



Good Faith in Australian Contract Law

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This article seeks to address and arrest the recent judicial trend to reduce 'good faith' in contract law to an implied term with a vague and inappropriate meaning. The authors argue that good faith is inherent in all common law contract principles, and that an attempt to imply an independent term requiring good faith is both unnecessary and a retrograde step. The article further discusses the meaning of 'good faith', which requires a sophisticated understanding of the meaning of 'honesty'. Further, the problems with defining 'good faith' as including 'reasonableness' and 'unconscionability' are outlined.

Introduction

To say that the role of good faith in Australian contract law is currently unsettled and that the law is in a state of flux would be an understatement. It may be closer to the mark to say that it is in a state of utter confusion. However, it would appear that Australian contract law is rapidly moving towards three propositions.

First, in most contracts (perhaps all contracts) a requirement of good faith must be implied, at least in connection with termination pursuant to an express term of the contract, but perhaps more generally.

Second, where it is present, the source of the implied requirement of good faith is an implied term of the contract.

Third, the implied requirement of good faith is satisfied by a party who has acted:

- honestly; and
- reasonably.

Judicial support for these three propositions is found, mainly, in recent cases purporting to apply the decision of the New South Wales Court of Appeal in *Renard Constructions (ME) Pty Ltd v Minister for Public Works*.¹ In *Renard* it was held that the ability of the principal under a building contract to rely on a show cause procedure was subject to requirements of reasonableness. Priestley JA said:²

The contract can in my opinion only be effective as a workable business document under which the promises of each party to the other may be fulfilled, if the subclause is read in the way I have indicated, that is, as subject to requirements of reasonableness.

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1 (1992) 26 NSWLR 234 (hereafter *Renard*).

2 (1992) 26 NSWLR 234 at 258.

It is because this requirement of reasonableness has in the subsequent cases been rationalised by reference to good faith that Australian courts have come to regard reasonableness as a key ingredient of good faith.

There is also considerable support for a requirement of good faith (although not necessarily the element of reasonable conduct) in academic writings.³ Indeed, it has even been suggested that the law should go further than the three propositions require; for example, by treating the implied term as 'entrenched', that is, non-excludable.⁴

Our purpose in writing this article is not to deny that a requirement of good faith is part of Australian contract law. Rather, our concern is to show:

- (1) that the first of the three propositions stated above has been misunderstood in a most fundamental way; and
- (2) that the two other propositions are wrong, at least in the sense they have been applied in the recent cases, including those relying on *Renard*.

At an abstract level this requires a position to be taken on two matters. First, is good faith an independent concept or something which is inherent in the institution which we call 'contract'? Our thesis is that good faith is not an independent concept as much as something which is inherent in contract law itself and therefore a concept which must be taken into account when interpreting a contract, determining the scope of contractual rights and so on. In short, good faith informs all of contract law and if a particular rule or principle is not producing results which are consistent with our current understanding of good faith, then there is something wrong with the rule or principle.

Second, what is the content of the good faith requirement? Our thesis here is simply that this depends on the scope of 'honesty' as a concept. One reason why the law is currently in such a confused state is, in our view, because of a failure to appreciate that 'honesty' means much more than a requirement that parties not act fraudulently towards each other. It is, of course, difficult to express the scope of the concept in abstract terms. This is because the characteristics which conduct must have to be honest conduct will depend on the circumstances. This, when combined with the fact that some aspects of good faith are usually expressed in negative terms, has led some to suggest theories under which good faith must be analysed in terms of whether it is merely an 'excluder', that is, a requirement which does not involve any

3 See, eg R Powell, 'Good Faith in Contracts' [1956] 9 *CLP* 16; H K Lücke, 'Good Faith and Contractual Performance' in *Essays on Contract*, P D Finn (ed), LBC, Sydney, 1987; The Hon Mr Justice Steyn, 'The Role of Good Faith and Fair Dealing in Contract Law: A Hair-Shirt Philosophy?' [1991] *Denning LJ* 131; J W Carter and M P Furmston, 'Good Faith and Fairness in the Negotiation of Contracts' (1994) 8 *JCL* 1 and (1995) 8 *JCL* 93; R Brownsword, 'Two Concepts of Good Faith' (1994) 7 *JCL* 197; J Beatson and D Friedmann, 'Introduction: From "Classical" to Modern Contract Law' in *Good Faith and Fault in Contract Law*, J Beatson and D Friedmann (eds), Clarendon, Oxford, 1995.

4 N C Seddon and M P Ellinghaus, *Cheshire & Fifoot's The Law of Contract*, 8th Aust ed, Butterworths, Sydney, 2002, para 10.43; Paul Finn, 'Equity and Commercial Contracts: A Comment' [2001] *AMPLA Yearbook* 414 at 418; however, see Finn J in *GEC Marconi Systems Pty Ltd v BHP Information Technology Pty Ltd* [2003] FCA 50 (12 February 2003), at paras 918–20 recognising the limits of the implied term approach.

positive duties.⁵ In our view such discussions are quite pointless. ‘Good faith’ sets a standard which is sometimes positive in its orientation and sometimes negative, but just as any condition subsequent can be expressed as a condition precedent, so also can every negative orientation of good faith be expressed in positive terms. It is all a matter of words. However, because we do not see good faith as an independent concept, the good faith content of contract law will in our view depend on the particular rule or principle and, indeed, the terms of each contract. On analysis it will be found that characteristics which conduct must have to be honest will necessarily include:

- (1) not acting arbitrarily or capriciously;
- (2) not acting with an intention to cause harm; and
- (3) acting with due respect for the intent of bargain as a matter of substance not form.

Because it is not a fixed concept, good faith may, in particular cases, embrace other things as well. In the context of contract performance and the exercise of discretions and rights, the presence of good faith will be felt in the process of interpretation. Depending on the term in question, good faith may include:

- (1) acting for a proper purpose;
- (2) consistency of conduct;
- (3) communication of decisions;
- (4) cooperation with the other party; or
- (5) consideration of the interests of the other party.

Absent from these lists is a requirement of ‘reasonableness’. With respect to those who think otherwise, we do not think it even arguable that for a party to a contract to act in good faith it must discharge a positive obligation to act ‘reasonably’. Therefore, to the extent that good faith is a general requirement applicable to all contracts it does not include a requirement of reasonable conduct.

As we will explain, the most important device for ensuring that good faith considerations are upheld in the application of contract rules and principles to particular contracts is ‘commercial construction’. The recent cases rely heavily on the implication of a term of good faith, but in our view the better approach is to give effect to the intention of the parties. Properly applied, commercial construction will achieve a result which is consistent with the underlying requirement of good faith. It is, moreover, a technique that has been in use for some time. As we will explain, it usually makes recourse to term implication quite unnecessary.⁶

⁵ The ‘classic’ explanation along these lines is by Robert S Summers, “‘Good Faith’ in General Contract Law and the Sales Provisions of the Uniform Commercial Code” (1968) 54 *Va L Rev* 195. This definition has received some judicial support in Australia, including being favoured by Priestley JA in *Renard* (1992) 26 NSWLR 234 at 266. The New South Wales Court of Appeal also mentioned it with seeming approval in *Burger King Corp v Hungry Jack’s Pty Ltd* [2001] NSWCA 187 (21 June 2001), at para [149].

⁶ On the interaction between construction and implication approaches see Elisabeth Peden, *Good Faith in the Performance of Contracts*, Butterworths, Sydney, 2003, ch 2; paras 6.10–6.19.

Good Faith as the Essence of Contract

Before turning to more specific objections to recent Australian decisions, we should explain why we view much of the discussion in the recent cases as quite misconceived. It is simply that, because good faith is inherent in all aspects of contract law, there is generally no need for any good faith term to be implied, and so the first proposition is a fallacy. Although this is not simply a disagreement with methodology, the fact that the wrong methodology has been employed has led to the implication of a requirement of good faith having a content which is far too onerous and is, indeed, inconsistent with key features of the institution itself.⁷

Every aspect of contract law is, or should be, consistent with good faith because good faith is the essence of contract. On that basis, illustrations of good faith in contract are infinite. One criticism of the recent cases is their failure to acknowledge the good faith element of contract rules. Thus, although it has sometimes been recognised that many rules of contract law give expression to ideas that can only be explained in terms of good faith,⁸ the implications of this may not have been fully understood or appreciated in the recent Australian cases.

For our purposes it is sufficient to provide seven illustrations by marching through the life of a contract. We make no apology for the fact that many of these examples are obvious, even trite, because part of our objective is to underline that contract law is redolent with good faith.

First, where an offer is not supported by consideration it gives rise to no contractual obligations. It merely serves to confer a right on the offeree. The law of contract is not concerned to hold an offeror to an unaccepted offer. However, it is concerned to ensure that the offeror acts in good faith. Thus, the ability of an offeror to withdraw an offer at any time prior to acceptance is qualified by the requirement that the revocation be communicated, so that the revocation does not take effect until communicated, or at least until the offeree obtains knowledge of revocation from a reliable source.⁹ Because an offer does not create any legal obligations, what justification can there be for the requirement that the revocation be communicated? In our view it can only be good faith, that is, that elementary considerations of honesty and fairness require the right of revocation to be qualified.¹⁰ Mention might be made of

⁷ This was basically Kirby J's concern with the idea of incorporating good faith in *Royal Botanic Gardens and Domain Trust v South Sydney City Council* (2002) 186 ALR 289 at 311–12.

⁸ Cf *Stocznia Gdanska SA v Latvian Shipping Co* [1996] 2 Lloyd's Rep 132 at 139 (varied without reference to the point [1998] 1 WLR 574).

⁹ With the result that an offeror who has posted a letter of revocation is contractually bound to an offeree who has already posted a letter of acceptance: *Byrne v Van Tienhoven* (1880) 5 CPD 344.

¹⁰ Calls for a doctrine of 'firm offer' to be part of Australian law (cf United Nations Convention on Contracts for the International Sale of Goods (1980), Art 16) while in one sense simply calls for a more onerous good faith standard, are problematic because of the requirement of consideration. In other words, the law cannot regard a person as acting contrary to good faith merely because they rely on the requirement of consideration. But concepts such as promissory estoppel fulfil a limiting role, and reduce the need to abolish the requirement of consideration.

other rules, including the rule in *Felthouse v Bindley*.¹¹

Second, where an agreement contains a provision to the effect that the parties' agreement is 'subject to' some requirement, such as finance or approval,¹² the question may arise whether the provision states a condition precedent. If it does — which will usually be the case — the further question may arise whether fulfilment of the condition is necessary for a contract to exist or the clause merely conditions the parties' performance obligations. If the parties have not expressly stated the position, a court must infer (or impute) an intention. Although that is purely a question of construction, in reaching a decision no court can ignore the fact that if the condition precedent is treated as qualifying the existence of a contract either party may withdraw while the contingency remains unfulfilled. However, the position, at least in Australia, is that if the parties have not expressly dealt with the matter the condition precedent will be interpreted as qualifying the parties' performance obligations, not the existence of a contract. As has been pointed out¹³ the effect of adopting this approach is to prevent withdrawal from negotiations on a ground not related to the agreed event. This is good faith pure and simple.

Third, consider the rules on the implication and incorporation of terms. We would not have a doctrine (or perhaps several doctrines) of implied terms if good faith were not an essential ingredient of contract law. How else could the concept of a term implied in law ever have evolved? The principal objective of that concept is to ensure that (subject to the parties' agreement) there is a minimum level of obligation,¹⁴ or to complete an otherwise incomplete agreement by reference to what the parties, acting in good faith, are presumed to have intended. Conversely, of course, if an implied term of good faith is present in all contracts, in many of the cases in which a term has been implied in law,¹⁵ no implication was necessary because the good faith implication would have dealt with the matter. We would note in passing that if good faith did involve a requirement of reasonableness the whole law of implied terms would be different: reasonableness (not necessity) would be a sufficient basis for implication.¹⁶ As we explain below,¹⁷ many of the recent cases in which terms have been implied contradict the rules on the implication of terms, for example, by the implication of a term which deals with a matter already sufficiently dealt with by the contract. In short, many of these implications have either been unnecessary or contrary to law.

In the context of the incorporation of terms by notice it is well-established that 'reasonable' notice must be given. It is now also clear that good faith is an appropriate test for determining the precise form or content of 'reasonable

11 (1862) 11 CBNS 869; 142 ER 1037.

12 We put 'subject to contract' to one side, on the basis that it is governed by special rules.

13 See J W Carter and M P Furmston, 'Good Faith and Fairness in the Negotiation of Contracts — Part I' (1994) 8 *JCL* 1 at 14–15.

14 Cf *Byrne v Australian Airlines Ltd* (1995) 185 CLR 410 at 450; 131 ALR 422 at 450 per McHugh and Gummow JJ ('concern of the courts that, unless such a term be implied, the enjoyment of the rights conferred by the contract would or could be rendered nugatory, worthless, or, perhaps, be seriously undermined').

15 See, eg *Liverpool City Council v Irwin* [1977] AC 239.

16 For a discussion of the test of implication in law see Elisabeth Peden, 'Policy Concerns in Terms Implied in Law' (2001) 117 *LQR* 459.

17 Text at n 30ff.

notice'. The judgment of Bingham LJ in *Interfoto Picture Library Ltd v Stiletto Visual Programmes Ltd*¹⁸ is an illustration of the overt recognition of the role of good faith in this context. He said:¹⁹

The well-known cases on sufficiency of notice are . . . [at] one level . . . concerned with a question of pure contractual analysis, whether one party has done enough to give the other notice of the incorporation of a term in the contract. At another level they are concerned with a somewhat different question, whether it would in all the circumstances be fair (or reasonable) to hold a party bound by any conditions or by a particular condition of an unusual and stringent nature.

In the result — as an impact of good faith — the 'more outlandish the clause the greater the notice which the other party'²⁰ is entitled to receive.

Fourth, moving on to the law of interpretation — the very heart of contract law — whatever else may be said about the modern approach to construction ('commercial construction'), it is clear that it is concerned to ensure good faith. The modern rationalisation of the established fact that interpretation is an objective process is a concern to insulate each contracting party from the other's subjective (but uncommunicated) intention. No concept other than good faith itself is needed to justify this approach. Again, we should note in passing that while courts are concerned to adopt reasonable interpretations, and view with suspicion alleged interpretations which are objectively unreasonable, it is clear law that a 'court has no jurisdiction to reject an interpretation, clearly intended by the parties, merely because it is in its view unreasonable or because it produces unreasonable results'.²¹

Fifth, there is the law on vitiating factors. Much of this is not strictly contract law, in that the definition of concepts such as 'misrepresentation' and 'unconscionable conduct' does not depend on contractual principles. Nevertheless, because these are the concepts by reference to which parties are required to justify unilateral decisions to resile from a contract, and because good faith is the essence of contract, commonsense tells us that if one party has by its conduct signalled bad faith it is likely that the law will permit rescission of the contract. Thus, the law on misrepresentation and some aspects of mistake clearly embody good faith. Significantly, however, the law of misrepresentation does not generally impose a positive obligation of disclosure, even though from the representee's perspective that would be a 'reasonable' approach. In other words, good faith requires a party to act honestly (which includes ensuring that representations are accurate), but it falls short of requiring a party to volunteer information for the benefit of the other party, whether or not this would be to their own disadvantage. It is for that reason that the duty of disclosure in the context of fiduciaries and insurance proposals is termed a duty of 'utmost' good faith. It is the epithet 'utmost' (not good faith) which distinguishes a proponent's position from that of others who negotiate contracts. Indeed, unless some specific content is given to 'utmost', implication of a requirement of good faith in the

¹⁸ [1989] QB 433.

¹⁹ [1989] QB 433 at 439.

²⁰ [1989] QB 433 at 443.

²¹ J W Carter and D J Harland, *Contract Law in Australia*, 4th ed, Butterworths, Sydney, 2002, para 704.

performance of all contracts must, in effect, assimilate all contracts with contracts of insurance.²²

Logically, the next areas in which to note the role of good faith are performance and the exercise of rights. However, since that is the heartland of the recent cases on good faith, we prefer, for the moment, to move on. Thus, the sixth area to mention briefly is frustration. At one time it was thought that a promise expressed in absolute terms should be interpreted as absolute in effect, so that except in cases of genuine impossibility (and even that is a modern development), if the promise could not be performed, compensation would be payable even though the promisor was in no sense 'responsible' for its inability to perform. Nowadays, however, it is clear that a party may be discharged by the occurrence of an event over which it has no control even though it is not literally impossible to perform the contract and notwithstanding that its promises are expressed in absolute terms. Such cases of frustration give effect to a community concern that parties should not be required to perform come hell or high water. Instead, good faith requires that the parties' obligations should be interpreted by reference to realities.²³ There is, therefore, a 'default rule' under which the parties to a contract will be discharged if the requirements set out in Lord Radcliffe's classic statement of principle in *Davis Contractors Ltd v Fareham Urban District Council*²⁴ are satisfied.

Whether this principle of frustration is termed 'construction', the operation of a 'constructive condition'²⁵ or based on some other theory does not matter: at the end of the day the ultimate rationale is good faith. Thus, in a passage which immediately precedes his statement in *Davis Contractors Ltd v Fareham Urban District Council*,²⁶ Lord Radcliffe, having canvassed the various explanations for frustration to be found in the earlier cases, said:²⁷

By this time it might seem that the parties themselves have become so far disembodied spirits that their actual persons should be allowed to rest in peace. In their place there rises the figure of the fair and reasonable man. And the spokesman of the fair and reasonable man, who represents after all no more than the anthropomorphic conception of justice, is and must be the court itself.

'Frustration', as a concept, is a judicial construct designed to prevent injustice. Expressed in terms of good faith, good faith requires each party to respect the

22 Cf *Trans-Pacific Insurance Co (Australia) Ltd v Grand Union Insurance Co Ltd* (1989) 18 NSWLR 675 which ignores the important distinction between a standard bilateral contract and an aleatory contract. The duty of utmost good faith finds its primary expression in the duty of disclosure. However, it does extend further. For example, in the context of insurance, an unreasonable delay by the insurer in paying a claim is a breach of the duty: see eg *Moss v Sun Alliance* (1990) 93 ALR 592. See also generally, F Hawke, 'Utmost Good Faith — What Does it Really Mean?' (1994) 6 *Ins LJ* 91; C Tay, 'The Duty of Disclosure and Materiality in Insurance Contracts — a True Descendant of the Duty of Utmost Good Faith?' (2002) 13 *Ins LJ* 183.

23 To treat *Paradine v Jane* (1647) Aleyn 26; 82 ER 897 as a starting point (*F C Shepherd & Co Ltd v Jerrom* [1987] QB 301 at 321) for the consideration of a frustration allegation today is to ignore completely the impact of good faith.

24 [1956] AC 696 at 729.

25 E W Patterson, 'Constructive Conditions in Contracts' (1942) 42 *Col LR* 903.

26 [1956] AC 696 at 729.

27 [1956] AC 696 at 728.

substance of the bargain struck and neither can call upon the other to perform in circumstances which are 'radically different' from those contemplated by the parties in their bargain.

Turning finally to remedies, it is obvious that the rule in *Hadley v Baxendale*,²⁸ because it is rooted in the 'contemplation' of the parties, is a limitation on damages recovery that is based on good faith. That is particularly true of the second limb of the rule, namely, that a party may recover such damages 'as may reasonably be supposed to have been in the contemplation of both parties, at the time they made the contract, as the probable result of the breach of it'. Courts have interpreted this as requiring communication of special circumstances. In other words, a party who wishes to recover in respect of an unusual loss must (at least) have communicated the risk that the loss would be sustained prior to entry into the contract, because good faith implies that a party should be given the opportunity to decline to contract on that basis. Another illustration is the concept of mitigation. The idea that a party should not be entitled to recover increases in its loss or damage attributable to 'unreasonable' conduct gives effect to good faith, and the placement of the onus of proof reflects the basic tenet that good faith does not require one party to act in the interests of the other.²⁹

One important conclusion to be drawn from this very brief analysis is that if the application of a particular rule or principle of contract law does not produce behaviour which is in accordance with what society requires — in the name of good faith — then there must be something wrong with that rule or principle, and it is that defect which needs to be remedied. Of course, good faith could be used in a general supervisory role, and it might be argued that this is what the recent cases are doing. But, for several reasons, it is in our view far better to amend the rule. Three reasons are as follows.

First, the risk that the solution will have greater impact than necessary is avoided. It seems clear that this has been one result of the recent cases.

Second, it creates less uncertainty. It seems clear from the cases and experience that because the courts have fixed upon a requirement of reasonableness in the context of termination that virtually every termination of a contract may be challenged. This is creating far too much (unnecessary) uncertainty.

Third, good faith, as applied in the recent cases works (if at all) in relation to the symptom but not the cause of the problem — real or perceived.

The Implied Term of Good Faith

Given the illustrations which we have noted of good faith as a concept or requirement underlying contract law, surely we must ask, do we really need an implied term of good faith? Nevertheless, as we have indicated, in a large number of recent Australian cases, judges have held or (more commonly) suggested that the requirement of good faith and reasonableness in the

28 (1854) 9 Ex 341 at 354; 156 ER 145 at 151.

29 See also the discussion in J W Carter, Andrew Phang and Sock-Yong Phang, 'Performance Following Repudiation: Legal and Economic Interests' (1999) 15 *JCL* 97 of the appropriate rationale for Lord Reid's 'legitimate interest qualification' in *White and Carter (Councils) Ltd v McGregor* [1962] AC 413 at 431.

exercise of rights arises from an implied term (or terms) of the contract.³⁰ This implied term has been treated in some cases as one implied in fact; however, more recently courts (especially in New South Wales) seem to prefer the idea that the term should be regarded as one implied in law.³¹ In this section we argue that all such decisions are either wrong or proceed on an illegitimate or misconceived basis. It seems obvious that because good faith is already inherent in contract doctrines, rules and principles, if a court implies a term of good faith the court is either implying a redundant term or implying a term which, by definition, must impose a more onerous requirement. Such a term must surely be justified by reference to particular circumstances and not general principle. In other words, we do not deny that in some cases it will be appropriate to imply a term which imposes a higher standard of good faith than the law otherwise requires, but it will necessarily have to satisfy the well-established rules for implication and will be a rare phenomenon. In relation to the cases which suggest that a term of good faith is implied in law, it is sufficient to say that such an implied term merely creates a default rule, and since that default rule already exists it is also an illegitimate implication. But it is also puzzling that courts should think it necessary to use the terminology of implied term in relation to something which is (ex hypothesi) part of every contract!

There are some that suggest that good faith is a universal term that cannot be excluded expressly by the parties.³² There are several problems with this suggestion. First, a term cannot be implied if it is inconsistent with the contract; there would be no 'gap' to fill, so that such a term would immediately render invalid provisions which in the past have been regarded as inherently valid, or render invalid particular and familiar kinds of terms (for example, forfeiture clauses) which are already the subject of specific validity criteria. The only implied terms that cannot be excluded are those incorporated by legislation which expressly or impliedly prohibits exclusion, and terms which it would be contrary to public policy to exclude. Examples include terms implied in consumer sales under the Trade Practices Act 1974 (Cth). Second, the public policy prohibition is currently extremely narrow, and any public policy prohibition on the exclusion of an implied obligation of good faith would need to be of limited effect since it would otherwise have a significant and quite unpredictable impact on the considerable freedom of contract which currently exists in the commercial context. In this respect it is unthinkable that a contracting party should be prohibited by the common law from agreeing to a term which is inconsistent with the standard of reasonableness that good faith is said to involve. Therefore, to suggest that despite a clear intention to the contrary, the parties could not exclude or modify an obligation to perform

30 For an overview see Elisabeth Peden, 'Incorporating Terms of Good Faith in Contract Law in Australia' (2001) 23 *Syd LR* 222; Elisabeth Peden, *Good Faith in the Performance of Contracts*, Butterworths, Sydney, 2003, paras 6.10–6.19.

31 See, eg *Burger King v Hungry Jack's Pty Ltd* [2001] NSWCA 187, at [164]; *Alcatel Australia Ltd v Scarcella* (1998) 44 NSWLR 349 at 369 per Sheller JA (with whom Powell and Beazley JJA agreed). Cf *Renard* (1992) 26 NSWLR 234 at 263 where Priestley JA seemed to conceive of a 'hybrid' term.

32 See above, n 4.

in good faith is contrary to the current state of law.³³ It would also be a retrograde step to introduce this restriction.

Consideration of implied terms is as much a methodology issue as it is a legal issue. Take frustration for instance. Whether the occurrence of an event frustrates a contract depends on the intention of the parties. Originally this was explained by recourse to an implied term.³⁴ The impact of *Davis Contractors Ltd v Fareham Urban District Council* has been for the courts to rely simply on construction. This reflects a higher level of confidence or maturity, as well as a dislike for fictions.³⁵ Part of our thesis is that because contract is a mature institution, good faith operates without the need for an implied term. Unfortunately, in the context of good faith we are seeing exactly the reverse of what occurred in relation to frustration: lack of confidence that construction of a contract will give effect to good faith concerns has led to the implication of terms. From another perspective, the cases implying a term of 'good faith' should in our view be seen as engaging in subterfuge. That subterfuge is the use of good faith as a rationale for a much more specific implication, such as that a party act reasonably when exercising an express right of termination. Of course, that specific implication would be difficult to reconcile with authority, and the attraction of 'good faith' is that it enables a judge to reach a result that authority would not otherwise permit.

Fictional recourse to the officious bystander might in the context of frustration have been avoided by treating the term as implied in law rather than one implied on a factual basis. However, since such a term is non-promissory in character, term implication would have been a pointless exercise: the legal position is simply that frustration depends on the interaction between a default rule and the terms of the contract. The same point can in our view be made in relation to suggestions that good faith is a term implied in law into all contracts.

It therefore follows from the analogy with frustration that one reason why a good faith term should not be implied is that it is otiose. We would say, simply, that in the vast majority of cases the implication has infringed the consistency rule because it deals with a matter already sufficiently dealt with by the contract. An interesting example of that rule is *Hospital Products Ltd v United States Surgical Corp.*³⁶ An implied term that a distributor would not do anything which was inimical to the manufacturer's market was not a valid implication where there was an express term that the dealer would devote his best efforts to distributing the company's products. Dawson J referred without disapproval to the finding of the trial judge that the contract contained a good faith obligation to the same effect as §205 of the Restatement (Second) Contracts (1979), which provides that every contract is regarded as including

33 See eg *GSA Group v Siebe Plc* (1993) 30 NSWLR 573, where Rogers CJ Comm D refused to incorporate an obligation of good faith into the contract because of its nature. The parties were commercial entities of equal bargaining power and 'able to look after their own interests'.

34 See *Taylor v Caldwell* (1863) 3 B & S 826 at 833–4; 122 ER 309 at 312 per the Queen's Bench.

35 Cf *Hongkong Fir Shipping Co Ltd v Kawasaki Kisen Kaisha Ltd* [1962] 2 QB 26 at 71 per Diplock LJ.

36 (1984) 156 CLR 41; 55 ALR 417.

a duty of good faith and fair dealing in performance. Clearly, Dawson J was not in favour of implying a more onerous good faith obligation, and the majority may well have taken the view that, given the express obligation, the implication made by the trial judge was either illegitimate or otiose.

If good faith means reasonableness — as has been implied from *Renard* — we reject it on the basis of a different aspect of the consistency rule, namely, that it is inconsistent with what the parties have agreed. That was in our view the position in *Renard*, a case has been treated as deciding much more than it decided, so that while the actual decision (but not the rationale) is easily justified, the subsequent cases in which it has been applied have led Australian contract law into a potentially disastrous situation.

In *Renard*, cl 44.1 of the contract provided that if the contractor defaulted the principal was entitled to call upon the contractor, by notice in writing, to ‘show cause within a period specified in the notice’ why the powers set out in the clause ‘should not be exercised’. Clause 44.1 included requirements of form and content:

The notice in writing shall state that it is a notice under the provisions of this clause and shall specify the default, refusal or neglect on the part of the Contractor upon which it is based.

Pausing there, it should be noticed that the clause expressly incorporates good faith elements — notice, writing, statement that it is under cl 41, specification of default — which might otherwise have been treated as implicit on the basis of commercial construction. The clause went on to provide:

If the Contractor fails within the period specified in the notice in writing to show cause to the satisfaction of the Principal why the powers hereinafter contained should not be exercised the Principal, without prejudice to any other rights that he may have under the Contract against the Contractor, may:

- (a) take over the whole or any part of the work remaining to be completed and for that purpose and in so far as it may be necessary exclude from the site the Contractor and any other person concerned in the performance of the work under the Contract; or
- (b) cancel the Contract, and in that case exercise any of the powers of exclusion conferred by sub-paragraph (a) of this paragraph.

When the contractor did not complete the work on time, the principal served a notice under cl 44.1. Although there was no doubt that the contractor was in default, it was also clear that the delay was in part attributable to the principal’s failure to provide necessary materials in accordance with the contract. Subsequently, the principal purported to terminate the contract. But its decision to do so was found to have been based on ‘misleading, incomplete and prejudicial information’. In those circumstances, a majority of the court considered that the contractor was correct in its contention that the principal had not complied with an implied term which required the principal to act reasonably. Meagher JA, on the other hand, considered that the principal had not complied with cl 44.1. He preferred to decide the case on the simple basis that the clause required the principal to act on accurate information when forming a view on whether the contractor had shown cause.

We find the approach of Meagher JA compelling, not just from an

interpretation perspective, but also from the good faith perspective. In our opinion the show cause procedure expressly embodied good faith: how else can the idea of considering whether a person has shown cause be viewed? The decision has interesting parallels with *Carr v J A Berriman Pty Ltd*,³⁷ a case which illustrates not only that good faith flows from interpretation, not implied terms, but also that good faith is not a new concept in our law. The main issue was whether the principal had repudiated a building contract. In the course of considering that issue the High Court made some observations (which have ever since been regarded as authoritative) on cl 1 of the conditions annexed to the contract. This provided that the architect could, 'in his absolute discretion and from time to time issue . . . written instructions or written directions . . . in regard to the . . . omission . . . of any work'. The builder was required 'forthwith' to comply with the architect's instructions. The principal contended that this clause entitled it to omit steel fabrication work from the contract for the purpose of having the work done by a third party. Fullagar J (with whom the other members of the High Court agreed) explained:³⁸

The clause is a common and useful clause, the obvious purpose of which — so far as it is relevant to the present case — is to enable the architect to direct additions to, or substitutions in, or omissions from, the building as planned, which may turn out, in his opinion, to be desirable in the course of the performance of the contract. The words quoted from it would authorize the architect (doubtless within certain limits . . .) to direct that particular items of work included in the plans and specifications shall not be carried out. But they do not, in my opinion, authorize him to say that particular items so included shall be carried out not by the builder with whom the contract is made but by some other builder or contractor. The words used do not, in their natural meaning, extend so far, and a power in the architect to hand over at will any part of the contract to another contractor would be a most unreasonable power, which very clear words would be required to confer.

While the description 'good faith' is not used, it is clear that the High Court adopted a good faith interpretation. The methodology is instructive. There is no reference to implied terms. The position was in our view precisely the same in *Renard*: interpretation was enough to show that the principal was not entitled to act in the way it had acted. The interpretation for which the principal in *Renard* contended would have created, to use Fullagar J's words, 'a most unreasonable power', because it would have permitted the principal to decide that cause had not been shown without ever taking accurate information into account. Accordingly, just as in *Carr v Berriman* there was no need to imply a term, so also in *Renard* there was no need for any implied term. If the matter must be expressed in terms of reasonableness, since the clause did not on its face entitle the principal to act unreasonably, the onus was on the principal to establish, by recourse to implied terms or otherwise, that it was entitled to act unreasonably.

Other now 'classic' good faith cases also reveal that construction of a contract based on a principle of good faith is sufficient without resort to the

³⁷ (1953) 89 CLR 327.

³⁸ (1953) 89 CLR 327 at 347.

implied term rationale. This includes *Alcatel Australia Ltd v Scarcella*,³⁹ where Sheller JA (with whom Powell and Beazley JJA agreed) held that an obligation to exercise contractual rights in good faith may be implied in commercial contracts.⁴⁰ A landlord had commissioned a report from a fire engineer, who reported that work was needed for fire safety reasons. At the landlord's invitation the local council inspected the premises and found they did not comply with requirements laid down in legislation and so the tenant would need to vacate the premises. The tenant wanted to challenge the council's decision, but the landlord would not permit the tenant to use its name to sue. The tenant argued the lease included an implied term to the effect that the landlord would cooperate with the tenant in the bringing of the action, or that there was an implied term of 'fair dealing'.

Sheller JA undertook a comparative review of cases and commentary on good faith,⁴¹ which was, in his view, on the whole supportive of the obligation of good faith as an implied contractual term. He held there was no reason why a duty of good faith should not be implied as part of the lease. However, on the facts, the landlord was not acting 'unconscionably or in breach of an implied term of good faith', where the landlord merely took steps to ensure that the requirement for fire safety contained in the expert's report should be put in place. Sheller JA stressed the commercial nature of the relationship and said:⁴²

In a commercial context it cannot be said, in my opinion, that a property owner acts unconscionably or in breach of an implied term of good faith in a lease of the property by taking steps to ensure that the requirements for fire safety advised by an expert fire engineer should be put in place.

The result is clearly appropriate. However, the better reason why no term requiring good faith was implied is that such a term would be inconsistent with the landlord's right as owner of the property to keep the premises safe, rather than to bow to the wishes of the tenant. Good faith would therefore have been achieved in the commercial construction of the contract.

What Good Faith Means

So far the courts have not offered much by way of explanation of the content of the implied term of good faith, other than emphasising that it requires contracting parties to act reasonably, at least when exercising express rights and discretions. Indeed, it has not even been explained whether the implied term is promissory in nature. Although there are many recent cases in which judges have expressed the requirement of good faith in terms of 'reasonableness', it is fair to say that the sense of that concept is not yet completely clear. In *Burger King Corp v Hungry Jack's Pty Ltd*⁴³ the New South Wales Court of Appeal did not clarify whether there are two implied terms, one of 'good faith' and one of 'reasonableness', which is what was

³⁹ (1998) 44 NSWLR 349.

⁴⁰ (1998) 44 NSWLR 349 at 369.

⁴¹ (1998) 44 NSWLR 349 at 363–9.

⁴² (1998) 44 NSWLR 349 at 369.

⁴³ [2001] NSWCA 187 (21 June 2001) (hereafter *Hungry Jack's*).

decided by Rolfe J at first instance,⁴⁴ or rather, one term of 'good faith and reasonableness'.⁴⁵ Although the court did explain that the cases 'make no distinction of substance between the implied term of reasonableness and that of good faith',⁴⁶ it is not clear what conclusion we are meant to draw from this. We are still left in doubt as to whether there is one implication or two, and why, if reasonableness is indeed an implication, good faith is required. It is, after all, difficult to see what room there can be for the operation of good faith *in addition* to reasonableness. In other words, are there any circumstances in which reasonable conduct will not be in good faith?

In our view reasonableness must be seen as an element of honesty and not as an additional requirement. The position is that conduct which no reasonable person could regard as permissible in the circumstances is not permitted.⁴⁷ On the other hand, the recent cases apply a far more onerous standard which requires conduct which is 'objectively reasonable', in the circumstances.⁴⁸ Moreover, while the cases are not very clear on the point it seems that not only has this meaning been implied from *Renard* it also seems that the onus is on the promisor to establish that it has acted reasonably.

It is well established that good faith requires 'honesty'.⁴⁹ In our view, good faith is necessarily an integral element of Australian contract law simply because contracting parties must act honestly in negotiating and performing their contracts, and also in exercising discretions and rights. Since that is self-evident, those who assume that 'good faith' is not a requirement of contract law must either be making an erroneous assumption or positing a concept which sets a higher standard. However, we see no need to set a higher standard, and in our view, whatever 'honesty' means, it does not require a party to act 'reasonably', except in the sense that a requirement of honest conduct must exclude conduct which no reasonable person could regard as reasonable in the circumstances.

We explore this issue further, and highlight certain major difficulties created in the context of contract termination, in the next section.

44 Cited by the Court of Appeal: [2001] NSWCA 187 at paras [141]–[142].

45 [2001] NSWCA 187 at [158], where the singular and plural are mixed: 'there may be implied, as a legal incident of a commercial contract, terms of good faith and reasonableness'. Later at [164] the plural 'terms' is used, and could either refer to several terms of 'good faith and reasonableness' or two separate terms, one of 'good faith' and one of 'reasonableness'.

46 [2001] NSWCA 187 at para [169]. It is possible to find decisions that distinguish the concepts. See eg *Francis v South Sydney District Rugby League Football Club Ltd* [2002] FCA 1306 (8 November 2002), para [203] per Lindgren J.

47 Cf *Paragon Finance Plc v Nash* [2002] 1 WLR 685 at 701–4 per Dyson LJ (with whom Astill and Thorpe LJ agreed).

48 J Stapleton, 'Good Faith in Private Law' (1999) 52 *CLP* 1.

49 See Sale of Goods Act 1923 (NSW) s 5(2) ('A thing is deemed to be done "in good faith" within the meaning of this Act when it is in fact done honestly, whether it be done negligently or not.'). Sir Anthony Mason, 'Contract and its Relationship with Equitable Standards and the Doctrine of Good Faith', *The Cambridge Lectures*, 1993 (8 July 1993), which was the basis of his later article, 'Contract, Good Faith and Equitable Standards in Fair Dealing' (2000) 116 *LQR* 66.

Good Faith's Impact on Termination Clauses

Renard involved a termination clause. But it was a specific category of termination clause, quite different from the more usual provision which simply confers a right of termination in the event of a particular kind of breach. As we have explained, because the principal was required to give the contractor an opportunity to show cause, that difference necessarily carried with it a more onerous type of good faith element than an ordinary termination clause.

Burger King v Hungry Jack's involved a complex franchise relationship and there were disputes over the termination of the relationship by Burger King. Although the court purported to go through the process of implying in law a term (or terms) of good faith and reasonableness, it clearly took the view that good faith and reasonableness were applicable unless the contract provided otherwise. The termination clause was activated by breach but, unlike *Renard*, did not involve any show cause element. Nevertheless, the New South Wales Court of Appeal considered that *Renard* applied. In one sense this is in line with the courts' generally unsophisticated approach to termination clauses. Although these clauses vary considerably in content and complexity, they have traditionally been treated as conferring rights, the scope of which depends solely on interpretation and implication. However, some insight may be gained in this area by drawing a distinction between rights and powers.

Although every termination clause necessarily confers a right, namely, the right of termination, some such rights are better seen as contractual powers. In this way, a clause which permits termination for, say, a material breach, is distinguishable from a clause which says, simply, that a party may terminate at any time by giving 30 days' notice. The former is a 'right', dependent on a condition, namely, breach. The latter is a 'power', exercisable in a certain way, namely, by giving notice. In only one area of contract law has this distinction between rights and powers been taken into account. This is where a vendor or mortgagee exercises a 'power of sale'. In that context it is well-established that good faith has a role.⁵⁰ (Admittedly, the meaning of 'good faith' in this context is also confused.⁵¹) Since the effect of *Renard* and *Hungry Jack's* is to treat termination clauses which do not involve the exercise of powers of sale as similarly subject to a good faith requirement, it might be said that the impact of those cases is to treat all contractual termination rights as in the nature of contractual powers. Not only is this a departure from the traditional approach, it is also one reason for several unexplained anomalies in the law of termination clauses which can be traced to *Renard* and *Hungry Jack's*.

The first anomaly is that the content of the good faith element which must be satisfied in the exercise of a power of sale is different from the good faith requirement applied in *Renard* and *Hungry Jack's*. Consistently with what we see as the 'proper' content of the good faith requirement, a mortgagee exercising a power of sale is merely required to act honestly, not reasonably,

50 [2001] NSWCA 187 (21 June 2001) (hereafter *Hungry Jack's*).

51 See, eg *Quennell v Maltby* [1979] 1 WLR 318; *National Australia Bank Ltd v Sproule* (1989) 17 NSWLR 505 at 510; 98 ALR 570 at 575; *Service Station Association Ltd v Berg Bennett & Associates Pty Ltd* (1993) 45 FCR 84; 117 ALR 393 at 401 per Gummow J.

in an objective sense. The standard applied in *Renard* and *Hungry Jack's* is therefore more onerous. Presumably, to remove the anomaly, the power of sale cases will need to be overruled!

The second is that by adopting good faith — the requirement of reasonableness — in the context of contracts where no proprietary interests were involved, the New South Wales Court of Appeal has adopted a standard for challenging termination which is far easier to satisfy than that adopted by the High Court adopted in *Legione v Hateley*.⁵² In that case, in order to challenge the vendors' termination of a sale of land contract pursuant to a termination clause activated by breach of an essential time stipulation, the purchasers were required to satisfy the requirements of relief against forfeiture. The paradox is that more stringent requirements were imposed in the name of equity in *Legione*, than the court in *Hungry Jack's* imposed in the name of the common law! Although it is, of course, a truism that the common law develops over time it seems quite remarkable that the judges who decided *Hungry Jack's* should not even refer to the issue, let alone be troubled by it. *Legione v Hateley* was itself a controversial decision, criticised by some,⁵³ and not followed by the Privy Council in *Union Eagle Ltd v Golden Achievement Ltd*⁵⁴ on the basis that it imposed an unacceptable fetter on contractual rights.

Further, unreasonable behaviour is not necessarily unconscionable behaviour. The third anomaly⁵⁵ is that by applying a requirement of good faith to the exercise of contractual rights in the commercial context, and treating the party having the right as subject to a requirement of reasonableness, the courts have ignored the fact that the High Court has consistently left open the question whether the exercise of a contractual right may be challenged on the ground of unconscionable conduct where no proprietary interest is in issue.⁵⁶ A requirement that a party act reasonably is clearly more onerous than a requirement that a party not act unconscionably, yet the anomaly has not so far occurred to the courts implying the good faith term.

Finally, in relation to termination, the law is clear that a promisee is entitled to terminate a contract, provided a valid ground existed for the termination.⁵⁷ This is so, even if the promisee subjectively believes it is entitled to rely on some other ground, which is, in fact, invalid. Some restrictions on this right exist, such as under estoppel and under statutory provisions. The imposition of an obligation requiring good faith and reasonable termination would be contrary to this basic approach. There is some support for such a position in Winn LJ's suggestion in *Panchaud Frères SA v Etablissements General*

52 See eg Peter Butt, *Land Law*, 4th ed, LBC, Sydney, 2001, paras 18110–18116; K Gray and S F Gray, *Elements of Land Law*, 3rd ed, Butterworths, London, 2001, pp 1433–1441.

53 (1983) 152 CLR 406; 46 ALR 1.

54 W M C Gummow, 'Forfeiture and Certainty: The High Court and the House of Lords' in *Essays in Equity*, P D Finn (ed), Law Book Co Ltd, 1985, p 30.

55 [1997] AC 514. See Hossein Abedian and M P Furmston, 'Relief Against Forfeiture After Breach of Essential Time Stipulation in the Light of *Union Eagle Ltd v Golden Achievement Ltd*' (1998) 12 JCL 189.

56 See J W Carter and Andrew Stewart, 'Interpretation, Good Faith and the "True Meaning" of Contracts: The Royal Botanic Decision' (2002) 18 JCL 182 at 190–4.

57 See *Sunbird Plaza Pty Ltd v Maloney* (1988) 166 CLR 245 at 263; 77 ALR 205.

*Grain Co*⁵⁸ that a 'requirement of fair conduct' could also prevent an innocent party relying on a breach, which was not obvious at the time of termination. However, this suggestion was rejected by the English Court of Appeal,⁵⁹ and has no basis in principle.

The unstated premise of the recent cases on termination clauses is that the common law rules are not operating in a way which is consistent with good faith. We reject that entirely in relation to the show cause procedure considered in *Renard*: the clause did require and give effect to good faith. The rules — including commercial construction — may not necessarily produce results which are consistent with good faith. If that is the position then the proper approach is to find a solution to that problem. The most likely candidate is the use of the equitable principle of unconscionability. It will have been noted that the impact of the decision that the principal did not act in good faith in *Renard* was that it repudiated the contract. The solution is very much a common law all or nothing solution. In effect, the duty to act reasonably becomes an essential term of the contract. It seems to us that unconscionability is likely to be more sensitive, and moreover to focus attention on what seems to us to be more legitimate concerns — matters such as whether there is advantage taking or exploitation. It might even be appropriate to grant relief on terms!

Conclusion

It seems clear that there are some who see Australian contract law as the 'poor relation' in comparison with other jurisdictions when it comes to good faith. A term of good faith is then implied almost by way of apology to the parties. We do not share this view. A term in the form 'X must act in good faith' should never be implied, for the simple reason that contract law already requires that.

Despite academic and judicial tendency to compare Australian common law with the law applied in the United States, particularly the incorporation of 'good faith' in the Uniform Commercial Code, Australian common law is not a code. It does not always provide a neat list of features, inclusions and exclusions. This does not mean it is inferior. It merely requires lawyers and judges to explain what is inherent in our law. Notions of fairness and good faith have become fashionable topics in contract law recently. However, that should not be used as the incentive to include as 'terms' that which is inherent in all the principles governing contractual interpretation and application.

Our courts, in a rush to 'take a stand' on the notion of 'good faith' by implying a term, have overlooked the detrimental impact this approach will have on the wider institution of contract law. This unsophisticated approach fails to take account of the inherent principle of 'good faith' that already exists, underlying and informing the whole framework of contract law. Furthermore, it inappropriately incorporates into a muddled definition of 'good faith' notions from other areas of the law, such as 'unconscionability', and *uberrimae fidei*, which should instead be seen as distinct concepts with their own operation. Unconscionability, in particular, has been used in the past

⁵⁸ See *Shepherd v Felt and Textiles of Australia* (1931) 45 CLR 359; *Sunbird Plaza Pty Ltd v Maloney* (1988) 166 CLR 345; *Concut Pty Ltd v Worrell* (2000) 176 ALR 693.

⁵⁹ [1970] 1 Lloyd's Rep 53 at 59.

when there are legitimate concerns about a contracting party's behaviour that would not necessarily fall foul of other contract rules. Courts do not need to resort to manipulating or misapplying the tests for implying terms in order to incorporate 'good faith'. Rather, in our view, a better understanding of contract principles, in particular, modern contract construction principles, and how they operate in relation to other doctrines, such as unconscionability, is required.