an appropriate generic description.

This leads to a third, and more general kind of incoherence, namely, 'legal incoherence'. Except when used to refer to bona fides, 'good faith' is not a distinctive legal concept. In effect, the implied terms rules have been used to legitimise a false conception that there is such a concept, and therefore a 'doctrine' of good faith. As a means to an end, the application of the implied terms rules has lacked rigour and consistency. Various anomalies have developed.

A fourth kind of incoherence emerges in a comparison between construction and implication. The good faith cases have used implied terms to contradict construction conclusions. Overt use of good faith as a concept has therefore led to the reformation of contracts. This has undermined the sanctity of the written contract. The principal theme of this paper is therefore that the good faith cases have failed to appreciate the importance of giving effect to the reasonable expectations of the parties through the process of 'commercial construction'.[18]

(c) 'Good Faith' Standards

'Good faith' is by definition a standard or the description of a standard.[19] In commercial law in general, three usages can be identified.[20] First, when used as a

17 See *Council of the City of Sydney v Goldspar Australia Pty Ltd* (2006) 230 ALR 437 at 498; [2006] FCA 472 at [166] per Gyles J.

18 This paper builds on the argument in J W Carter and Elisabeth Peden, 'Good Faith in Australian Contract Law' (2003) 19 *JCL* 155.

19 For a more sophisticated analysis see S M Waddams, 'Good Faith, Unconscionability and Reasonable Expectations' (1995) 9 *JCL* 55.

synonym for 'bona fides' good faith states a prescriptive standard of honesty in fact. This is the 'legal meaning' of good faith for the common law.[21] The standard sometimes receives overt recognition, as in the concept of 'bona fide purchaser',[22] and in the compromise of a disputed claim, one element of which is that the claim must be made in good faith.[23]

Second, good faith may describe a prescriptive relational standard. Thus, 'good faith' is a shorthand description for the standards applicable where a person stands in a fiduciary position.[24]

Third, good faith may be a presumptive standard of the market place. It is this standard which underlies, and is expressed by, much of the common law of contract. This usage relies on the existence of a general (community) consensus that good faith is characterised by certain features ('incidents'). Examples include co-operation in performance, consistency of conduct, communication of decisions and acting reasonably. On this basis, good faith underlies any rule which incorporates one or more of these incidents. Although normative, the standard is not prescriptive. In other words, unless it is prescribed by law, a contract may depart from any market place standard. The basic fallacy of the good faith cases is the view that particular incidents, such as acting reasonably, can be deployed to resolve contractual disputes even though there is no agreement to that effect.

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20 Compare *Kennedy v De Trafford* [1897] AC 180 at 185 per Lord Herschell ('It is very difficult to define exhaustively all that would be included in the words "good faith" ...'.).

21 See *Strzelecki Holdings Pty Ltd v Cable Sands Pty Ltd* (2010) 41 WAR 318 at 335; [2010] WASCA 222 at [47] per Pullin JA, with whom Newnes JA agreed ('honesty' as 'natural and ordinary meaning' of good faith).

22 See *Service Station Association Ltd v Berg Bennett & Associates Pty Ltd* (1993) 45 FCR 84 at 91; 117 ALR 393 per Gummow J.

23 See *Wigan v Edwards* (1973) 1 ALR 497 at 513; 47 ALJR 586 at 595 per Mason J (with whom Walsh J agreed). See also *Hirachand Punamchand v Temple* [1911] 2 KB 330 at 339 per Fletcher Moulton LJ (action of creditors after they had agreed to accept payment of lesser sum from third party was 'inconsistent with the duty of an honest man'); *Scuderi v Morris* (2001) 4 VR 125 at 145; [2001] VSCA 190 at [58] per Chernov JA, with whom Ormiston JA substantially agreed and Buchanan JA agreed (debtor's composition with creditors).

24 See *Service Station Association Ltd v Berg Bennett & Associates Pty Ltd* (1993) 45 FCR 84 at 91; 117 ALR 393 per Gummow J.

(d) Influence of United States Law

If the question is asked why it has been thought necessary to raise the profile of good faith, the basic answer seems to be a view that, otherwise, Australian law would be deficient when compared with other legal systems and common law jurisdictions. In particular, there has been a tendency to look wistfully at United States law.[25]

Reference has sometimes been made to §1-203 of the Uniform Commercial Code,[26] which states:

> Every contract or duty within this Act imposes an obligation of good faith in its performance or enforcement.

Because §1-203 states a requirement of 'honesty in fact',[27] there is no reason to doubt that Australian law is the same. However, the (Australian) good faith cases have promoted a broader requirement. For that purpose, reliance has been placed on §2-102, which applies the more exacting standard of 'honesty in fact and reasonable standards of fair dealing in the trade' to contracts for the sale of goods. However, it is seldom noted that this applies only to 'merchants'.

The provision most frequently cited is §205 of the Restatement (Second) Contracts (1979):[28]

> Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement.

While the rule does not have the force of law, it can be assumed that most, if not all, American jurisdictions recognise a common law concept, usually articulated as an 'implied covenant of good faith'.[29]

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25 See the judgment of Priestley JA in *Renard*. See also *Yam Seng Pte Ltd v International Trade Corp Ltd* [2013] 1 Lloyd's Rep 526 at 546; [2013] EWHC 111 (QB) at [127]-[128] per Leggatt J, where Australian cases such as *Renard* are looked at in the same way. And see Lady Justice Arden, 'Coming to Terms with Good Faith' (2013) 30 *JCL* 199.

26 American Law Institute and National Conference of Commissioners on Uniform State Laws, *Uniform Commercial Code*, 1990 Official Text.

27 See §1-201(19).

28 American Law Institute, *Restatement of the Law Second, Contracts 2d*, as adopted and promulgated in May 1979, American Law Institute Publishers, St Paul, 1981. See further on §205 below, text at nn 40, 125.

29 See, eg *Metropolitan Life Insurance Co v RJR Nabisco Inc*, 716 F Supp 1504 at 1515 (SDNY, 1989). See R S Summers, 'The General Duty of Good Faith — Its Recognition and Conceptualization' (1982) 67 *Cornell L Rev* 810.

Comparative analysis is important: there is no reason why the solutions for contract problems which arise in Australia should be significantly different from those reached in other jurisdictions.[30] However, there are certain difficulties which necessarily undermine the good faith cases. First, borrowing in the good faith context is not supported by decisions of the High Court. For example, in *Breen v Williams*[31] the court emphasised that Canadian decisions requiring 'utmost good faith and loyalty' in the doctor-patient context are not reliable precedents.

Second, it is impossible to obtain guidance from an undefined concept.[32] What passes for 'good faith' under a foreign law may be known by another name in Australia. It remains far easier for Australian courts to appreciate usages in English decisions than in American cases, with which Australian courts can only hope to have a passing acquaintance.[33] It therefore seems somewhat paradoxical that the implied term of 'trust and confidence' adopted by English law[34] as an incident of employment contracts, is yet to be fully recognised in Australia.[35]

Third, what an Australian lawyer might understand to be required by 'good faith' may differ markedly from the actual position. An Australian court investigating how the concept is applied in the United States must examine the case law. But there are a great many jurisdictions to choose from![36] There is a vast and diverse body of law in relation to a concept which has been described as 'uncertain'.[37]

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30 And see UNIDROIT Principles of International Commercial Contracts 2010, Art 1.7(1) ('Each party must act in accordance with good faith and fair dealing in international trade.').

31 (1996) 186 CLR 71; 138 ALR 259.

32 Compare R S Summers, 'The General Duty of Good Faith — Its Recognition and Conceptualization' (1982) 67 *Cornell L Rev* 810 at 820 (absence of definition means that good faith operates as an 'excluder').

33 Similarly, in *Yam Seng Pte Ltd v International Trade Corp Ltd* [2013] 1 Lloyd's Rep 526; [2013] EWHC 111 (QB), Leggatt J makes no reference to *CGU* when commenting on the role of good faith in Australian law.

34 See, eg *Malik v Bank of Credit and Commerce International SA* [1998] AC 20.

35 See *Russell v Trustees of the Roman Catholic Church for the Archdiocese of Sydney* (2008) 72 NSWLR 559 at 567; [2008] NSWCA 217 at [33] per Basten JA (with whom Giles and Campbell JJA agreed). Cf *Merrill Lynch International (Australia) Ltd v Commissioner of Taxation* (2001) 191 ALR 420 at 447; [2001] FCA 1127 at [95] per Lindgren J.

36 See *Service Station Association Ltd v Berg Bennett & Associates Pty Ltd* (1993) 45 FCR 84 at 92; 117 ALR 393 per Gummow J.

37 See H O Hunter, 'The Growing Uncertainty about Good Faith in American Contract Law' (2004) 20 *JCL* 50. Several of the cases referred to by Professor Hunter are cited in the

Understandably, in no Australian case has an attempt been made to develop an understanding of the law in the way that is routinely done for English law.[38] But it seems reasonably clear that the (Australian) good faith cases have adopted a more intrusive approach.[39]

Fourth, because contract law is a coherent whole, it is dangerous to divorce one rule from other contract rules. For example, the rule stated in §205 of the Restatement (Second) Contracts (1979) is applied by construction. If other provisions are a reliable guide, as compared with Australian law there are significant differences in relation to what raw material is admissible in construction.[40] For example, in contrast with Australian law, §214 treats prior negotiations as admissible as a direct aid to construction. Since what 'good faith' requires turns on the construction of the particular contract at issue, rules on admissibility of evidence are important.[41] In no Australian case has any attempt been made to explain the interaction between the rule stated by §205 and the evidence admissible in construction.

2. The Underlying Concept

(a) Introduction

Given that contract is a very successful institution, dealing with an infinite variety of agreements, the standards which it embodies must reflect with a high degree of accuracy those of society. It is therefore impossible to contemplate contract law as anything other than an expression of good faith, including as that concept is understood in the market place.[42]

But because this aspect of good faith relevantly refers to the fact that certain incidents conventionally associated with the concept are present in contract rules,

discussion below. See also H K Lücke, 'Good Faith and Contractual Performance' in P D Finn, ed, *Essays on Contract*, 1987, p 161 (no 'coherent theory of good faith').

38 See further below, text at n 125.

39 See H O Hunter, 'The Growing Uncertainty about Good Faith in American Contract Law' (2004) 20 *JCL* 50 at 55-6 (suggesting that argument in J W Carter and Elisabeth Peden, 'Good Faith in Australian Contract Law' (2003) 19 *JCL* 155 is 'consistent with American law').

40 For a brief survey see J W Carter, 'Context and Literalism in Construction' (2014) 31 *JCL* 100.

41 See, eg *Metropolitan Life Insurance Co v RJR Nabisco Inc*, 716 F Supp 1504 at 1515 (SDNY, 1989) ('extrinsic evidence to evaluate the scope of an implied covenant of good faith').

42 Cf M G Bridge, 'Does Anglo-Canadian Contract Law Need A Doctrine of Good Faith?' (1984) 98 *Canadian Business Law Journal* 385.

there is no reason to expect uniformity of approach. The general position is that incidents of good faith simply inform contract law, and it is therefore unnecessary for 'good faith' to figure in the rules themselves.[43] However, the underlying concept does sometimes rise to the surface. In these cases 'good faith' may be an ingredient of a rule incorporating a standard which not only requires more than honesty but also sets a standard which is higher than usual in the market place. By definition, these are regarded as special cases.[44] Examples include situations in which a requirement of utmost good faith applies.[45] Even when they impact on the performance of contracts, these higher standards are not usually implemented as implied terms.[46]

(b) Giving Effect to the Underlying Concept

Because good faith informs the whole law of contract, countless illustrations could be given of situations in which incidents conventionally associated with good faith are present in common law rules.[47]

One such incident is communication. Good faith therefore underlies a great many common law rules. For example, unless supported by consideration, an unaccepted offer creates no obligation. Nevertheless, the freedom to revoke which the offeror enjoys is limited by a requirement of communication to the offeree. The limitation gives effect to good faith. At the other end of contract is the rule in *Hadley v Baxendale*.[48] Various reasons justify a rule of remoteness, and good faith underlies the content of the rule. For example, the basis for recovery of a loss under the second limb is that the prospect that it would be suffered was (at least) communicated to the promisor.[49] The most important illustration is the objective theory of contract. 'It

43 See Bingham LJ's well-known statement in *Interfoto Picture Library Ltd v Stiletto Visual Programmes Ltd* [1989] QB 433 at 439.

44 For further examples, see below, text at n 172.

45 See, eg *United Dominions Corp Ltd v Brian Pty Ltd* (1985) 157 CLR 1; 60 ALR 741 (negotiation of a contract of partnership).

46 See *Khoury v Government Insurance Office of New South Wales* (1984) 165 CLR 622 at 637; 54 ALR 639 per Mason, Brennan, Deane and Dawson JJ (insured's common law duty of utmost good faith not an implied term). Contrast Insurance Contracts Act 1984 (Cth), s 13.

47 Some of the illustrations are taken from J W Carter and Elisabeth Peden, 'Good Faith in Australian Contract Law' (2003) 19 *JCL* 155 at 158ff, where further examples are given.

48 (1854) 9 Ex 341 at 354; 156 ER 145 at 151 per Alderson B (for the court).

49 See also J W Carter and Elisabeth Peden, 'A Good Faith Perspective on Liquidated Damages' (2007) 23 *JCL* 157.

would be contrary to good faith to permit the promisor to hold the promisee bound by an uncommunicated intention.'[50]

As expressions of standards of the market place, common law rules are presumptions of intention based on experience. The law constantly evolves under the guidance of experience. For example, as originally conceived, discharge by frustration was regarded as an exception to absolute liability in contract.[51] However, today there is a default rule — presumption of intention — that the parties are discharged by an event which makes the performance of the contract radically different from what was envisaged.[52] The rule is applied by construction.

The standards of the common law are of course affected by statutory standards. Conduct in trade or commerce which is misleading or deceptive, or unconscionable, is prohibited by legislation, including the Australian Consumer Law.[53] While in some of the good faith cases statutory norms of conduct have been used to support the implication of good faith terms,[54] logically they point in the opposite direction. The good faith cases have sought to achieve substantive fairness in commercial contracts. That area is largely untouched by Australian Consumer Law. Moreover, the implied term of reasonableness which has frequently been implied in relation to the exercise of rights sets a much higher standard than the unconscionable conduct prohibition in the Australian Consumer Law.

(c) No 'Doctrine' of Good Faith

With very few exceptions, the rules which express the common law of contract are no more than presumptions of intention. General default rules, such as the rule in *Hadley v Baxendale*, have a doctrinal status. They are therefore supported by dedicated sub-rules and coherent classification. Other examples include implied terms, the doctrine of frustration and the common law regime of discharge for breach. No homogeneous

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50 J W Carter, *The Construction of Commercial Contracts*, Hart Publishing, Oxford, 2013, §3-37.

51 See, eg *Hirji Mulji v Cheong Yue SS Co Ltd* [1926] AC 497 at 510 per the Privy Council.

52 See *Davis Contractors Ltd v Fareham Urban District Council* [1956] AC 696 (adopted in *Codelfa Construction Pty Ltd v State Rail Authority of New South Wales* (1982) 149 CLR 337; 41 ALR 367).

53 Competition and Consumer Act 2010 (Cth), Sch 2.

54 See, eg *Hungry Jack's* (2001) 69 NSWLR 558 at 566-7; [2001] NSWCA 187 at [151]-[152] per the court.

set of principles has emerged in the good faith cases. No doctrine has been established and explained.[55] That is hardly surprising.

Aspects of contract law which illustrate the operation of incidents associated with good faith are many and varied. Since the market place is diverse, the standards expressed in the underlying concept are context sensitive. It is impossible to conceive of the formulation of those incidents in a doctrinal way. There is no general principle supported by dedicated sub-rules and coherent classification. It is clearly impermissible for courts to resolve unique contractual disputes simply on the basis of a court's subjective conception of what good faith requires in the situation which has arisen. Whether termed 'circular', 'top down' or 'conclusory', it is reasoning which has consistently been rejected by the High Court.[56] The court has more than once singled out 'high-sounding generalisations'. For example, Gummow and Hayne JJ said in *Australian Broadcasting Corp v Lenah Game Meats Pty Ltd*:[57]

> Commercial enterprises may sustain economic harm through methods of competition which are said to be unfair ..., or by reason of other injurious acts or omissions of third parties ... . However, the common law does not respond by providing a generalised cause of action 'whose main characteristic is the scope it allows, under high-sounding generalisations, for judicial indulgence of idiosyncratic notions of what is fair in the market place': *Moorgate Tobacco Co Ltd v Philip Morris Ltd (No 2)* (1984) 156 CLR 414 at 445-6[; 56 ALR 193 per Deane J (with whom the other members of the High Court agreed)]. Rather, the common law provides particular causes of action and a range of remedies. These rights and remedies strike varying balances between competing claims and policies.

Another example, from a slightly different perspective, is 'equitable fraud'. The expression describes a range of situations in which certain forms of relief are commonly available.[58] The fact that unconscionable conduct tends to operate as a unifying feature does not allow courts to apply that feature as if it were an independent principle. Accordingly, as Gummow and Hayne JJ also said in *Australian*

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55 See also *Ng Giap Hon v Westcomb Securities Pte Ltd* [2009] 3 SLR(R) 518 at 550; [2009] SGCA 19 at [60] per Andrew Phang Boon Leong JA (for the court).

56 See, eg *McGinty v Western Australia* (1996) 186 CLR 140 at 232; 134 ALR 289 per McHugh J; *Lumbers v W Cook Builders Pty Ltd (In Liq)* (2008) 232 CLR 635 at 662; 247 ALR 412; [2008] HCA 27 at [77] per Gummow, Hayne, Crennan and Kiefel JJ.

57 (2001) 208 CLR 199 at 238; 185 ALR 1; [2001] HCA 63 at [80]. Gaudron J agreed.

58 Cf *Stern v McArthur* (1988) 165 CLR 489 at 526-7; 81 ALR 463 per Deane and Dawson JJ.

Broadcasting Corp v Lenah Game Meats Pty Ltd,[59] 'the notion of unconscionable behaviour does not operate wholly at large'.

The High Court has also, in various contexts, emphasised the importance of 'legal coherency'.[60] In relation to good faith, there is the problem of identifying the limits on a concept expressed in terms of 'high-sounding generalisations'. So far, the good faith cases have not attempted to tackle directly particular doctrines of the common law.[61] But relentless pursuit of an independent concept would swallow up many rules of contract law. The test for frustration would become whether it is 'fair' for the promisee to hold the promisor bound by the contract. By giving effect to the reasonable expectations of the parties, the underlying concept ensures that doctrines such as frustration reflect the good faith of the market place. To conceive that a party is bound to perform only when it is objectively fair for the other party to call for performance would be incoherent.

Even requirements such as consideration would also be subject to a gloss of good faith, so that a promise not supported by consideration would, logically, be binding if good faith required it. For as long as consideration remains an essential feature of contract, the law must be coherent in applying qualifications to the requirement. For example, the complexity of principles of estoppel is perhaps to be regretted, but is largely attributable to the need for estoppel and consideration to have a coherent relationship.

(d) Freedom of Contract

Whether the parties have adopted or displaced a common law rule is a question of construction. The application of market place standards as presumptions of intention

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59 (2001) 208 CLR 199 at 245; 185 ALR 1; [2001] HCA 63 at [98]. See also *Australian Competition and Consumer Commission v C G Berbatis Holdings Pty Ltd* (2003) 214 CLR 51 at 72; 197 ALR 153; [2003] HCA 18 at [42] per Gummow and Hayne JJ; *Tanwar Enterprises Pty Ltd v Cauchi* (2003) 217 CLR 315 at 326; 201 ALR 359; [2003] HCA 57 at [24]-[26] per Gleeson CJ, McHugh, Gummow, Hayne and Heydon JJ; *Clough Engineering Ltd v Oil and Natural Gas Corp Ltd* (2008) 249 ALR 458 at 492; [2008] FCAFC 136 at [131] per the court.

60 See, eg *CAL No 14 Pty Ltd v Motor Accidents Insurance Board* (2009) 239 CLR 390 at 406-10 per Gummow, Heydon and Crennan JJ, 415 per Hayne J; 260 ALR 606 at 616-20, 625; [2009] HCA 47 at [39]-[42], [56]; *Miller v Miller* (2011) 242 CLR 446; 275 ALR 611; [2011] HCA 9; *Equuscorp Pty Ltd v Haxton* (2012) 246 CLR 498; 286 ALR 12; [2012] HCA 7.

61 But see Richard Hooley, 'Controlling Contractual Discretion' [2013] *CLJ* 65 at 89 (argument that 'doctrinal coherence' requires common law rights of termination to be subjected to good faith in the same way as contractual discretions).

therefore reflects the higher priority accorded by the common law to freedom of contract. Since freedom of contract includes the ability to control the operation of contract doctrine, even if good faith were to be established as doctrinal in nature, its operation would still be subject to the agreement of the parties.

In the commercial context the principal rationale for freedom of contract is the intrinsic value of party autonomy. The High Court has continued to emphasise the importance of the concept in this context. For example, in *Ringrow Pty Ltd v BP Australia Pty Ltd*,[62] the court said that the 'law of contract normally upholds the freedom of parties, with no relevant disability, to agree upon the terms of their future relationships'. But the good faith cases pull in a different direction. They seek to control freedom of contract by implying terms.

As the cases illustrate, seeking to give effect to good faith as a concept in its own right brings about constant conflict with express terms. A surprising feature of the cases[63] which have relied on Priestley JA's judgment in *Renard* is the willingness to imply terms into standard form contracts, even where prepared by third parties. By definition, these documents express the good faith standards of particular markets or categories of transaction. So also do commonly used precedent documents. Although even a third party standard form must be given a commercial construction, consistency of decision has always been regarded as important.[64] Market-awareness provides opportunities for those responsible for drafting such documents to address good faith issues by amendment.[65] Implying terms in the name of good faith is dangerous indeed.

62 (2005) 224 CLR 656 at 669; 222 ALR 306; [2005] HCA 71 at [31].

63 See also *Hughes Bros Pty Ltd v Trustees of the Roman Catholic Church for the Archdiocese of Sydney* (1993) 31 NSWLR 91; *Hungry Jack's* (2001) 69 NSWLR 558 at 569; [2001] NSWCA 187 at [163] per the court (good faith terms 'more readily implied in standard form contracts').

64 See J W Carter, *The Construction of Commercial Contracts*, Hart Publishing, Oxford, 2013, §§1-30, 13-13.

65 A relevant example is the introduction of an 'anti-technicality' clause in time charterparty on NYPE form, as a market response to the construction of withdrawal clause. See, eg *Afovos Shipping Co SA v Pagnan* [1983] 1 WLR 195.

3. Application of the Implied Term Rules

(a) Introduction

Although they proceed on the basis that Australian law regards good faith as something more than an underlying concept, the good faith cases rely on an implied term methodology. The rules governing implication are therefore important.

Terms are implied into contracts by the application of specific rules, as determined by reference to particular categories.[66] Because there is no category of 'terms implied into all contracts',[67] there are no dedicated rules which can be applied to establish such terms.

The two main categories are terms implied 'in fact' and terms implied 'in law'. The lack of rigour shown in the good faith cases in the application of the rules which govern implication in these categories is disturbing, but easily explained. It is attributable to their use as a surrogate for a non-existent doctrine of good faith. In fact, the reliance in cases such as *Hungry Jack's* on terms implied in law is suggestive of a belief that good faith — in a sense which is much broader than honesty in fact — is a prescriptive standard of the common law.[68]

(b) Terms Implied in Fact

For terms implied in fact, in *Secured Income Real Estate (Australia) Ltd v St Martins Investments Pty Ltd*[69] the High Court approved[70] the approach of the majority of the Privy Council in *BP Refinery (Westernport) Pty Ltd v Shire of Hastings*.[71] The propounded term:

(1) must be reasonable and equitable;

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66 But see *Attorney General of Belize v Belize Telecom Ltd* [2009] 1 WLR 1988 at 1995; [2009] UKPC 10 at [27] per the court.

67 However, rules of law rationalised as implied terms exist. See J W Carter, *The Construction of Commercial Contracts*, Hart Publishing, Oxford, 2013, §3-30. See further below, text at n 117.

68 Cf Elisabeth Peden, 'When Common Law Trumps Equity: the Rise of Good Faith and Reasonableness and the Demise of Unconscionability' (2005) 21 *JCL* 226 at 232.

69 (1979) 144 CLR 596; 26 ALR 567 ('*Secured Income*').

70 (1979) 144 CLR 596 at 605-6; 26 ALR 567 per Mason J (with whom the other members of the High Court agreed). See also *Codelfa Construction Pty Ltd v State Rail Authority of New South Wales* (1982) 149 CLR 337 at 347; 41 ALR 367 per Mason J (with whom Stephen and Wilson JJ agreed).

71 (1977) 180 CLR 266 at 282-3; 16 ALR 363 at 376 ('*BP*').

(2) must be necessary to give business efficacy to the contract so that no term will be implied if the contract is effective without it;

(3) must be so obvious that 'it goes without saying';

(4) must be capable of clear expression; and

(5) must not contradict any express term of the contract.

This uncompromising approach, adopting stringent *cumulative* requirements, remains applicable to contracts complete on their face. For other contracts, in *Byrne v Australian Airlines Ltd*[72] the High Court adopted less onerous requirements.[73] Because most of the good faith cases have concerned detailed contracts, the *BP* requirements have governed implication. Their application determines whether the presumption that the contract is complete without the term is rebutted. The more detailed the contract, the less likely it is that a term will be implied, particularly where the contract is a third party standard form which has been in use for many years.[74]

Since a term implied in fact must be formulated in specific terms, it is impossible for an undefined term of 'good faith' to satisfy the *BP* requirements.[75] It is therefore surprising that the contrary has often been assumed, and occasionally held. Although implications expressed in terms of 'reasonableness' are more common, the reasoning of the good faith cases is rarely compelling, particularly if there is no statement of the sense in which the word is used. The leading example is Priestley JA's judgment in *Renard*. In deciding that 'reasonableness' was an implied term of a detailed show cause procedure in a standard form commercial building contract, he considered business efficacy to be the only problematic requirement.[76]

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72 (1995) 185 CLR 410; 131 ALR 422.

73 The court approved a test suggested by Deane J in *Hawkins v Clayton* (1988) 164 CLR 539 at 573; 78 ALR 69, to the effect that if 'it is apparent that the parties have not attempted to spell out the full terms of their contract' such terms may be implied as are 'necessary for the reasonable or effective operation of a contract of that nature in the circumstances of the case'. See Gregory Tolhurst and J W Carter, 'The New Law on Implied Terms' (1996) 11 *JCL* 76.

74 See, eg *Codelfa Construction Pty Ltd v State Rail Authority of New South Wales* (1982) 149 CLR 337; 41 ALR 367.

75 Compare *CGU* (2007) 69 NSWLR 680 at 706; [2007] NSWCA 193 at [143] per Mason P, with whom Hodgson and Santow JJA agreed (failure to satisfy business efficacy requirement as basis for rejecting implied term of good faith in statutory contract).

76 See (1992) 26 NSWLR 234 at 257.

Just how a form of contract in use for many years could be regarded as lacking business efficacy, or incomplete without the term implied, is not easy to explain.[77]

(c) Terms Implied in Law

Putting terms implied by statute to one side, the usual examples of terms implied in law are those implied as incidents of commonly occurring contracts. If a contract falls within the relevant class, it is presumed to include the term. Since the term expresses a presumption of intention, construction of the contract may displace the presumption. New implications can sometimes be made in such contracts; and novel terms are occasionally implied in law.

Succinct expression of the legal requirements for a term to be implied in law in a novel situation is difficult.[78] However, the High Court has approved a test under which the term must be 'necessary', in the sense that, unless the term is implied, the 'enjoyment of the rights conferred by the contract would or could be rendered nugatory, worthless, or, perhaps, be seriously undermined'.[79]

Satisfaction of that test ought to be more or less impossible in a detailed commercial contract between sophisticated parties. That was the context of *Hungry Jack's*, where it was argued that two novel terms were implied in law, formulated in the composite expression 'good faith and reasonableness'. The court recognised that there was no relevant class of contract into which the terms could be implied. That ought to have been the end of the matter.[80] In order to be implied in law, the term must be identified as one which the 'nature of the contract itself implicitly requires'.[81] Even though neither term was of that nature, both were held to be implied.[82] Had a relevant class of contract been available, it seems impossible to say that the High Court's test would have been satisfied.[83] Indeed, implying 'reasonableness' as a gloss

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77 The other members of the court travelled a construction path. See below, text at n 189.

78 See Elisabeth Peden, 'Policy Concerns in Terms Implied in Law' (2001) 117 *LQR* 459.

79 *Byrne v Australian Airlines Ltd* (1995) 185 CLR 410 at 450; 131 ALR 422 per McHugh and Gummow JJ. See also *Breen v Williams* (1996) 186 CLR 71; 138 ALR 259.

80 Cf *Central Exchange Ltd v Anaconda Nickel Ltd* (2002) 26 WAR 33 at 50; [2002] WASCA 94 at [52] per Steytler J (with whom Wallwork J agreed).

81 *Liverpool City Council v Irwin* [1977] AC 239 at 254 per Lord Wilberforce.

82 The court also implied the standardised term of co-operation. See below, text at n 136.

83 See Elisabeth Peden, 'When Common Law Trumps Equity: the Rise of Good Faith and Reasonableness and the Demise of Unconscionability' (2005) 21 *JCL* 226. See also *Ng Giap*

on everything a party has agreed to do under a contract is not implication. In *Hungry Jack's*, it was reformation of what was regarded as an unfair bargain.

4. Role of Construction

(a) Introduction

Entry into a contract is a commitment by both parties to the contract institution. Accordingly, except to the extent that they have agreed otherwise, the contract is a commitment to the common law's expression of the standards adopted by society, including the applicable good faith standards of the market place. Whether the parties have reached a contrary agreement is decided by construction. A court cannot impose its own standards.

In *First Energy (UK) Ltd v Hungarian International Bank Ltd*,[84] Steyn LJ referred to giving effect to the 'reasonable expectations of honest' people as a theme which runs through contract law as a whole. It is a theme of good faith.[85] One aspect is giving effect to what the parties have agreed; the other is ensuring that contracts are construed commercially. The former associates good faith with loyalty to the objective construction of documents which the parties have adopted.[86] Accordingly, notwithstanding that the good faith appear to assume otherwise, it is contrary to good faith for either party to seek to second-guess the construction of a contract on the basis that the contract does not operate as 'fairly' as it would like. For example, it might be said to be contrary to good faith for a promisor to seek to rely on an exclusion of liability for loss caused by an intentional breach of contract. However, as a matter of construction the clause may be applicable, whether or not it refers expressly to 'intentional breach'.

Loyalty to the construction of a contract is not, however, a commitment to literal application of words on a page. Courts have a duty to ensure that contracts are

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Hon v Westcomb Securities Pte Ltd [2009] 3 SLR(R) 518 at 544; [2009] SGCA 19 at [44] per Andrew Phang Boon Leong JA (for the court).

84 [1993] 2 Lloyd's Rep 194 at 196. Nourse and Evans LJJ agreed. See also S M Waddams, 'Good Faith, Unconscionability and Reasonable Expectations' (1995) 9 *JCL* 55; Johan Steyn, 'Contract Law: Fulfilling the Reasonable Expectations of Honest Men' (1997) 113 *LQR* 433.

85 Cf S J Burton, 'Breach of Contract and the Common Law Duty to Perform in Good Faith' (1980) 94 *Harv L Rev* 369 at 371.

86 See J W Carter, *The Construction of Commercial Contracts*, Hart Publishing, Oxford, 2013, §3-37.

construed commercially. 'Commercial construction' describes not only how the construction of a commercial contract should be carried out, but also the result ('commercially sensible') for which a court should strive when construing *any* contract.[87] The process of resolving one-off contractual disputes by commercial construction offers a more coherent approach than the good faith cases. A preference for commercially sensible results has been constant theme in decisions of the High Court.[88]

(b) Application of Contracts

The rules of contract law do not determine what contracts 'mean'. That is the function of 'construction'. However, contract law includes rules which regulate how meaning is determined. 'Construction' is also the process used to apply contract doctrine and to determine the scope of contracts, including how they apply in particular fact situations. All such issues are decided by applying the 'perspective rule'.[89] The construction of a contract is therefore an expression of the conclusion which a reasonable person in the position of the person to whom the words at issue are addressed would reach, due regard being had to the context of the contract.[90] The most important ingredient of context is commercial purpose, objectively determined.

Many of the default rules of contract law state presumptions as to how contracts are intended to be applied. In giving effect to market place standards, the default rules rely on a variety of considerations, such as common sense, conventions, market practices and precedent. They are presumed to achieve commercially acceptable results.[91] But the parties may agree to the contrary and, obviously, for any

87 See J W Carter, *The Construction of Commercial Contracts*, Hart Publishing, Oxford, 2013, Chapter 1.

88 See, eg *Gollin & Co Ltd v Karenlee Nominees Pty Ltd* (1983) 153 CLR 455 at 464; 49 ALR 135 per the High Court ('commercial efficacy' and 'common sense'); *Concut Pty Ltd v Worrell* (2000) 176 ALR 693 at 708-9; [2000] HCA 64 per Kirby J ('practical', 'businesslike' and 'commercially realistic'); *International Air Transport Association v Ansett Australia Holdings Ltd* (2008) 234 CLR 151 at 160; 242 ALR 47 at 51; [2008] HCA 3 at [8] per Gleeson CJ ('businesslike'). For older illustrations see *Ringstad v Gollin & Co Pty Ltd* (1924) 35 CLR 303 at 316 per Starke J; *J Kitchen & Sons Pty Ltd v Stewart's Cash & Carry Stores* (1942) 66 CLR 116 at 124-5 per Latham CJ and McTiernan J.

89 J W Carter, *The Construction of Commercial Contracts*, Hart Publishing, Oxford, 2013, §4-22.

90 See, eg *Toll (FGCT) Pty Ltd v Alphapharm Pty Ltd* (2004) 219 CLR 165 at 179; 211 ALR 342; [2004] HCA 52 at [40] per the court.

91 Cf *Tsakiroglou & Co Ltd v Noblee Thorl GmbH* [1962] AC 93 at 122-4 per Lord Radcliffe.

given situation there may be no default rule. Therefore, the intended application of a contract is always a question of construction.

Litigated contract disputes rarely concern factual situations in which a contract has only one tenable application. In any choice between competing constructions (applications), a court should always reject one which is, in light of commercial purpose, 'absurd', 'foolish' or 'nonsensical'.[92] There is, however, a more general principle which can be expressed in positive form, namely, a preference for constructions which achieve reasonable results. As Gibbs CJ said in *Australian Casualty Co Ltd v Federico*,[93] a court is not bound to apply a contract literally where there is an 'alternative construction which is more reasonable and more in accord with the probable intention of the parties'.

Even though not articulated as such, good faith terms have been implied to qualify the literal application of contracts so as to achieve what are regarded as being 'good faith applications'. The lack of coherence in the law shows just how important it is that the work be done by construction. Whereas the construction of any negotiated contract has no value as a precedent in the construction of any other contract,[94] some value is attributed to cases in which terms are implied. *Hungry Jack's* and Priestley JA's judgment in *Renard* have been influential primarily because the resolutions for specific problems (as perceived) were derived from, and expressed in terms of, generalised concepts potentially applicable in a wide range of situations. *Renard* concerned a third party standard form and had no relevance beyond that. The court in *Hungry Jack's* held that it involved a one-off contract. These limitations might well have been recognised if the analysis had been expressed in terms of construction. Instead, the cases have served to create a presumption that all express rights of termination must be exercised 'reasonably'.[95]

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92 See, respectively, *Summers v The Commonwealth* (1918) 25 CLR 144 at 149 per Isaacs J (affirmed (1919) 26 CLR 180); *J Kitchen & Sons Pty Ltd v Stewart's Cash & Carry Stores* (1942) 66 CLR 116 at 124-5 per Latham CJ and McTiernan J; *Zhu v Treasurer of New South Wales* (2004) 218 CLR 530 at 560; 211 ALR 159 at 180; [2004] HCA 56 per the court.

93 (1986) 60 CLR 513 at 520; 66 ALR 99.

94 See J W Carter, *The Construction of Commercial Contracts*, Hart Publishing, Oxford, 2013, §13-09.

95 See J W Carter, *Contract Law in Australia*, 6th ed, LexisNexis Butterworths, Sydney, 2013, §2-02. Cf *Telstra Corp Ltd v Optus Network Pty Ltd* (2002) 193 ALR 353 at 393; [2002] FCAFC 296 at [113] per Conti J, dissenting judgment ('more readily attracted').

(c) Good Faith and Commercial Construction

As a concept, commercial construction resembles good faith in having certain incidents.[96] However, it is supported by a body of law. Therefore, unlike good faith, 'commercial construction' is more than an underlying concept. The presumptions and preferences in construction which give it content and substance are as much grounded in precedent as the technical rules which restrict the use of extrinsic evidence in arriving at a commercial construction.

The implied term methodology of the good faith cases has served to highlight a general lack of consistency in the approach to construction. Three features of Australian law underline the incoherence of the good faith cases. First, courts have often accepted without question that the contract at issue was intended to be applied literally. Good faith terms have been implied to defeat that construction. This must 'contradict basic principle'.[97] The real question is whether a literal application of the contract is intended. In deciding that issue, the commercial objectives of the parties are crucial. English courts have dealt with the matter from that perspective in a long series of cases which began with *Prenn v Simmonds*,[98] a decision approved by the High Court in *Codelfa Construction Pty Ltd v State Rail Authority of New South Wales*.[99]

In *Prenn*, the issue was whether Simmonds was entitled to acquire from Prenn an interest in Radio & Television Trust Ltd. That depended on whether the 'aggregate profits of RTT ... available for dividend' had reached a certain level. Since the contract defined 'RTT' as 'Radio & Television Trust Ltd', if the contract was applied literally, the profits of a single entity were at issue. In the Court of Appeal, it appears[100] that Lord Denning MR was influenced by evidence of Simmonds's anxiety

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96 See J W Carter, *The Construction of Commercial Contracts*, Hart Publishing, Oxford, 2013, §1-23.

97 *Koehler v Cerebos (Australia) Ltd* (2005) 222 CLR 44 at 58; 214 ALR 355 at 362; [2005] HCA 15 at [36] per McHugh, Gummow, Hayne and Heydon JJ. See also *Wood Hall Ltd v Pipeline Authority* (1979) 141 CLR 443 at 451; 24 ALR 385 per Gibbs J (with whom Barwick CJ, Stephen and Mason JJ agreed).

98 [1971] 1 WLR 1381; [1971] 3 All ER 237.

99 (1982) 149 CLR 337; 41 ALR 367 ('*Codelfa*'). The High Court also approved *Reardon Smith Line Ltd v Yngvar Hansen-Tangen* [1976] 1 WLR 989, another leading English case in which the contract was not applied literally.

100 See [1971] 1 WLR 1381 at 1385; [1971] 3 All ER 237 at 241.

'to protect himself against unilateral decisions' by Prenn. There was no intention for 'aggregate profits of RTT' to be applied literally because Simmonds's entitlement would have depended, effectively, on how much of the group profits Prenn passed up to the parent company. The House of Lords said that none of this evidence was admissible. Nevertheless, having regard to context, it concluded that a literal application was not intended. The expression 'aggregate profits of RTT' was applied on the basis that, relevantly, 'RTT' referred to RTT and its subsidiaries. That was the construction which gave effect to the commercial objectives of the parties.[101] English law has continued to develop so that, for example, in *Rainy Sky SA v Kookmin Bank*[102] the Supreme Court of the United Kingdom said that to choose an alternative application it is not 'necessary to conclude that, unless the most natural meaning of the words produces a result so extreme as to suggest that it was unintended, the court must give effect to that meaning'.

Second, even in situations where a more commercial construction is available, Australian courts seem often to prefer literal application. For example, in *Jireh International Pty Ltd t/as Gloria Jean's Coffee v Western Exports Services Inc*[103] the New South Wales Court of Appeal adopted a construction conclusion which was manifestly inconsistent with the same court's long-standing commitment to good faith. It did so on the basis that the conclusion was literally correct. The court focused on a statement by Gibbs J in *Australian Broadcasting Commission v Australasian Performing Right Association Ltd*,[104] that if the 'words used are unambiguous the court must give effect to them, notwithstanding that the result may appear capricious or unreasonable, and notwithstanding that it may be guessed or suspected that the parties intended something different'. In the same statement, Gibbs J also recognised that

> if the language is open to two constructions, that will be preferred which will avoid consequences which appear to be capricious, unreasonable, inconvenient or unjust, 'even though the construction

101 Contrast *McGrath v Sturesteps* (2011) 81 NSWLR 690; 284 ALR 196; [2011] NSWCA 315.

102 [2011] 1 WLR 2900 at 2908; [2011] UKSC 50 at [20] per Lord Clarke (delivering the judgment of the court). See J W Carter, *The Construction of Commercial Contracts*, Hart Publishing, Oxford, 2013, §16-15.

103 [2011] NSWCA 137.

104 (1973) 129 CLR 99 at 109-10.

> adopted is not the most obvious or the most grammatically accurate' (*Locke v Dunlop* (1888) 39 Ch D 387 at 393).

It seems clear that Gibbs J was making two different points. One was that if the contract is unambiguous, a court cannot depart from that construction, even if the result is absurd. Nevertheless, some of the good faith cases appear to proceed on the basis that a term may be implied to displace a literal application which is 'capricious'.[105] And in *Jireh* the court thought that it possible to intervene in an unambiguous contract if the result was absurd.[106]

The other point made by Gibbs J applies if the contract 'is open to two constructions'. There is then a preference against a construction the adoption of which would lead to 'capricious, *unreasonable*, inconvenient or unjust' consequences. Therefore, it is open to a court to reject an unreasonable construction or, as he later stated in *Federico*, to prefer the more reasonable construction. That has also been the approach of the English cases. Unfortunately, in *Jireh* the court saw matters differently. It treated the contract as open to two tenable applications, but adopted the more literal application on the basis that it was not absurd, even though a more commercial (reasonable) application was available. It concluded:[107]

> Whilst in some cases there may be difficulties in determining upon which side of the line the case falls, a finding of absurdity of operation is different in principle from a finding that a contract would have an uncommercial or unbusinesslike operation if given a particular meaning ... . In my view it is clear that the present case fell only within the latter category, rather than the former.

With respect, neither statement by Sir Harry Gibbs required this contrast between 'absurdity of operation' and 'uncommercial ... operation'. In the statement quoted by the court he treated 'unreasonable' operation as sufficient, provided two constructions were open.

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105 See *Alcatel Australia Ltd v Scarcella* (1998) 44 NSWLR 349 at 368 per Sheller JA (with whom Powell and Beazley JJA agreed); *Hungry Jack's* (2001) 69 NSWLR 558 at 571; [2001] NSWCA 187 at [176] per the court.

106 See [2011] NSWCA 137 at [55] per Macfarlan JA ('[t]he court must give effect to that language unless to do so would give the contract an absurd operation'). Young JA and Tobias AJA agreed.

107 [2011] NSWCA 137 at [64] per Macfarlan JA. Young JA and Tobias AJA agreed. See also *Positive Endeavour Pty Ltd v Madigan* (2009) 105 SASR 109 at 135; [2009] SASC 281 at [85] per Gray J.

In addition, it seems unlikely that the parties to a commercial contract would distinguish between 'uncommercial' and 'absurd' applications. The conclusion that literal application should be preferred is also inconsistent with the perspective rule. Why would a reasonable person choose an uncommercial construction when a commercial construction is available? Although the position might be different in the construction of a third party standard form, there is no basis for attributing a general preference for literalism to the reasonable person who is taken to construe the contract.

In *Jireh* the court also relied[108] on English authority, citing *Investors Compensation Scheme Ltd v West Bromwich Building Society*[109] and treating the criterion that 'something must have gone wrong with the language' as not only necessary, but also an embodiment of the absurdity requirement. That is a very narrow view of English law.[110] For example, in *Equitable Life Assurance Society v Hyman*[111] Lord Steyn said the purpose of construction is 'to assign to the language of the text the most appropriate meaning which the words can legitimately bear'. If an alternative construction was reasonably open in *Jireh*, as the court conceded, the decision is impossible to support.[112]

Third, there is a long-standing debate in Australian law as to the proper approach to the use in construction of 'surrounding circumstances', that is, the context of the contract. All of the leading good faith cases[113] have been decided on the basis of Mason J's statement in *Codelfa*:[114]

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108 See [2011] NSWCA 137 at [64].

109 [1998] 1 WLR 896 at 913 per Lord Hoffmann. Lords Goff, Hope and Clyde agreed.

110 And the same can be said of the perception of the English cases applied in *McGrath v Sturesteps* (2011) 81 NSWLR 690 at 697; 284 ALR 196 at 202-3; [2011] NSWCA 315 at [18] per Bathurst CJ. Macfarlan JA and Sackville AJA agreed.

111 [2002] 1 AC 408 at 458. The other members of the House of Lords agreed. On problems with Lord Hoffmann's 'mistake' rationalisation see J W Carter, *The Construction of Commercial Contracts*, Hart Publishing, Oxford, 2013, §§2-13, 3-09.

112 For a full discussion see David McLauchlan and Matthew Lees, 'Construction Controversy' (2011) 28 *JCL* 101.

113 Ironically, the court in *Jireh* applied a more generous approach to context. See [2011] NSWCA 137 at [55] per Macfarlan JA (with whom Young JA and Tobias AJA agreed). But the members of the High Court who refused the special leave application took the opportunity to express their view that the passage in *Codelfa* states the law. See *Western Export Services Inc v Jireh International Pty Ltd* (2011) 282 ALR 604; [2011] HCA 45.

114 (1982) 149 CLR 337 at 352. Stephen and Wilson JJ agreed.

> The true rule is that evidence of surrounding circumstances is admissible to assist in the interpretation of the contract if the language is ambiguous or susceptible of more than one meaning. But it is not admissible to contradict the language of the contract when it has a plain meaning.

The 'true rule' is absolutely incompatible with a concern to promote good faith as a concept. But putting to one side the question whether the law is or ought to be different,[115] it seems most peculiar for courts to promote good faith overtly when the use of context is restricted. There is a logical inconsistency in saying that while context cannot be used to qualify an unambiguous document, a term can be implied to do just that. Whatever else might be said about seeking to police good faith explicitly, its role must be relative to commercial purpose. It is difficult to have confidence in results achieved on the basis of an abstract concept which is applied independently of commercial purpose.

5. Good faith in Performance

(a) Introduction

It is perfectly correct,[116] but not in itself helpful, to say that Australian courts have recognised that good faith is part of the law relating to contract performance. The key questions are what that means how good faith is achieved.

'Good faith' is not a term which is implied in all contracts.[117] However, terms do exist which are implied into all contracts. Such terms state *rules of law*, that is, presumptions of intention which must be brought into account in construction. The most relevant rules relate to co-operation in performance.

(b) Co-operation in Performance

The well-known statement of Lord Blackburn in *Mackay v Dick*[118] recognises the distinction between rules of law and implied terms. He stated a rule of 'construction' applicable 'where in a written contract it appears that both parties have agreed that

115 See David McLauchlan, 'Plain Meaning and Commercial Construction: Has Australia Adopted the ICS Principles?' (2009) 25 *JCL* 7.

116 See *United Group Rail Services Ltd v Rail Corporation of New South Wales* (2009) 74 NSWLR 618 at 635; [2009] NSWCA 177 at [61] per Allsop P. Ipp and Macfarlan JJA agreed.

117 See above, text at n 13.

118 (1881) 6 App Cas 251 at 263.

something shall be done, which cannot effectually be done unless both concur in doing it'. The rule is that each party 'agrees to do all that is necessary to be done on his part for the carrying out of that thing'. This presumption of intention applies even though there are 'no express words to that effect'. Of course, Lord Blackburn also recognised that what is 'necessary' will depend on the circumstances.

Lord Blackburn's rule is the positive aspect of a requirement of co-operation in contract performance. The negative aspect concerns conduct by which one party prevents performance by the other. An implied term forbidding such conduct has often been stated.[119] But in *Southern Foundries (1926) Ltd v Shirlaw*,[120] Lord Atkin preferred to see it as a rule of law, to the effect that conduct which renders performance impossible is a breach of contract.[121]

These rules have been applied in countless cases. That is hardly surprising given that nearly all contracts require co-operation in performance. Perhaps that is why Griffith CJ felt able to state in *Butt v M'Donald*[122] a 'general rule applicable to every contract', namely, that 'each party agrees, by implication, to do all such things as are necessary on his part to enable the other party to have the benefit of the contract'. Since its approval[123] by Mason J in *Secured Income*, the statement has been a prominent feature of Australian law. As a rule applicable to all contracts, it states a presumption of intention applied by construction. Although the implied term rationalisation adds nothing,[124] it is convenient to relate discussion to a 'co-operation term'. Since there is a general consensus that co-operation is an incident of good faith, the term is a legitimate 'good faith term'.

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119 See, eg *Stirling v Maitland* (1864) 5 B & S 840 at 852; 122 ER 1043 at 1047 per Cockburn CJ.

120 [1940] AC 701 at 717.

121 See also *Commissioner for Main Roads v Reed & Stuart Pty Ltd* (1974) 131 CLR 378 at 379 per Gibbs J, 384-5 per Stephen J (with whom Gibbs J generally agreed and Mason J agreed); 4 ALR 571; *Australis Media Holdings Pty Ltd v Telstra Corp Ltd* (1998) 43 NSWLR 104 at 123-4 per the Court of Appeal; J W Carter, *The Construction of Commercial Contracts*, Hart Publishing, Oxford, 2013, §3-24.

122 (1896) 7 QLJ 68 at 70-1. Cooper and Power JJ concurred.

123 (1979) 144 CLR 596 at 607; 26 ALR 567. The other members of the High Court agreed.

124 The term was referred to (see (1979) 144 CLR 596 at 608; 26 ALR 567) as a 'rule of construction'. See also Elisabeth Peden, 'Co-operation in English Contract Law: to Construe or Imply?' (2000) 16 *JCL* 56; A F Mason, 'Contract, Good Faith and Equitable Standards in Fair Dealing' (2000) 116 *LQR* 66 at 75.

(c) 'Good Faith' and the Co-operation Term

Since co-operation is an incident of good faith, the co-operation term elevates a market place standard to the level of a rule of law, that is, presumption of intention. Consistently with its role as a presumption of intention, the contract must be construed to determine what is 'necessary ... to enable the other party to have the benefit of the contract'. The relationship between this term and the good faith terms implied in the past 20 years is an important matter. Several of the good faith cases have relied on §205 of the Restatement (Second) Contracts (1979) to support the implication of a term expressed simply as 'good faith'. There is no reason why the co-operation term should have the same content as that provision. However, since a court cannot imply a redundant term, whether that is the case is an important issue.

In *Hospital Products Ltd v United States Surgical Corp*[125] Dawson J noted the decision of the trial judge that, having regard to expert evidence of the law of New York and Connecticut, §205 was to the same effect as the co-operation term.[126] Similarly, in *Hungry Jack's* the court appears to have approved[127] the conclusion reached in an American case,[128] that the 'implied covenant of good faith is breached only when one party seeks to prevent the contract's performance or to withhold its benefits'. It is therefore difficult to support the court's conclusion that both the co-operation term and a term of 'good faith' were implied in law in the contract.

The court also concluded[129] that there was 'no distinction of substance' between the 'good faith' implied term and the 'reasonableness' term which was also implied in law. That conclusion is inconsistent with American cases which hold that the 'good faith covenant does not impose a general requirement that a party act reasonably'.[130] Similarly, the co-operation term does not state a general requirement

125 (1984) 156 CLR 41 at 137-8; 55 ALR 417.

126 Cf *Central Exchange Ltd v Anaconda Nickel Ltd* (2002) 26 WAR 33 at 39 per Malcolm CJ, 52 per Steytler J (with whom Wallwork J agreed); [2002] WASCA 94 at [21], [63].

127 (2001) 69 NSWLR 558 at 570; [2001] NSWCA 187 at [173].

128 *Metropolitan Life Insurance Co v RJR Nabisco Inc*, 716 F Supp 1504 at 1517 (SDNY, 1989).

129 (2001) 69 NSWLR 558 at 570; [2001] NSWCA 187 at [169] per the court.

130 *United States v Basin Electric Power Cooperative*, 248 F 3d 781 at 796 (8th Cir, 2001). See also *Original Great American Chocolate Chip Cookie Co Inc v River Valley Cookies Ltd*, 970 F 2d 273 at 280 (7th Cir, 1992).

of reasonableness in performance.[131] This leads to two possibilities. Either the court implied two redundant terms or the implied term of 'reasonableness' was broader in operation than the co-operation term (and the good faith term). Neither is tenable as a matter of law.

The co-operation term does not of itself prevent the implication of a further term regulating some particular aspect of contract performance. Such an implication would be made on a factual basis. And the fact that the co-operation term may require reasonable co-operation in performance does not of itself prevent specific (factual) implications being made in favour of reasonable conduct.[132] But the implication of reasonableness made in *Hungry Jack's* was not of that character. It was expressed as a generalised requirement, and it was implied in law. The term was not a legitimate implication. The conclusion that the decision in *Hungry Jack's* does not present a coherent analysis of good faith seems inevitable.

(d) Use of Commercial Construction

In construing a contract to give effect to the intention of the parties, the co-operation term must be brought into account. The extent to which one party must co-operate, to enable the other to enjoy some benefit, is a question of construction. Accordingly, the co-operation term is a presumption in aid of commercial construction. Unsurprisingly, there is support for the view that §205 of the Restatement (Second) Contracts (1979) is itself a device to achieve commercial construction.[133] For example, good faith has been said to be concerned 'to honor the parties' *justified* expectations'.[134]

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131 See *Council of the City of Sydney v Goldspar Australia Pty Ltd* (2006) 230 ALR 437 at 497; [2006] FCA 472 at [162] per Gyles J (co-operation term does not express a general requirement of reasonable conduct).

132 See *Booker Industries Pty Ltd v Wilson Parking (Qld) Pty Ltd* (1982) 149 CLR 600 at 605; 43 ALR 68 per Gibbs CJ, Murphy and Wilson JJ (business efficacy basis for implied term to do what is reasonably necessary where third party consent is required).

133 See S J Burton, 'Breach of Contract and the Common Law Duty to Perform in Good Faith' (1980) 94 *Harv L Rev* 369 at 371 ('standard for contract interpretation'); Howard Hunter, 'Good Faith and the Construction of Terms in Commercial Contracts: The American Perspective' (2009) 25 *JCL* 39 at 41 (ensures sensible construction in accordance with commercial purpose).

134 *Taylor Equipment Inc v John Deere Co*, 98 F 3d 1028 at 1033 (8th Cir, 1996). See also H O Hunter, 'The Growing Uncertainty about Good Faith in American Contract Law' (2004) 20 *JCL* 50 at 51.

Mason J explained[135] the approach to be taken to the co-operation term in *Secured Income*:

> It is easy to imply a duty to co-operate in the doing of acts which are necessary to the performance by the parties or by one of the parties of fundamental obligations under the contract. It is not quite so easy to make the implication when the acts in question are necessary to entitle the other contracting party to a benefit under the contract but are not essential to the performance of that party's obligations and are not fundamental to the contract. Then the question arises whether the contract imposes a duty to co-operate on the first party or whether it leaves him at liberty to decide for himself whether the acts shall be done, even if the consequence of his decision is to disentitle the other party to a benefit. In such a case, the correct interpretation of the contract depends, as it seems to me, not so much on the application of the general rule of construction as on the intention of the parties as manifested by the contract itself.

Cases such as *Hungry Jack's*, where generalised terms have been implied into detailed commercial contracts in addition to the co-operation term, are quite impossible. Such terms must contradict the construction of the contract. As the passage from Mason J's judgment indicates, that is impermissible.

In *Hungry Jack's* the facts were complex, and the court's judgment was very lengthy.[136] It is therefore difficult to evaluate the case from a commercial construction perspective by reference to the short passages quoted below. Even so, it is not easy to appreciate the reasoning of the court.[137] The key provision was cl 4.1 of a 'Development Agreement'. This stated that, as 'a condition to the granting of a Franchise Approval', Hungry Jack's was required to obtain 'operational, financial and legal approval' from Burger King Corp ('BKC'). Such approval was expressed to be 'in the sole discretion' of BKC.

Clause 4.1 defined 'operational, financial and legal' as follows:

> **(a) Operational**
> HUNGRY JACK'S conducts each of its Burger King Restaurants in accordance with the terms and conditions of this Agreement, the

135 (1979) 144 CLR 596 at 607-8; 26 ALR 567. The other members of the High Court agreed. See also *NT Power Generation Pty Ltd v Power and Water Authority* (2001) 184 ALR 481 at 573; [2001] FCA 334 at [392]-[393] per Mansfield J.

136 Only a small part of the judgment is reported in the *New South Wales Law Reports*.

137 See also Elisabeth Peden, *Good Faith in the Performance of Contracts*, Butterworths, Sydney, 2003, §7.11.

> applicable Franchise Agreements, and the standards, specifications and procedures specified in the volumes comprising the Manual of Operating Data, as amended, including the maintenance of interior and exterior of the restaurants so as to reflect an acceptable Burger King image. HUNGRY JACK'S understands that changes in said standards, specifications and procedures may become necessary from time to time. HUNGRY JACK'S agrees to accept, as reasonable, said changes and HUNGRY JACK'S further agrees that it is within the sole discretion of BKC to make such changes.
>
> **(b) Financial**
> HUNGRY JACK'S has performed and is faithfully performing all terms and conditions under each individual Franchise Agreement issued, and is not in default of any money obligations owed by HUNGRY JACK'S to BKC. HUNGRY JACK'S acknowledges and agrees that it is vital to BKC's interests that a franchisee be financially sound to avoid a business failure affecting the reputation and good name of the Burger King marks.
>
> **(c) Legal**
> HUNGRY JACK'S has promptly submitted to BKC all information and documents reasonably requested by BKC prior to and as a basis for the issuance and consummation of individual franchises, has taken additional action requested from time to time and is in compliance with all obligations under all agreements with BKC.

Clause 4.2 was to the effect that BKC could refuse to grant (or withdraw) a franchise approval if the standards set out in cl 4.1 were not met.

In commenting on cl 4.1, the court said:[138]

> [T]he granting of operational, financial and legal approval is within 'the sole discretion' of BKC. If full force is given to that concept, it would allow BKC to give or to withhold relevant approval 'at its whim' including capriciously, or with the sole intent of engineering a default of the Development Agreement, giving rise to a right to terminate. That is hardly the language of objectivity.

Referring to Hungry Jack's as 'HJPL', to support the conclusion that terms of 'reasonableness' and 'good faith' were implied (in addition to the co-operation term), the court said:[139]

> There is such an extraordinary range of detailed considerations, particularly in relation to whether operational requirements have been satisfied, contained within cl 4.1(a), that unless there was an implied

138 (2001) 69 NSWLR 558 at 571; [2001] NSWCA 187 at [176]. Nothing appears to have been said concerning the effect of 'agrees to accept, as reasonable'.

139 (2001) 69 NSWLR 558 at 573; [2001] NSWCA 187 at [183].

> requirement of reasonableness and good faith, BKC could, for the slightest of breaches, bring to an end the very valuable rights which HJPL had under the Development Agreement. Further, contrary to BKC's submissions, cl 4 does not contain only objective criteria against which the discretion is to be exercised. There are many subjective, evaluative notions involved. The reflection of 'an acceptable Burger King image' is one example.

Pausing there, three points may be made. First, once the co-operation term was taken into account in construction — as the court was obliged to do — BKC had no ability to engineer a 'default' by HJPL.[140] No further implication was necessary because any such conduct was a breach of contract by BKC.[141]

Second, it seems unlikely that the construction of the contract was that BKC could 'give or to withhold relevant approval "at its whim" including capriciously'. The contract set out the relevant considerations, and the power to withhold approval was necessarily to be exercised by reference to those matters.[142] In any event, the terms which the court in *Hungry Jack's* felt compelled to imply did not conform to accepted principle[143] because they were not the minimum terms *necessary* to deal with the matters which the court identified. If the court was correct in its construction, and also in thinking that capricious conduct was consistent with the co-operation term, each of which seems unlikely, it could still have considered whether a term was to be implied in fact, limited to particular exercises of the discretion. But a term could not be implied in law which subjected BKC to a general requirement of reasonable conduct.[144]

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140 See (2001) 69 NSWLR 558; [2001] NSWCA 187 at [310]: 'the evidence clearly establishes that BKC's conduct is properly characterised as being directed ... to preventing HJPL from performing its obligations under the Development Agreement'.

141 See *Council of the City of Sydney v Goldspar Australia Pty Ltd* (2006) 230 ALR 437 at 499; [2006] FCA 472 at [168] per Gyles J (instruction could not 'validly be given' under express clause for purpose of causing other party to default thereby providing a pretext for termination).

142 The court said ((2001) 69 NSWLR 558 at 572; [2001] NSWCA 187 at [177]) that counsel for Hungry Jack's argued that 'an exercise of discretion on wrong facts fell within the ambit of cl 4.1 provided that the wrong facts were not fraudulently determined'.

143 See, eg *Australis Media Holdings Pty Ltd v Telstra Corp Ltd* (1998) 43 NSWLR 104 at 124 per the Court of Appeal.

144 See *Equitable Life Assurance Society v Hyman* [2002] 1 AC 408 at 458-9 per Lord Steyn. The other members of the House of Lords agreed. See also Richard Hooley, 'Controlling Contractual Discretion' [2013] *CLJ* 65 at 76 (fully objective standard 'undermines ... autonomy of the parties').

On the other hand, if as a matter of construction BKC was entitled to act 'capriciously', that was the end of the matter. Indeed, such a conclusion could have been supported by reference to American cases on the 'covenant of good faith'. Although relevant to the exercise of discretions,[145] some cases have taken a narrow view of the impact of the covenant in relation to terms 'actually negotiated'.[146] In addition, they suggest that good faith does not qualify an 'unfettered'[147] discretion. And, as the court in *Hungry Jack's* noted,[148] some American cases hold that the implied covenant does not 'block' the use of express terms.

The third point is that the parties cannot have intended the 'slightest of breaches'[149] to be a sufficient justification for refusing or withholding approval.[150] In the application of any clause with 'an extraordinary range of detailed considerations', literal application would hardly ever be intended by the parties. In relation to 'operational requirements', which the court singled out, the clause required Burger King restaurants to be conducted 'in accordance with' the agreement, and so on. This did not have to be read as if it said 'strictly in accordance with'.[151]

Moreover, cl 4.1 was not a termination clause. Under that provision, the question was whether HJPL was entitled to approval, not whether BKC could 'bring

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145 See, eg *Bank IV Salina NA v Aetna Casualty & Surety Co*, 810 F Supp 1196 at 1204 (D Kansas, 1992). See Howard Hunter, 'Good Faith and the Construction of Terms in Commercial Contracts: The American Perspective' (2009) 25 *JCL* 39 at 44 ('honestly and in good faith').

146 See, eg *Continental Bank NA v Everett*, 964 F 2d 701 at 705 (CA, 7th Cir, 1992); *United States v Basin Electric Power Cooperative*, 248 F 3d 781 at 796 (8th Cir, 2001). Cf S J Burton, 'Breach of Contract and the Common Law Duty to Perform in Good Faith' (1980) 94 *Harv L Rev* 369.

147 See *Bank IV Salina NA v Aetna Casualty & Surety Co*, 810 F Supp 1196 at 1205 (D Kansas, 1992)). See also H O Hunter, 'The Growing Uncertainty about Good Faith in American Contract Law' (2004) 20 *JCL* 50 at 54, 56.

148 See (2001) 69 NSWLR 558 at 570; [2001] NSWCA 187 at [173]. It referred to *Kham & Nate's Shoes No 2 Inc v First Bank of Whiting*, 908 F 2d 1351 at 1357 (7th Cir, 1990). See also, eg *United States v Basin Electric Power Cooperative*, 248 F 3d 781 at 796 (8th Cir, 2001).

149 It was said ((2001) 69 NSWLR 558 at 572; [2001] NSWCA 187 at [178]) that counsel for Hungry Jack's argued 'that whilst *de minimis* contraventions of operation [sic] or financial requirements were simply "to be disregarded", minor breaches were not'.

150 Compare the court's construction of cl 2.1; see (2001) 69 NSWLR 558; [2001] NSWCA 187 at [139].

151 Compare cl 12 of the contract, which included a statement that the 'language of all provisions of this Agreement shall be construed according to its fair meaning'.

to an end the very valuable rights which HJPL had under the Development Agreement'. Termination was, in fact, the main issue in the case. The court's construction of the termination clause was that for every breach — 'slight' or otherwise — which was capable of being remedied, BKC was required to afford HJPL an opportunity to do so.[152]

The court explained how the terms of good faith and reasonableness operated by saying:[153]

> BKC's contractual powers under cl 4.1 are to be exercised in good faith and reasonably. That does not mean that BKC is not entitled to have regard only to its own legitimate interests in exercising its discretion. However, it must not do so for a purpose extraneous to the contract — for example, by withholding financial or operational approval where there is no basis to do so, so as to thwart HJPL's rights under the contract.

Having rejected 'BKC's submissions' and concluded that 'cl 4 does not contain only objective criteria against which the discretion is to be exercised', the sense in which 'reasonableness' was an implied term becomes unclear. But the term necessarily contradicted the court's conclusion that some criteria were subjective in nature.[154]

The court also made the point, several times, that use of cl 4 for 'extraneous' purposes was not permitted. It would therefore seem more pertinent to say that the discretion was conferred on BKC for certain purposes, such as the protection of its intellectual property. Those purposes could only be determined by construction of the contract as a whole. Once identified, they would have established what interests it was 'legitimate' for BKC to pursue. But the terms implied by the court had a greater impact. They required BKC to act for a proper purpose *and* reasonably. Given the court's view of the relationship between the implied terms of reasonableness and good

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152 It appears that the court construed the termination clause on the basis that for any breach which could not be remedied there was an immediate right to terminate, but that for a breach capable of being remedied BKC was required to serve a notice even though the breach could not be remedied within the time which BKC was required to allow.

153 (2001) 69 NSWLR 558 at 573; [2001] NSWCA 187 at [185].

154 Having assumed that the acknowedgment and agreement at the end of cl 4.1(b) had 'contractual intent', the court concluded ((2001) 69 NSWLR 558 at 573 [2001] NSWCA 187 at [185]): 'the provision is also wide and can have both an objective and subjective content. That being so, it reinforces our view that BKC's contractual powers under cl 4.1 are to be exercised in good faith and reasonably'.

faith — that they were the same as a matter of substance — support for the narrower conclusion could have been found in United States authorities on the good faith covenant. The purpose lies in 'effectuating ... intent in unforseen [*sic*] circumstances',[155] and the implied term ensures that a party does not 'take opportunistic advantage in a way that could not have been contemplated at the time of drafting, and which therefore was not resolved explicitly by the parties'.[156] Similarly, it has been said to prevent a party taking advantage of gaps in the contract to 'exploit the vulnerabilities that arise when contractual performance is sequential rather than simultaneous',[157] as was the position in *Hungry Jack's*.

Finally, the unqualified proposition that BKC was entitled to have regard *only* to its own legitimate interests suggests that the court understood the implied term of reasonableness to operate as a standard which would be met unless BKC made a decision that no reasonable person could have regarded as reasonable in the circumstances. However, that would be inconsistent with the thrust of the judgment, namely, that BKC was subject to a fully objective standard of reasonableness. It would also be inconsistent with the co-operation term, and therefore contradict the commercial construction of the contract. Indeed, the conclusion seems to contradict every term which the court implied.

6. Good faith in the Exercise of Rights

(a) Introduction

The word 'right' tends to be used generically in the contract context, to refer to any right, power, discretion or performance option conferred by a contract, either expressly or under a common law rule.[158] Although refined terminology is sometimes

155 *United States v Basin Electric Power Cooperative*, 248 F 3d 781 at 796 (8th Cir, 2001).

156 *Kham & Nate's Shoes No 2 Inc v First Bank of Whiting*, 908 F 2d 1351 at 1357 (7th Cir, 1990).

157 *Original Great American Chocolate Chip Cookie Co Inc v River Valley Cookies Ltd*, 970 F 2d 273 at 280 (7th Cir, 1992). See also *Taylor Equipment Inc v John Deere Co*, 98 F 3d 1028 at 1033 (8th Cir, 1996).

158 See W N Hohfeld, *Fundamental Legal Conceptions as Applied in Judicial Reasoning and Other Legal Essays*, ed, W W Cook, Yale University Press, New Haven, p 36, where the point is more generally made, by way of criticism.

used,[159] 'right' is employed generically because the common law does not attribute particular legal incidents according to an established legal classification. In other words, there is no point in trying to decide whether an express clause confers a 'power', rather than a 'right', unless a legal consequence (presumption of intention) flows from the choice of label.[160] Similarly, since the exercise of most rights is a matter of discretion, analysis of the role of good faith by reference to whether a person enjoys a 'discretion', rather than a 'right', is unhelpful. However, four points can be made. First, as always, construction of the contract is crucial.

Second, at least in cases where the express right is activated by an event other than breach of contract, the purpose for which the right was conferred is a relevant consideration.

Third, there is a difference between contracts under which exercise of a right (discretion) is necessary for the other party to become entitled to receive an agreed return under the contract and other discretions, such as to refuse consent in relation to an assignment of the benefit of the contract. The co-operation term is relevant to the former, but not the latter.[161]

Fourth, there is an analytical framework which must be respected if a legally coherent analysis is to be achieved.

(b) The Analytical Framework

Where one party (the promisee) claims to have exercised a particular express right, three questions may arise. The first is a question of construction, namely, whether the right has become available. Most commercial contracts include a variety of express rights. Typically, these relate to matters such as extension of term, *force majeure*

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159 See, eg *Carr v J A Berriman Pty Ltd* (1953) 89 CLR 327 at 347 per Fullagar J, with whom the other members of the High Court agreed (discretion to omit work a 'power'); *Cooper v Ungar* (1958) 100 CLR 510 at 513 per the court (vendor's right of resale a 'right in the nature of a power'); *Vodafone* [2004] NSWCA 15 at [124] per Giles JA, with whom Sheller and Ipp JJA agreed ('contractual power'). But see *Excomm Ltd v Guan Guan Shipping (Pte) Ltd (The Golden Bear)* [1987] 1 Lloyd's Rep 330 at 342, where Staughton J was sceptical of a 'class of contractual rights described as powers'.

160 See *Barns v Queensland National Bank Ltd* (1906) 3 CLR 945 at 943 per the court (power of sale under mortgage 'like any other power, must be exercised honestly for the purposes of the power'). See also *Pendlebury v Colonial Mutual Life Assurance Society Ltd* (1912) 13 CLR 676 at 700 per Isaacs J.

161 Compare *Vodafone* [2004] NSWCA 15 at [124] per Giles JA, with whom Sheller and Ipp JJA agreed (co-operation was not relevant to discretion).

events, termination and price variation. Construction of the contract usually involves the identification of a 'trigger event'. The onus of proving that the event has occurred rests with the promisee. However, if a 'right' is entirely discretionary, there may be no trigger event.

Second, has the promisee validly exercised the right? This is again a question of construction. Commercial contracts commonly specify requirements which serve to *limit* the operation of rights. For example, service of a notice providing the promisor with an opportunity to remedy a material breach may be essential to valid termination under an express clause, or as an agreed requirement for termination in respect of a common law right.[162] Similarly, the contract may include a procedure to be followed when a *force majeure* event is alleged to have occurred. If no requirements are specified, the minimalist approach of the common law applies. Where exercise of a right involves an election by the promisee, unequivocal notice of exercise must be given. The promisee is therefore entitled to choose whether or not to exercise the right. There is no presumption of law — and no implied term — to the effect that reasonableness limits the choice. That is true whether the right is express or conferred by law.[163] Whatever the requirements, the onus of proving their satisfaction rests with the *promisee*. If exercise of the right is subject to the promisor's consent or approval which has been withheld, the onus again rests with the promisee to establish that the promisor has not acted in accordance with the clause.[164]

Third, assuming that the promisee has exercised the right in accordance with its terms, is that exercise nevertheless affected by a particular legal restriction? Doctrines such as estoppel, election and waiver (if it exists as a doctrine) potentially restrict the ability to rely on the exercise of *any* right. However, whether an express right or a common law right is at issue, the law does not recognise a general restriction on exercise expressed in terms of unconscionable or unreasonable

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162 As in *Legione v Hateley* (1983) 152 CLR 406; 46 ALR 1.

163 See, eg *White and Carter (Councils) Ltd v McGregor* [1962] AC 413 at 430 per Lord Reid, 445 per Lord Hodson (with whom Lord Tucker agreed); *Wood Hall Ltd v Pipeline Authority* (1979) 141 CLR 443; 24 ALR 385; *Sunbird Plaza Pty Ltd v Maloney* (1988) 166 CLR 245 at 263; 77 ALR 205 per Mason CJ (with whom Deane, Dawson and Toohey JJ agreed); *Canberra Advance Bank Ltd v Benny* (1992) 115 ALR 207 at 213 per the Full Federal Court.

164 See, eg *Secured Income* (1979) 144 CLR 596 at 609; 26 ALR 567 per Mason J (with whom the other members of the High Court agreed).

conduct.[165] But there are specific restrictions which operate in particular contexts, such as relief against forfeiture. If a restriction is alleged to operate, the general rule is that the *promisor* bears the onus of proving it was operative when the promisee purported to exercise the right.

(c) The Implied Term of Reasonableness

The framework explained above is largely ignored in the good faith cases. The judgment of Priestley JA in *Renard*, and the cases in which it has been applied, illustrate a surprising eagerness to imply a good faith term requiring rights to be exercised 'reasonably'. They give effect to the view that the law recognises a generalised requirement of good faith one specific manifestation of which is an implied term of 'reasonableness'.

Standards and requirements of 'reasonableness' operate throughout the law of contract to resolve a wide variety of matters. The most important rule of construction — that the construction of a contract is determined by the conclusion of a reasonable person — relies on the concept. Often reasonableness is a default standard, as in 'reasonable time', 'reasonable price' and 'reasonable care'. Occasionally, the law prescribes the standard, as in the context of a covenant in restraint of trade. But the standard is by no means obligatory for the common law, and the idea that it is a prescribed standard of conduct is repugnant to the contract institution. A particularly relevant example relates to implied terms. Whether a term is sought to be implied in fact or law, it is not sufficient that it would be 'reasonable' to imply a particular term.

Because of the good faith agenda which they have sought to address, the good faith cases have implied terms of reasonableness simply on the basis that it appears reasonable to do so. But there is little analysis of the concept. While 'reasonableness' is often available as a default standard, it cannot be imposed. The most obvious example is 'reasonable time'. There can be no implied term to that effect if the parties have agreed to a specific time.[166] And the failure of the parties to an executory agreement to agree a price does not of itself justify the implication of an obligation to

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165 See, eg *Sunbird Plaza Pty Ltd v Maloney* (1988) 166 CLR 245 at 263; 77 ALR 205 per Mason CJ (with whom Deane, Dawson and Toohey JJ agreed); *Glencore Grain Rotterdam BV v Lebanese Organisation for International Commerce* [1997] 4 All ER 514.

166 See *Agricultural and Rural Finance Pty Ltd v Gardiner* (2008) 238 CLR 570; 251 ALR 322; [2008] HCA 57.

pay reasonable sum: it must be possible to infer an intention to that effect. A standard of reasonableness may be presumed, under a rule of construction or a recognised term implied in law. The implied agreement of a service provider to a standard of reasonable care is one example. Another is the requirement that, even when activated by breach, an express right to terminate must be exercised within a reasonable time.[167] However, as noted above, the common law does not require rights to be exercised reasonably.

So far as the common law is concerned, the standard of 'reasonableness' is almost invariably fully objective, and the parties' views are largely irrelevant. Assessment is made on the basis of the context of the contract, the rights and obligations undertaken by the parties and the circumstances which exist at the relevant time.[168] But the standard is not always approached in this way. When operative as an implied *restriction* on the exercise of rights, reasonableness is not a fully objective standard. For example, implied terms to the effect that a person must not act 'arbitrarily, capriciously or unreasonably' do not contemplate a fully objective exercise.[169] The sense of 'unreasonably' is that the exercise is one which no reasonable person, acting reasonably, could make. For example, the English cases have held that exercise of a right at any time to vary the rate of interest payable under a loan contract is restricted by an implied term to the effect that it cannot be exercised for an improper purpose, capriciously or arbitrarily.[170]

An obvious deficiency of many of the good faith cases is that there is no explanation of the sense in which 'reasonableness' is used. For example, *Hungry Jack's* is ambivalent. However, the placement of the onus of proof on the promisee in most of the cases, including Priestley JA's judgment in *Renard*, is a sufficient indication that the fully objective standard is intended to be invoked. In terms of the 'analytical framework' referred to above, the good faith cases have preferred

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167 See J W Carter, *Carter's Breach of Contract*, LexisNexis Butterworths, Sydney, 2011 and Hart Publishing, Oxford, 2012 *(Hart Edition)*, §11-23.

168 See, eg *Carlton SS Co Ltd v Castle Mail Packets Co Ltd* [1898] AC 486 at 491 per Lord Herschell (reasonable time).

169 See, eg *Abu Dhabi National Tanker Co v Product Star Shipping Ltd (The Product Star) (No 2)* [1993] 1 Lloyd's Rep 397 at 404 per Leggatt LJ.

170 See *Paragon Finance Plc v Nash* [2002] 1 WLR 685; [2001] EWCA Civ 1466; *Paragon Finance Plc v Pender* [2005] 1 WLR 3412; [2005] EWCA Civ 760.

reasonableness as a limitation on rights, rather than an implied term restriction. To justify this approach — which is indefensible as a matter of principle — inappropriate analogies have been relied on.

(d) Analogies

There are particular contracts or relationships in which *restrictions* on the exercise of express rights have long been recognised and explained in terms of 'good faith'. Until the good faith cases, these situations were regarded as both special and specific. If there is a link between the special cases, it is the intervention of equity. One example is an express right to expel a member of a partnership, or to dissolve the partnership.[171] Further examples relate to the steps which a promisee is entitled to take following exercise of a right. The classic example is the mortgagee's power of sale. Once the mortgagee has taken possession and determined to sell, it must act in good faith. Under Australian law,[172] the restriction is expressed in terms that the mortgagee must act 'without fraud and without wilfully or recklessly sacrificing the interests of the mortgagor'.[173] But this has no impact on the decision to demand payment of the debt: no good faith requirement applies.[174] None of these special restrictions create presumptions of intention to be carried over into other contexts. The same is true of the operation of a standard clause in contracts for the sale of land which has been the principal analogy invoked in the good faith cases.

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171 See *Neilson v Mossend Iron Co* (1886) 11 App Cas 298 at 309 per Lord Watson; *Kerr v Morris* [1987] Ch 90 at 111 per Dillon LJ.

172 The power of sale may also be regulated by statutory requirements, including where the security is an interest in land.

173 *Forsyth v Blundell* (1973) 129 CLR 477 at 493 per Walsh J (adopting the test stated by Lord Herschell in *Kennedy v De Trafford* [1897] AC 180 at 184-5). See also (1973) 129 CLR 477 at 481 per Menzies J (dissenting), 506 per Mason J; *Barns v Queensland National Bank Ltd* (1906) 3 CLR 945 at 942-3 per the court; *Pendlebury v Colonial Mutual Life Assurance Society Ltd* (1912) 13 CLR 676 at 679 per Griffith CJ, 694 per Barton J, 700 per Isaacs J; *Commercial and General Acceptance Ltd v Nixon* (1981) 152 CLR 491 at 522; 38 ALR 225 per Brennan J; *Downsview Nominees Ltd v First City Corp Ltd* [1993] AC 295 at 312 per the Privy Council; *Service Station Association Ltd v Berg Bennett & Associates Pty Ltd* (1993) 45 FCR 84 at 91; 117 ALR 393 per Gummow J; *Upton v Tasmanian Perpetual Trustees Ltd* (2007) 242 ALR 422 at 427-8 per Kiefel and Besanko JJ, 440-3 per Graham J; [2007] FCAFC 57 at [14]-[22], [86].

174 See *China and South Sea Bank Ltd v Tan* [1990] 1 AC 536 at 545 per the Privy Council; *Falk v Mortgage Services Funding Plc* [1993] Ch 330 at 337 per Sir Donald Nicholls V-C (with whom Butler-Sloss LJ and Sir Michael Kerr agreed), 343 per Sir Michael Kerr; [1993] 2 WLR 415 at 420, 425.

The standard clause applies where a vendor is unable or unwilling to comply with a requisition by the purchaser. If the purchaser declines a formal request to withdraw the requisition, the vendor is entitled to rescind.[175] Exercise of the right may be challenged if the vendor did not act in good faith and consistently with the purpose of the clause.[176] The purchaser must establish that the vendor acted for an extraneous purpose,[177] unreasonably or unconscionably.[178] Perhaps because rescission prevents specific performance being awarded to the purchaser, the principles are derived from equity.[179] And because they *restrict* reliance on exercise of the right, the onus of proof rests with the purchaser.[180] The clause was perhaps devised to address the purchaser's equitable right to rescind, derived from a lack of mutuality in the remedy of specific performance,[181] that is, the ability of a purchaser to waive a defect in title and claim specific performance. Whatever the rationale, it is fundamental to appreciate that the clause confers a right on a vendor who is unwilling or unable to comply with the contract.

It would seem remarkable to say that a clause which confers a right to rescind on a person who is unwilling or unable to comply with a contract is analogous to a clause which confers a right of termination on one party when the other breaches the contract. Nevertheless, that is what the good faith cases say. In *Renard*, Priestley JA

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175 Such clauses have been common for a very long time. See *Selkirk v Romar Investments Ltd* [1963] 1 WLR 1415 at 1418 per the Privy Council. Current standard form contracts may expressly incorporate a concept of reasonableness. See *Nassif v Caminer* (2009) 74 NSWLR 276 at 279; [2009] NSWCA 45 at [10].

176 *Re Dames* (1885) 29 Ch D 626 at 634 per Lindley LJ; *Gardiner v Orchard* (1910) 10 CLR 722 at 738, 739 per Isaacs J; *Alchemy Estates Ltd v Astor* [2009] 1 WLR 940 at 962; [2008] EWHC 2675 (Ch) at [61] per Sales J.

177 *Godfrey Constructions Pty Ltd v Kanangra Park Pty Ltd* (1972) 128 CLR 529 at 543, 546 per Walsh J (with whom Gibbs J agreed), 547 per Gibbs J, 548, 552 per Stephen J.

178 *Godfrey Constructions Pty Ltd v Kanangra Park Pty Ltd* (1972) 128 CLR 529 at 538 per Barwick CJ; *Pierce Bell Sales Pty Ltd v Frazer* (1973) 130 CLR 575 at 587 per Barwick CJ (with whom McTiernan and Gibbs JJ agreed).

179 *Pierce Bell Sales Pty Ltd v Frazer* (1973) 130 CLR 575 at 590 per Gibbs J (adopting *Selkirk v Romar Investments Ltd* [1963] 1 WLR 1415 at 1422-3 per the Privy Council).

180 *Pierce Bell Sales Pty Ltd v Frazer* (1973) 130 CLR 575 at 589 per Barwick CJ. McTiernan and Gibbs JJ agreed.

181 See *Halkett v Earl of Dudley* [1907] 1 Ch 590. There is an unresolved debate as to the relationship between the equitable right and the common law right to terminate for repudiation by inability to perform. See Charles Harpum, 'Selling Without Title: A Vendor's Duty of Disclosure?' (1992) 108 *LQR* 280.

suggested,[182] as part of his *obiter* discussion of good faith, that 'general rules' were operating in the cases on the standard clause. That is manifestly incorrect.[183] It was, moreover, a view rejected by the New South Wales Court of Appeal in *Champtaloup v Thomas*,[184] where Glass JA made the point that the clause has 'little, if any, affinity' with a provision conferring a right of 'rescission' on a purchaser for a vendor's default. It is obvious that the cases on the standard clause do not express any general principle. And it also seems good common sense to regard them as irrelevant to a promisee's right to terminate for the promisor's breach of contract. Priestley JA's suggestion that *Champtaloup* could be confined to its own facts was not only untenable but also beside the point because *Renard* concerned a provision which was more closely analogous to the clause at issue in *Champtaloup* than the standard clause.[185] He also said that the cases on the latter 'recognised that, in some circumstances, exercise of legal rights will be restrained', which largely begs the question and would seem to have no relevance unless equitable relief is being sought, which was clearly not the case in *Renard*.

Priestley JA's discussion has, however, been relied on. For example, in *Hungry Jack's*, another case of alleged termination for breach, the court referred[186] to the cases as discussing 'general rescission clauses', even though 'specific rescission clauses' would be more appropriate.[187] Similarly, the discussion in *Renard* informed the conclusion of Sheller JA in *Alcatel Australia Ltd v Scarcella*[188] that a 'vendor may not be allowed to exercise a contractual power where it would be unconscionable in the circumstances to do so'. That general conclusion is not justified by the rescission clause cases.

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182 (1992) 26 NSWLR 234 at 269, 270.

183 See *Gardiner v Orchard* (1910) 10 CLR 722 at 737 per Isaacs J ('of a very special nature and for a very special purpose').

184 [1976] 2 NSWLR 264 at 271. Street CJ agreed.

185 The conclusion in *Champtaloup* was a rejection of an argument made by K R Handley QC. In *Renard*, Handley JA did not seek to question the decision.

186 (2001) 69 NSWLR 558 at 566; [2001] NSWCA 187 at [151].

187 See *Sargent v ASL Developments Ltd* (1974) 131 CLR 634 at 654; 4 ALR 257 per Mason J.

188 (1998) 44 NSWLR 349 at 368. Powell and Beazley JJA agreed. See also *Vodafone* [2004] NSWCA 15 at [216] per Giles JA (with whom Sheller and Ipp JJA agreed).

In any event, the good faith cases (including Priestley JA's judgment in *Renard*) do not conform to the analogy. Apart from the fact that the cases on the rescission clause are not based on an implied term analysis, the impact is materially different. In relation to the rescission clause, the onus is on the purchaser because good faith is a restriction on the exercise of a right which is enjoyed by the vendor. It is the use of the right which is impugned, not its existence. In the good faith cases, because reasonableness limits the scope of the right, and determines whether the right is enjoyed, the onus is on the promisee. To create a contractual limitation by way of implied term out of an equitable restriction applied in a totally different context is hardly reasoning by analogy.

(e) Termination for Breach

In *Renard*, the issue was whether the principal had validly exercised its rights under a detailed show cause provision in a schedule of rates building contract. Relevantly, the clause applied if the contractor defaulted in the 'performance or observance of any covenant, condition or stipulation in the Contract'. The right of the principal was to suspend payment and 'call upon the Contractor, by notice in writing, to show cause within the period specified by the notice why the powers' conferred by the clause 'should not be exercised'. If the contractor failed to show cause to its 'satisfaction', the principal could take over part or all of the work and cancel the contract.

Following alleged breach by the contractor, the principal issued a show cause notice and purported to take over the work on the basis that it was not satisfied with the contractor's response. However, the evidence established that the principal's decision was 'based on a fundamental misunderstanding of relevant matters ... and was grounded on "misleading, incomplete and prejudicial information"'.[189] Given those facts, the decision that the principal had not acted in accordance with the clause ought logically to have been straightforward. That was Meagher JA's view. Handley JA founded himself on construction. Relying[190] on authorities which were 'not referred to during the course of argument', he focused on whether 'satisfaction' required an honest decision, or one based on reasonable grounds. He inferred that the latter was intended. Given that most of the cases to which he referred were in favour

189 See (1992) 26 NSWLR 234 at 276, 279.

190 (1992) 26 NSWLR 234 at 279.

of the contrary view, the inference he drew was by no means inevitable. However, the construction approach was at least orthodox.[191]

In a 'postscript'[192] to his judgment, Priestley JA expressed agreement with Handley JA, who had brought

> to light cases which both bear directly on the principal question of substance in this case and provide illustrations of my general theme of the anxiety of courts, by various techniques, to promote fair and reasonable contract performance.

He refused to incorporate those reasons as part of his 'own *ratio decidendi*' because 'it may raise matter not fully argued by the parties'. Accordingly, Priestley JA based his decision on a term implied in fact which required the principal to act reasonably when deciding whether the contractor had shown cause.[193]

Priestley JA was also of the view that a term could be implied in law.[194] He referred to a 'common class of contract' comprising contracts 'to build a work of some size' for a fixed price and in which express provisions regulating matters such as termination would commonly be included. Such a vague conception is unworkable as a basis for implication at law. And it was entirely beside the point. Since the implication (in fact) made by Priestley JA was not based on unique contextual features of the contract, the term would be implied in every use of the class of contract represented by the standard form. Accordingly, it operated as a term implied in law.

The conclusion in favour of the implied term of reasonableness was a reaction by Priestley JA to his construction of the clause. He said:[195]

> Thus for a completely trivial default the principal can give a notice to show cause. It is possible to imagine many situations in which, if a notice for some trivial breach were given the contractor might fail, as a matter of fact, to show cause within the specified period to the satisfaction of the principal why the powers should not be exercised

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191 Compare the wording of an earlier version of the clause considered in *Forestry Commission of New South Wales v Stefanetto* (1976) 133 CLR 507; 8 ALR 297 ('in the opinion of the Principal offers reasonable assurance that the default will be remedied').

192 (1992) 26 NSWLR 234 at 271.

193 Given that he alone took the implied term approach, the influence of *Renard* in the subsequent cases is nothing short of remarkable.

194 See (1992) 26 NSWLR 234 at 261-2.

195 (1992) 26 NSWLR 234 at 258.

> against him. (One obvious example would be where, through some mistake, the contractor's attempt to show cause was delivered late.)

There was, however, no logical basis for that construction. Although Handley JA also thought the clause was intended to be applied literally,[196] if he was correct in treating 'satisfaction' as subject to an objective standard there would be little point in issuing a show cause notice in respect of a minor breach. Even so, the commercial construction of the clause was that it was inapplicable to minor breach. The idea that the parties would work their way through the onerous details of the clause in respect of an insignificant breach seems unrealistic. The appropriate inference from the power of suspension, the detailed procedure which the clause included and the scope of the powers conferred, was that the parties did not intend the clause to be applied literally. Moreover, Priestley JA's 'obvious example' raised a different construction point: whether timely notice was a condition precedent to an entitlement to be heard. The example had no relevance to whether a minor breach of the building contract activated the clause. And whatever was meant by 'some mistake', the implied term did not deal with the point unless the assumption is made that acting reasonably included excusing failure by the contractor to comply with the clause.

Courts have always preferred to resolve the construction of termination clauses without getting into the details of administration of the contract. Commercial constructions of the trigger events have been preferred. Prior to the good faith cases, suggestions in favour of a requirement of reasonableness in the context of rights to terminate for breach were always rejected.[197] Indeed, courts have rarely been troubled by such arguments, dealing instead with attempts to extend principles of relief against forfeiture, and various other arguments all of which assume that reasonableness of exercise is quite irrelevant.[198] And in the long line of Australian cases in which the issue of penalty has been debated in the context of chattel leases containing

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196 See (1992) 26 NSWLR 234 at 279, a passage in which he treats the principal as entitled to exercise the rights conferred for any breach, glossing over the show cause aspect.

197 See, eg *Financings Ltd v Baldock* [1963] 2 QB 104 (explaining *Overstone Ltd v Shipway* [1962] 1 WLR 117). See generally J W Carter, *Carter's Breach of Contract*, LexisNexis Butterworths, Sydney, 2011 and Hart Publishing, Oxford, 2012 *(Hart Edition)*, §10-15.

198 See, eg *Scandinavian Trading Tanker Co AB v Flota Petrolera Ecuatoriana (The Scaptrade)* [1983] 2 AC 694; *Westminster Properties Pty Ltd v Comco Constructions Pty Ltd* (1991) 5 WAR 191 at 198 per Malcolm CJ (with whom Pidgeon J agreed).

termination clauses activated by minor breach, inquiring whether the owner must act reasonably has never been considered relevant.[199]

As did *Renard*, some of these cases concerned third party standard form contracts. Cases on the right of shipowners to withdraw a vessel for failure to pay hire on time formed part of the background to *Antaios Compania Naviera SA v Salen Rederierna AB (The Antaios)*.[200] The decision is a well-known illustration of commercial construction.[201] A time charterparty contract on the New York Produce Exchange form conferred a right to withdraw the vessel, 'failing the punctual and regular payment of the hire, ... or on *any breach of this charterparty*'. The italicised words were at issue. If the contract was applied literally, the shipowners were entitled to withdraw the vessel for any breach by the charterers, no matter how minor. However, the House of Lords held[202] that 'any breach' was to be applied as 'any repudiatory breach'. A similar conclusion was made by Burchett J in *Amann Aviation Pty Ltd v The Commonwealth*,[203] which, like *Renard*, concerned a show cause termination provision.[204]

Unfortunately, the implied term approach has been preferred in the good faith cases. It is very destabilising. Unresolved anomalies appear from comparison with several lines of High Court authority.[205] For example, unconscionability is not a

199 See, eg *AMEV-UDC Finance Ltd v Austin* (1986) 162 CLR 170; 68 ALR 185.

200 [1985] AC 191.

201 A passage in Lord Diplock's judgment (with whom the other members of the House of Lords agreed) [1985] AC 191 at 201 has been adopted as a key feature. See, eg *Francis v NPD Property Development Pty Ltd* [2005] 1 Qd R 240 at 257; [2004] QCA 343 at [42] per Williams J; *Maggbury Pty Ltd v Hafele Australia Pty Ltd* (2001) 210 CLR 181 at 198; 185 ALR 152; [2001] HCA 70 at [43] per Gleeson CJ, Gummow and Hayne JJ. See J W Carter, *The Construction of Commercial Contracts*, Hart Publishing, Oxford, 2013, §§13-46, 15-20, 15-23.

202 Agreeing with the conclusion of the arbitrators. See [1985] AC 191 at 201.

203 (1990) 92 ALR 601 at 629; cf at 616 per Sheppard J (affirmed *sub nom Commonwealth of Australia v Amann Aviation Pty Ltd* (1991) 174 CLR 64; 104 ALR 1).

204 However, the show cause notice was required to be issued by the Secretary of the Department of Transport, and Davies J and Sheppard J considered that the Secretary was required to have regard to the interests of the contractor. See (1990) 92 ALR 601 at 607, 617. See also on appeal (1991) 174 CLR 64 at 96; 104 ALR 1 per Mason CJ and Dawson J.

205 For a more detailed discussion see J W Carter and Elisabeth Peden, 'Good Faith in Australian Contract Law' (2003) 19 *JCL* 155.

general restriction on the exercise of rights.[206] That is sufficient to prevent reasonableness being a term implied in law. The good faith cases offer no explanation of why reasonableness does not limit a lessor's express right of re-entry for non-payment of rent. Indeed, even in cases where a court has jurisdiction to grant relief against forfeiture on the basis of unconscionable conduct, proof of unreasonable conduct is not sufficient. Most of the sale of land cases have concerned express provisions supported by an agreement that time is of the essence.[207] But whether or not that is the case, relief against forfeiture illustrates a narrow restriction on termination. Unlike the term which has been implied in the good faith cases relying on *Renard*, the onus is on the promisee. The lack of coherence in the law is patent.

(f) Termination where no Breach

The High Court's position in relation to express rights not activated by breach is clear. It is illustrated by cases such as *Carr v J A Berriman Pty Ltd*.[208] The scope of the principal's express right to omit certain work from a building contract was a question of construction. The right did not include omitting the work for the purpose of having it done by another contractor. The role for good faith in this context is also clear. Issues of construction are resolved by reference to the purpose for which the right was inserted in the contract.[209] However, in relation to rights of termination, it should be anticipated that the purpose may simply be to provide an unqualified right the exercise of which calls for no justification.[210] Nevertheless, the good faith cases have required reasonableness in this context as well.

Hughes Bros Pty Ltd v Trustees of the Roman Catholic Church for the Archdiocese of Sydney[211] concerned the standard form considered in *Renard*. Under the relevant clause, the principal was entitled to take over the work, or to terminate

206 Mason CJ's suggestion in *Sunbird Plaza Pty Ltd v Maloney* (1988) 166 CLR 245 at 263; 77 ALR 205, that a restriction of that nature might be developed, has never been taken up by the High Court. (Deane, Dawson and Toohey JJ agreed with Mason CJ.)

207 See, eg *Tanwar Enterprises Pty Ltd v Cauchi* (2003) 217 CLR 315; 201 ALR 359; [2003] HCA 57 (explaining *Legione v Hateley* (1983) 152 CLR 406; 46 ALR 1).

208 (1953) 89 CLR 327. See also *Commissioner for Main Roads v Reed & Stuart Pty Ltd* (1974) 131 CLR 378; 4 ALR 571.

209 Cf *British Equitable Life Assurance Co Ltd v Baily* [1906] AC 35 at 42 per Lord Lindley (principle applicable to all 'powers').

210 See *Reda v Flag Ltd* [2002] IRLR 747; [2002] UKPC 38 at [42]-[43] per the court.

211 (1993) 31 NSWLR 91.

the contract, if the contractor suffered an act of bankruptcy. That included any proceeding 'which has as an object or may result in the winding up' of the contractor. By contrast with the clause at issue in *Renard*, there was no show cause element. Accordingly, while proceedings which Priestley JA described[212] as 'winding up proceedings' were on foot, the principal gave notice taking over the work. The majority held that *Renard* required the principal to establish that it had acted reasonably.

In *Renard*, Handley JA had said[213] that even if the principal established reasonable dissatisfaction with the contractor's response, reasonableness would also have governed its decision on what to do. Priestley JA said[214] that the term which he implied would also have operated in that situation. It is not easy to justify these statements. The clause expressly related satisfaction to whether the powers conferred by the clause should not be exercised. By definition, in those circumstances the principal was entitled to act.[215] Even though the statements in *Renard* were unnecessary to the decision, the majority in *Hughes* treated them as part of the *ratio* of the case.[216] Therefore, in deciding whether to exercise any of the 'powers' which had become available — and which power — the principal was required to act reasonably. But Priestley JA said[217] that in most cases it would 'not be difficult' for the principal to 'fulfil' what he described as the reasonableness 'obligation'.

Unfortunately, in the eagerness to extend *Renard*, a basic point is lost sight of in the analysis in *Hughes*. Logically, adoption of the *obiter* statements in *Renard* meant that the principal was required to establish that it had acted reasonably in taking over the work, not in deciding whether the clause had been activated. However, Priestley JA opined on what the principal had to do to determine whether the proceedings were *reasonably brought* by the third party. Accordingly, he considered

212 (1993) 31 NSWLR 91 at 103.

213 See (1992) 26 NSWLR 234 at 280.

214 See (1992) 26 NSWLR 234 at 257. But cf (1993) 31 NSWLR 91 at 93-4 per Kirby P.

215 Compare *Council of the City of Sydney v Goldspar Australia Pty Ltd* (2006) 230 ALR 437 at 510; [2006] FCA 472 at [193] per Gyles J ('air of unreality' in implying further term where contractor has not shown reasonable cause).

216 Contrast (1993) 31 NSWLR 91 at 104 per Meagher JA.

217 (1993) 31 NSWLR 91 at 101.

that, before giving any notice, the principal was required to make an informed judgment as to whether the contractor might defeat the proceedings.[218] With respect, it might be suggested that this was the very thing which the clause was intended to avoid.

Priestley JA also referred[219] to the possibility of a 'vexatious and unfounded proceeding', and to a situation in which the 'principal has engineered ... the commencement of the proceedings'. With respect, these statements relate to matters which were irrelevant to whether the principal had acted reasonably in taking over the work. Clearly enough, the clause would not have been triggered by proceedings which were 'vexatious and unfounded', or 'engineered' by the principal. In light of the ability of a court to control abuse of process, Meagher JA described[220] as 'fanciful' the idea that notice could be given in respect of vexatious proceedings.

Finally, it was contemplated that, in order to establish reasonable conduct, the principal might have to postpone its decision and obtain information from the contractor, so as to make a reasonable judgment as to the likely success of the proceedings. If the contractor was engaged in negotiations to settle the proceedings, the principal might be required to give the contractor an opportunity to conclude those negotiations. In effect, therefore, Priestley JA required the principal to undertake a procedure which, although analogous to that of the show cause provision, did not exist.[221] And, again, it could only be relevant in a case where there was some reasonable doubt as to whether the proceedings might result in a winding up.

In fact, the court never addressed the question whether the principal had acted reasonably in taking over the work. Priestley JA referred to the contractor's failure to put in issue the belief of the principal in relation to the matters set out in its notice, the fact that the failure of the contractor to pay sub-contractors had led to the proceedings and that the principal had acted bona fide when disputing claims for payment made by

218 See (1993) 31 NSWLR 91 at 102.

219 (1993) 31 NSWLR 91 at 102.

220 See (1993) 31 NSWLR 91 at 104.

221 Perhaps that is why in *Strzelecki Holdings Pty Ltd v Cable Sands Pty Ltd* (2010) 41 WAR 318 at 350; [2010] WASCA 222 at [99] Murphy JA, in a passage which wrongly attributes certain observations of Priestley JA to Handley JA (who was not a member of the court), treats the decision as involving a show cause procedure.

the contractor. Those facts established honesty, not reasonableness. And they related principally, if not solely, to whether, in the circumstances, the clause had been triggered.

The influence of *Renard* (and *Hughes*) has been considerable. A requirement of reasonable conduct has also been implied, or assumed to be implied, in cases where the contract entitles one party to terminate by giving notice of a specified duration,[222] even if the contract includes an express obligation to compensate the other party.[223] What the cases do not explain is how courts can imply terms in the commercial context when for so long the law has refused to recognise any default rule of reasonableness. And it seems incoherent that no requirement of reasonableness applies to an employer who dismisses an employee without cause, in the exercise of an express right or by giving reasonable notice.[224]

7. Conclusions

More than 25 years ago, Professor Lücke perceptively regarded good faith as a concept which could play a role in addressing the overly literalistic approach of Australian courts to the construction of contracts.[225] That has certainly been the impact of the good faith cases. But because the commitment to the concept has varied, there has been nothing approaching consistency in application. The law is incoherent.

It is regrettable that the High Court has not considered the good faith cases. Since they do not have the imprimatur of the High Court, lower courts which have promoted good faith as if it were a distinct concept have simply taken to themselves a 'jurisdiction' to do so. If nothing else, it exposes the obvious inability of the High

222 See *Dickson Property Management Services Pty Ltd v Centro Property Management (Vic) Pty Ltd* (2000) 180 ALR 485 at 487; [2000] FCA 1742 at [11] per Ryan J (whether it was 'unreasonable' to terminate services contract under 90 days' notice provision for purpose of contracting with supplier who would charge a lower price a serious question to be tried).

223 As under a termination for convenience clause. See *GEC Marconi Systems Pty Ltd v BHP Information Technology Pty Ltd* [2003] FCA 50 at [753] per Finn J; *Kellogg Brown & Root Pty Ltd v Australian Aerospace Ltd* [2007] VSC 200.

224 See, eg *Byrne v Australian Airlines Ltd* (1995) 185 CLR 410 at 429; 131 ALR 422 at 433 per Brennan CJ, Dawson and Toohey JJ (implied term); *Reda v Flag Ltd* [2002] IRLR 747; [2002] UKPC 38 at [43], [57] per the court; *Russell v Trustees of the Roman Catholic Church for the Archdiocese of Sydney* (2008) 72 NSWLR 559 at 567; [2008] NSWCA 217 at [32] per Basten JA (with whom Giles and Campbell JJA agreed).

225 See H K Lücke, 'Good Faith and Contractual Performance' in P D Finn, ed, *Essays on Contract*, 1987, p 155.

Court to give effect to its view that no other court can create new rules of law. There are simply too few High Court cases in contract for it to keep the law up to date. That is one reason why commercial construction is so important. Construing contracts to achieve commercially sensible results does have the imprimatur of the High Court. At the moment it seems we have to put up with the worst of both worlds: cases adopting an overly literal approach to construction but at the same time, but not coherently, conjuring up implied terms with the object of contradicting the literal construction of the contract.

In arguing against the good faith cases I have not sought to put forward the view that the underlying concept sets the limits for good faith in contract. Rather, the point is that solutions to what some judges have perceived as good faith problems should come from within, and not be imposed as if good faith was some sort of 'sweeper' to be called on to control unfair contracts. It is, as the good faith cases show, too destabilising to draw on an ethereal concept to imply terms which contradict what the court says the contract means.

In this regard, I think that three things stand out about the good faith cases. First, it is by no means clear that a good faith term was necessary. The conclusions in the cases discussed would have been just the same even if no terms had been implied. The majority view in *Renard* was that the construction of the contract showed that the principal had not acted in accordance with its terms. On the evidentiary findings in *Hungry Jack's*, no implied term other than the co-operation term was necessary. The implication of that term was not controversial. In *Hughes*, where the court went out of its way to arrive at an implied term which was wholly counter-intuitive, the implication had no impact. Implying terms which are either unnecessary or broader than necessary creates incoherence through legal error.

Second, by implying terms which not only fail to satisfy the applicable rules but also go beyond what is *necessary* to deal with the matter at issue, the good faith cases have done a great disservice to the law. The scope of the terms can be traced directly to conclusions on construction which were neither fully reasoned nor tested for consistency with decisions of the High Court. From the broader perspective of the relationship between implied terms, the underlying concept and established principles in relation to the operation of express rights, this has led to a degree of legal

incoherence which is quite intolerable in the commercial context. It is not simply destabilising, it has the potential to undermine the law of contract as a whole.

Third, it follows that, unfortunately, Professor Lücke's prediction[226] that there is 'no reason to fear that Australian judges, if armed with a good faith standard, would use it in an undisciplined way', has not come to pass.[227]

226 See H K Lücke, 'Good Faith and Contractual Performance' in P D Finn, ed, *Essays on Contract*, 1987, p 166.

227 Cf *Holt v Markham* [1923] 1 KB 504 at 513 per Scrutton LJ.