Journals

The concept of reasonableness in construction contracts

Honourable Mr Justice T R H Cole

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(1994) 10 BCL 7

Contracts and conduct are the twin towers of construction problems. They come together in good faith. The doctrine of good faith is thought by many to be one reserved to American jurisprudence. On the contrary, it not only has long standing roots in our jurisprudence but has virtually arrived in the significant judgments in Minister for Public Works v Renard Constructions (ME) Pty Ltd (1992) *26 NSWLR 234* [PDF].
In construction contracts, the competing alternative is the doctrine of the implied term of reasonableness; yet that creates even greater uncertainty.
In the following article from a paper, given at a recent legal convention, the Honourable Mr Justice Cole, judge administering the Construction List in the Supreme Court of New South Wales gives great learning and experience to the subject.

In White and Carter (Councils) Ltd V McGregor [1] Lord Reid stated:
It might be, but it never has been, the law that a person is only entitled to enforce his contractual rights in a reasonable way, and that a court will not support an attempt to enforce them in an unreasonable way. One reason why that it is not the law is, no doubt, because it was thought that it would create too much uncertainty to require the court to decide whether it is reasonable or equitable to allow a party to enforce his full rights under a contract.
At least in New South Wales, exercise of full contractual rights in construction contracts is now subject to an implied constraint that such contractual rights may only be exercised reasonably.
The decision of the New South Wales Court of Appeal in Renard Constructions (ME) Pty Ltd v Minister for Public Works [2] marks a further step in the intrusion of equitable concepts of reasonableness and good faith in commercial contracts.[3] This progression was noted in 1984 by Sir Anthony Mason who spoke of:
The increasing penetration of equitable doctrines into contract and commercial law notwithstanding the strength of the counterveiling philosophies and attitudes.[4]
Renard and Hughes Bros [5] highlight those differing legal philosophies.
Renard considered cl 44 [6] of the standard form of construction contract NPWC Edition 3 (1981)

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(NPWC Ed 3 (1981)) which conferred upon a principal upon default by the contractor in performance of a contractual obligation, the power to suspend payment and to call upon the contractor by notice to show cause to the satisfaction of the principal why a power to take over the whole of the work and exclude the contractor from the site, or to cancel the contract, should not be exercised. Priestley and Handley JJA both held that cl 44 imposed upon the principal an obligation of reasonableness in determining, first, whether the contrctor had failed to show cause and,

assuming the principal had reasonably as distinct from honestly so determined, then to consider reasonably whether any power, and if so which, should be exercised. Priestley JA said:

For myself, I cannot see why a term should not be implied at both stages; that is, it seems to me relatively obvious that an objective and reasonable outsider to this contract upon reading cl 44.1 would assume without serious question that the principal would have to give reasonable consideration to the question whether the contractor had failed to show cause and then, if the principal had reasonably concluded that the contractor had failed, that reasonable consideration must be given to whether any power and if any which power should be exercised.[7]

Similarly, but for different reasons, Handley JA wrote:

It seems to me that cl 44.1 should be construed as requiring the principal to act reasonably as well as honestly in forming the opinion that the contractor had failed to show cause to his satisfaction and thereafter in deciding whether or not to take over the whole or any part of the remaining work or to cancel the contract. See generally, Amann Aviation Pty Ltd v Commonwealth of Australia (1990) *22 FCR 527* [PDF] and The Commonwealth of Australia v Amann Aviation Pty Ltd (1991) *66 ALJR 123*.[8]

Meagher JA expressed the contrary view denying the importation, by construction or implication, of any concept of reasonableness in exercise of the powers conferred by cl 44 . His Honour said:

Cole J rejected any submission that reasonableness could be imported as a limitation on the exercise of cl 44 powers. In my opinion he was right to do so. Such limitation, if it existed, could only arise either from the express words of the contract or by way of an implied term. Obviously enough it does not arise as a matter of construction of cl 44 . It is not referred to expressly in that clause, nor is it to be discerned as a matter arising by necessary implication from the words used. Nor, in my view, is there any room to imply a term. Any such attempt could not survive the tests adumbrated by the High Court in Codelfa Construction Pty Ltd v State Rail Authority of New South Wales (1982) *149 CLR 337* [PDF] and Secured Income Real Estate (Australia) Ltd v St Martins Investments Pty Ltd (1979) *144 CLR 596* [PDF]. Moreover, it suffers a more basic defect: it is difficult, if not impossible, to ascribe any sensible meaning to such a concept in this connection. As Taylor J said in a very different context:

…But reasonableness, alone, is an abstract concept and does not by itself provide a test for determining what charges may or may not be made; it is a useful guide if, and only if, we are aware of the various matters which must be considered where the necessity arises of determining whether particular charges are or are not reasonable.

(Armstrong v State of Victoria (No 2) (1957) *99 CLR 28* [PDF].)

In the present case the parties apparently interpreted the concept of reasonableness as involving the balancing "of the interests of the principal against those of the contract". There is no possible basis for inflicting such a duty on the principal, and his Honour was correct to repudiate it. There is no reason why the principal should have regard to any interests except his own.[9]

Priestley JA imposed the obligation of reasonableness upon the principal upon the basis that the requirements for implication of a term noted in

BP Refinery (Westernport) Pty Ltd v Hastings Shire Council [10] were satisfied, including the requirement that such an implied term was necessary to give business efficacy to the contract. His Honour recognised that a literal interpretation of cl 44 would permit the principal to give notice to show cause for a minor contractual default (any default) by the contractor, and thereafter to exclude the contractor from the site or cancel the contract.[11] That was thought "as a matter of business" to make the contract "quite unworkable" and thus cl 44.1 was to be read as being subsidiary to the "main contractual promises by each party to the contract to the other".[12] Thus the constraint of reasonableness was imposed upon the proprietor because business efficacy so required.

In addition to discerning a hierarchy of contractual obligations, described as the "main contractual promises", found within different clauses in the construction contract, his Honour also discerned a hierarchy of defaults. "Significant defaults" were accepted as permitting the giving of the notice to show cause and exercise of the cl 44 powers.[13] It was recognised that there may be other cases in which views may differ regarding whether a default was significant or not, and thus whether a principal was permitted by the contract either to give a notice to show cause, or hold that reasonable cause had not been shown such as to trigger exercise of the power of exclusion or cancellation.[14] Whilst recognising that the clause as "drafted leaves the matter in the hands of the principal", his Honour held that:

it will only be if the non-satisfaction of the principal does not have a reasonable basis or the decision to exercise a power or powers has no reasonable basis that the exercise of one or more of the powers will be in breach of one or both the implied obligations.[15]

It is apparent that the imposition of an obligation of reasonableness upon a proprietor in both considering whether to exercise a power in terms conferred by cl 44 to call upon the contractor to show cause for an assumed default, and a further obligation of reasonableness in

considering whether, if cause be shown, the proprietor is permitted to exercise a power of exclusion or cancellation of the contract, introduces a considerable measure of contractual uncertainty. Whilst recognising that cl 44 was a clause of obvious practical importance to, and was for the benefit of the principal,[16] the introduction of the obligation of reasonableness opens for review by an arbitrator or a court the question, not of whether the proprietor acted honestly in determining to give a show cause notice and thereafter to exercise a power of exclusion or cancellation, but whether judged by some standard of reasonableness which the arbitrator or court is able to determine, (presumably at the date when the powers were purportedly exercised), the actions of the principal were in fact reasonable.[17] The fact that a decision by the proprietor to exercise cl 44 powers fell within the arbitration clause was a matter regarded by Handley JA as a reason why, in addition to the obligation to reach decisions honestly, there should be imposed upon the principal an obligation of reasonableness in reaching decisions to exercise cl 44 powers.[18]

The more traditional approach to the construction of clauses such as cl 44 adopted by Meagher JA is typified by the passage in the judgment of Gibbs J in Australian Broadcasting Commission v Australasian Performing Right Assoc Ltd [19] when his Honour wrote:

It is trite law that the primary duty of a court in construing a written contract is to endeavour to discover the intention of the parties from the words of the instrument in which the contract is embodied. Of course the whole of the instrument has to be considered, since the meaning of any one part of it may be revealed by other parts, and the words of every clause must if possible be construed so as to render them all harmonious one with another. 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. The court has no power to remake or amend a contract for the purpose of avoiding a result which is considered to be inconvenient or unjust. On the

other hand, 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 adopted is not the most obvious, or the most grammatically accurate", to use the words from earlier authority cited in Locke v Dunlop *[1888] 39 Ch D 387*, which, although spoken in relation to a will, are applicable to the construction of written instruments generally; see also Bottomley's Case *[1880] 16 Ch D 681*. Further, it will be permissible to depart from the ordinary meaning of the words of one provision so far as is necessary to avoid an inconsistency between that provision and the rest of the instrument. Finally, the statement of Lord Wright in Hillas & Co Ltd v Arcos Ltd (1932) *147 LT 503* that the court should construe commercial contracts "fairly and broadly, without being too astute or subtle in finding defects", should not, in my opinion, be understood as limited to documents drawn by businessmen for themselves and without legal assistance.[20]

It was not suggested by either Priestley or Handley JJA that cl 44 contained any ambiguity: however, the otherwise clear consequence of the words used by the parties in their contract succumbed to the view of the majority that as exercise of the powers literally conferred by the clause would result, in the view of those judges, in commercial unreasonableness, a term should be implied which effectively circumvented the unambiguous words chosen by the parties in their contract.

The concept of reasonableness

In a stimulating paper, Professor J H Baker wrote: "Reasonableness may be a measure of conduct but it is not a source of obligation.[21] " However, whether it be a standard of conduct, or an obligation flowing from the expectation of at least one and presumably both parties to a contract, it is necessary to consider how one determines a standard of reasonableness so that the parties to the contract and the courts may determine whether that standard has been adhered to. Any examination of the concept of reasonableness quickly leads to the view that the standard is entirely subjective and probably indefinable. Judges have not sought to define reasonableness, and nor did either Priestley or Handley JJA in Renard . Rather, discussion has focused upon the operation and application of the concept in particular circumstances, it being assumed that judges know what it means or at least how to apply its meaning in the given circumstances. In Hillas & Co Ltd v Arcos ,[22] Lord Wright said: "The law, in determining what is reasonable, is not concerned with ideal truth, but with something much less ambitious, though more practical." [23] Attempts to define reasonableness have lead some to suggest that it is difficult, if not impossible, to ascribe any sensible meaning to the concept. As previously noted Taylor J put it succinctly when he said:

But reasonableness, alone, is an abstract concept and does not by itself provide a test for determining what charges may or may not be made; it is a useful guide if, and only if, we are aware of the various matters which must be considered when the necessity arises of determining whether particular charges are or are not reasonable.[24]

Notwithstanding an incapacity to define reasonableness, the courts have recognised its existence and importance in the law of contract. Lord Wright in Hillas stated that: "The legal implication in contracts of what is reasonable … runs throughout the whole of modern English law in relation to modern business contracts" [25] and Hope JA in Biotechnology Australia Pty Ltd v Pace [26] said:

The law has filled innumerable lacunae in the contractual arrangements of parties by applying a doctrine of reasonableness.[27]

Not being able to define the concept, but nonetheless recognising its existence and purporting to know what it means and how to apply it, the courts have sought to explain the concept by reference to other concepts, equally uncertain, such as fairness, good faith, or absence of unconscionable conduct. That has occurred notwithstanding the failure of English law to adopt a general concept of good faith because, as

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Professor Goode pointed out: "we do not know quite what it means".[28] Further, the explanation of reasonableness by reference to concepts such as fairness has occurred notwithstanding a recognition that all commercial dealings between parties are not necessarily fair. As Kirby P said in Biotechnology v Pace :

Contracts are the agreements between parties. Generally, their terms must be those which reflect the will of the parties, objectively determined. Judges, by reason of their experience and knowledge, may not have the relevant expertise by which to clarify the ambiguous, elucidate the uncertain or give content to the illusory terms of a contract or suggested contract between the parties. To do so by reference to an imported standard of reasonableness may satisfy the lawyer's desire for fairness. But the law of contract which underpins the economy, does not, even today, operate uniformly upon a principle of fairness. It is the essence of entrepreneurship that parties will sometimes act with selfishness. That motivation may or may not produce fairness to the other party. The law may legitimately insist upon honesty of dealings. However, I doubt that, statute or special cases apart, it does or should enforce a regime of fairness upon the multitude of economic transactions governed by the law of contract.[29]

Reasonableness and unconscionable conduct

The application of both equitable and common law concepts by one court, the so called "fusion" of law and equity, has resulted in "words such as unconscionable and inequitable having drawn closer to more objective concepts such as fair, reasonable and just".[30] Although absence of reasonableness of conduct would not itself constitute unconscionable conduct, unconscionable conduct would always be unreasonable. Unconscionable conduct involves absence of good conscience and fair dealing, conduct which would "stand condemned by ordinary standards of honesty and decency".[31] Concepts of unconscionability thus involve consideration of moral perspectives which may be absent in any consideration of concepts of reasonableness. Professor Yates, in commenting upon s 2–302 of the United States *Uniform Commercial Code* which permits a court to refuse to enforce a contract which was unconscionable at the time when it was made, or to limit an unconscionable clause to avoid an unconscionable result, expressed the difference between unconscionability and unreasonableness in the following terms:

The essential difference seems to lie in the fact that notions of conscience and of unconscionability are essentially subjective. Tests of reasonableness are objective, determined in accordance with the conduct, thoughts and responses one might expect from the reasonable man…. A test of unconscionability can cater for the susceptibilities of the particular parties to the agreement in a way that the more objective criteria of reasonableness does not.[32]

Whilst the test of reasonableness may be more objective than the test of unconscionability because reasonableness is said to be judged by the standards of the reasonable man, that standard is itself subjective, being that standard which in given circumstances a court determines to be the manner in which it assesses the hypothetical reasonable man would act. What is regarded as reasonable conduct will, no doubt, vary with the perception of different judges. In my view little assistance is gained by considering concepts of unconscionability when trying to define a standard of reasonableness because unconscionability embodies moral concepts higher than a basic standard of reasonable conduct. That is particularly so when considering commercial contracts.

Reasonableness and the concept of good faith

Priestley JA in Renard was of the view that an implication of reasonableness may apply to a category of contracts because contracts of a particular class require the parties to act reasonably towards each other in the performance of their contractual obligations. This was an implication of reasonableness by law, it being regarded as "necessary for the working of that class of contract".[33] However, the same obligation of reasonableness might also arise from

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an intention deduced from the full scope and bearing of (the parties) contractual intent, not the parties mental state, and in one sense as a matter of interpretation and upon considering the circumstances in which the parties contracted.[34]

In either circumstance the implication seems to be imposed because it must be taken to reflect the reasonable expectation of both of the parties at the time of contract. At the root of the concept that both parties would expect when contracting that they would, post-contract, exercise powers and discretions conferred upon them by the contract reasonably, is the notion that a contractual relationship is based upon a relationship of good faith by each party to the other. As Priestley JA indicated, the notion of good faith in contractual relationships is a concept well accepted in the civil law systems of Europe as well as in the United States of America.

A distinction is to be drawn between concepts of good faith between contracting parties in contractual negotiations pre-contract on the one hand, and the performance of contractual obligations, powers and discretions on the other. Renard dealt only with this latter aspect. Waltons Stores (Interstate) Ltd v Maher [35] makes clear that the law will in some circumstances provide a remedy for pre-contractual unconscionable conduct, but it makes no mention at all of pre-contractual conduct which might be regarded as unreasonable yet not unconscionable. The law provides remedies if pre-contractual statements which result in a contract are dishonest or misrepresent a material factual situation or which might be regarded as unfairly inducing the contract.[36] But it does not, so far as I am aware, provide any remedy for unreasonable conduct pre-contract on the part of one contracting party.[37] The law recognises that, in a commercial context, in the pursuit of its own commercial interest, a party is entitled pre-contract to adopt an unreasonable position to seek to obtain commercial advantage. There seems no reason in principle why a commercial body should not be entitled to reach agreement with another that it will exercise powers or discretions conferred upon it by agreement in an unreasonable manner.[38] Were such agreement to be expressed it would deny the implication at law or ad hoc of reasonableness in the performance of the contract for there would be no room for the argument that the parties had contracted on the basis of good faith in respect of the operation of the contract, or on the basis that the reasonable expectation of the parties was that they would exercise powers and discretions conferred by the contract in a reasonable way. It could not be said that there was any absence of good faith by one party to another simply because one used its commercial position to negotiate with the other a provision favourable to it. It is not the function of the court at some later time to seek to review and change contractual provisions freely agreed by reconsidering actual commercial relationships which produced the contractual provision being considered, and replacing or amending that provision because of a view of the court that the provision, considered on some amorphous basis, is unfair or unreasonable. To do so would be to disregard the commercial circumstances in which the contract was negotiated by the parties.

If it be true that party A, in pursuit of its commercial interest, can negotiate for a commercially advantageous position pre-contract, and in disregard of the interest of party B, it seems incongruous that if A is successful in achieving that position by agreement with B, A must, nonetheless, exercise powers or discretions so achieved by agreement, reasonably, if reasonably means having regard to more than A's own perception of its commercial interests. To deny A that position is to assert that, in truth, because of construction or implication of a term of reasonableness, the agreement between A and B was not to that effect. Yet the words of the contract may be entirely clear, denying such construction or implication. It should be unnecessary for commercial parties to explicitly state in their agreement that each is acting in and entitled to act in its own perception of its commercial interest: men of commerce would take that

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for granted; although they may also recognise that A may, but not necessarily will, perceive it to be in its commercial interest to have regard to the interests of B as ultimately advantaging A's interest.

A principal may regard it as being in its commercial interest to exercise powers upon a major breach of contract by a contractor because the principal's interests in ensuring completion so requires. That decision would normally be reached without any consideration of the contractor's position. In contrast, even an apparently minor breach of contract by a contractor may have significant consequences for a principal; for instance, otherwise insignificant contractual delay may jeopardise the principal's financing arrangements. Again, a principal's decision to exercise a contractual power in consequence of such minor breach would also be taken in disregard of the contractor's interests.

Both decisions would, presumably, be regarded as a reasonable exercise of power; each is necessary in the principal's commercial interest. Each decision to exercise a contractual power of, say, termination of contract may be taken pursuant to a contractual power so to act for "any default" as was the case in Renard . Each decision may have disastrous commercial consequences for the contractor. Yet why should the principal be required to consider those consequences; and even if it (or some court) does, how can any judgment be reached which denies to the principal the right to act in its perceived commercial interest as it judges it? How can the principal make any sensible assessment of the detailed consequences of its desire to exercise a contractual power without full knowledge of the contractor's financial position? What measure

does a principal (or a court) use to weigh the competing consequences of exercise or non exercise of the power upon the principal and the contractor? What weight in that assessment is to be given to the undisputed fact of breach by the contractor, and of express contractual power to act on such breach?

The answer to these questions is found by returning to the time when the contract was made. At that time, each commercial party regarded it as being in its commercial interest, as it then perceived it, to enter into the contract in the terms in which it was written; namely, to grant to the principal the power to exercise the power (for example, of termination) for *any* breach with knowledge that in exercise of such contractual powers each party would act in its own perception of its commercial interest. If the defaulting party (B) is also bound by concepts of reasonableness, it would have reasonably anticipated that the non-defaulting party (A) would determine whether and how to exercise conferred powers by reference to A's commercial interest. It is that understanding which has lead the courts to look to the contractual language used by the parties. To import a concept of reasonableness as a restraint on exercise of express power is, in reality, to qualify the agreement as expressed by imposing a requirement to act in a manner which may be otherwise than in pursuit of one party's commercial interests, and to weigh the other party's interest. It must be doubtful whether any concept of good faith requires a party so to act.

The philosophy at the very heart of the decision of Priestley JA in Renard is disclosed in the following passage when discussing Hughes Bros , and in particular whether a principal would be entitled to exercise a cl 44 power upon the contractor being served with a groundless winding-up petition that power being conferred, in terms, upon service of a petition on the contractor:

There can be no doubt that cl 44.7 is one which a prudent principal would want to have in a contract such as NPWC Ed 3 (1981). One reason is that the contract involves subcontractors and thus potentially all the difficulties that can beset a principal from that quarter if the contractor gets into financial trouble. The protection of the principal is achieved by the way cl 44.7 works with cl 44.1 .

…

I find it hard to think either that a contractor would agree to giving a principal the unqualified right to exercise the powers in subpars (a) or (b) of cl 44.1 in the event that a third party instituted a groundless proceeding or that the principal would have the hardihood to insist on such a completely unqualified right.

…

I can therefore imagine a principal saying to a contractor that it was essential for the principal to have a cl 44.7 right, *but I also feel sure that the principal would tell the contractor that the contractor could rely on the principal not to exercise it except for a good commercial reason* – why should a *reasonable* businessman insist on anything more?

[My emphasis.][39]

The first paragraph quoted recognises the principal's right to protect its own commercial

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interest and to do so in disregard of the contractor's interests.

The second paragraph rejects implicitly the expressed power conferred by cl 44.1 which the first paragraph acknowledged the principal would be entitled to require in protection of its own interest.

The third paragraph restates the principal's requirement to have in terms an unqualified power but then qualifies that principal's self interest requirement by surmising that the principal would himself qualify it by restricting use of the power only "for good commercial reason".

I would have thought that if a businessman, after requiring a power to be expressed in unfettered terms in the contract then volunteered a restriction (which I would doubt), the fetter of exercising the power "for good commercial reason" could only be the good commercial reason as that businessman perceived it, and as judged by him having regard to his commercial interests. To interpret "for good commercial reason" as meaning having regard to the interests of both the principal and the contractor as judged by some unstated standard, and by a third party, effectively removes the very protection which was recognised as being reasonably required by the principal to avoid "potentially all the difficulties that can beset a principal from that quarter if the contractor gets into a financial trouble".

Further, it is wrong in my view to regard a businessman when negotiating a contract as "reasonable", if by reasonable is meant a desire to ensure that the other contracting party is not disadvantaged by a foreseen circumstance, no matter how unlikely. At negotiation, the businessman's interest is to secure to the maximum extent the protection of his commercial interest in express terms. He may at a later time choose not to exercise those powers for any number of reasons, but he would not at negotiation restrict a power unless commercially obliged to do so. Negotiations proceed upon the basis of self interest, not upon some undefined basis of reasonableness.

Priestley JA in Hughes Bros returned to these matters. He recognised as a powerful consideration:

the practical need for a principal, whose chief interest in the construction contract is to have the works completed in accordance with the contract, to keep clear of any difficulty of a financial kind or related disputation that the contractor may encounter in the course of the contract.[40]

However that, and another consideration, led his Honour not to find that:

no requirement of reasonableness is implied in the exercise of the subclause 44.7 power, but that because of the practical commercial need of the principal already mentioned, it will not be difficult in ordinary circumstances for the principal to fulfil the reasonableness obligation.[41]
Returning to the vexatious winding-up petition example his Honour said:
In such a case it seems to me that the general expectation of commercial people would be that the principal *should* take into account any knowledge it has of the circumstances concerning the presentation of the proceedings.[42]
Priestley JA concluded that implying a term of reasonableness would not cause any: "Undue or unacceptable inconvenience to principals in contracts adopting NPWC Edition 3 (1981)." [43]
With great respect, the very fact of cases such as Renard and Hughes Bros involving litigation over three years regarding whether a power was properly exercised demonstrates eloquently the inconvenience of adopting NPWC Ed 3 (1981) with a reasonableness obligation imported. And it has never been the test of implication of a term whether there was a general expectation of commercial people that a principal in such circumstances "should" take such case knowledge into account. The test rather is whether it was necessary to give business efficacy to the contract that regard be so had. The distinction is in my view important because once it is recognised, as Priestley JA did, that the principal is entitled to negotiate pre-contract in its own interest, it becomes difficult to impose by implication an obligation based upon the views of others (whether generally accepted or not) of matters required to be considered before exercise of a specified power. It is only if those views coincided with the self interest of the principal that he would respond that the proposed implied term is "so obvious that it goes without saying". A principal breaches no concept of good faith by pursuing his self interest in negotiations for the contract.
Yet neither in Europe nor the United States has there been any difficulty in propounding concepts

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of good faith in commercial transactions. The Restatement of Contracts, Second, s 205 provides that: "Every contract imposes on each party a duty of good faith and fair dealing in its performance and enforcement."
A similar provision is found in the *Uniform Commercial Code*.[44] Good faith is defined to mean "honesty in fact in the conduct or transaction concerned".[45] Apart from statutory provisions, the common law has developed in the United States to import notions of good faith in contract. For instance in Carrico v Delp [46] it was said:
Good faith between the contracting parties requires the party vested with contractual discretion to exercise it reasonably and it may not do so arbitrarily, capriciously or in a manner inconsistent with the reasonable expectations of the parties.
As Professor Farnsworth makes clear, the existence of statutory definitions of good faith in America has not meant there is any agreement regarding its meaning. Some regard it as "the source of … an implied term". Professor Summers argued that it operated only as "an excluder" to rule out behaviour regarded as "bad faith performance". Professor Burton, in lamenting that "neither courts nor commentators have articulated an operational standard that distinguishes good faith performance from bad faith performance" argued that good faith "limits the exercise of discretion in performance conferred on one party to the contract" so that it was bad faith to use discretion "to recapture opportunities foregone in contracting" as determined by the other party's expectations.[47]
It may seem incongruous that this last concept of good faith can be used to support a concept of reasonableness so as to deny the party on whom a power is conferred after breach, the right to exercise that power: one might have expected good faith to have required the defaulting party to accept the expressed agreed consequences of its breach.

Reasonableness and honesty

Reasonableness is partly but not wholly coincidental with honesty. Dishonesty could not be reasonable, but no doubt a lack of reasonableness covers both honest and dishonest acts.[48]
On the other hand, in Meehan v Jones ,[49] Mason J (as he then was) distinguished reasonableness and honesty when finding it unnecessary to then determine whether a purchaser
in deciding whether finance is on satisfactory terms, is bound to act honestly or whether he is also bound to act reasonably…. And there is some ground for thinking that the parties contemplated that the question was to be left to the honest judgment of the purchaser rather than to the judgment of the court as to whether the purchaser acted reasonably in the circumstances.[50]
In Renard Handley JA found that the principal's decision "however honest, was objectively unreasonable and therefore an invalid exercise of the power".[51] His Honour agreed with Priestley JA that as a matter of construction of cl 44 the power must be exercised reasonably.
It seems clear that honesty in conduct is required, but that does not inform one as to the meaning of, or any requirement to act, reasonably.

The effect of an arbitration clause

Handley JA was much influenced in implying an obligation of reasonableness by the fact that the exercise of the power or discretion by the principal was subject to review by an arbitrator pursuant to a contractual provision. That was thought to be an indication that the "powers conferred are subject to some limitations other than honesty".[52] His Honour saw the question flowing from permitted arbitral review as being:
Is it to be supposed that the parties intended that the only issue for the arbitrator in such a case would be the honesty or good faith of the principal? Is it not rather to be supposed that the parties intended that an expert lay arbitrator should determine whether the principal had acted reasonably?[53]
With great respect, I would have thought the existence of an arbitration clause says nothing

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regarding the extent or scope of a power conferred in terms by the contract upon a principal. The question for the arbitrator would be whether the contractor had breached the contract, and if so, whether the principal had complied with any contractual requirements regarding exercise of the power conferred upon it after breach. I have difficulty with the logic which says that because the exercise of a power may be reviewed it follows that the scope of the power is restricted.
I think a businessman would be startled if it was suggested to him at the time of contract that if he agreed to an arbitration clause permitting review of exercise of a conferred power the consequence would be that the scope of his power after a breach by the other contracting party was restricted. He would be even more startled if he was told that by agreeing to an arbitration clause he was agreeing not to act in exercise of an express power unless he had regard to the commercial interests of the party in breach as possibly qualifying his right to act in pursuit of his own commercial interests after the other party breached the contract. I would have thought any principal so informed at the time of contract would unhesitatingly reject an arbitration clause if told it had those consequences.

Reasonableness: a variable standard?

Renard requires that when deciding to exercise a power or discretion conferred by a contract, a party must act honestly and reasonably. In acting reasonably the party must have regard to the reasonable expectation of both parties at the date of contract as to the manner in which they are deemed to have expected that the powers and discretions would be exercised. The reasonable expectation of the parties at the date of contract is associated with or grounded upon an implicit view of the contracting parties acting in good faith towards each other in implementation of the contract. Absent express words, and notwithstanding that a clause may be accepted as having been drawn for the benefit of one party (as was the case in Renard), a party may no longer have regard only to its own commercial interests. It must consider the assumed mutual expectation of the manner of implementation of the contract of both parties at the date of contract.
The difficulty in practice of introducing a concept of reasonableness restricting the exercise of a power or discretion conferred upon one party to a construction contract is the uncertainty that will produce. Lord Wilberforce in Bunge Corporation [54] made clear the difficulties flowing from introduction into a commercial or mercantile contract of review by a court of the consequences of a particular breach by reference to its effect upon the benefit of the contract to the party not in default. Recognising that such a step would be "commercially most undesirable", his Lordship stated:
It would fatally remove from a vital provision in the contract that certainty which is the most indispensable quality of mercantile contracts, and lead to a large increase in arbitrations. These are serious objections in practice.[55]
It seems that, absent express provisions to the contrary, the court will presume the parties mutually intended that parties would exercise powers and discretions reasonably because as Priestley JA put it in Renard , "no contractor in his senses would enter into a contract" on any other basis.[56]
Although reasonableness has been said to be a more objective standard than unconscionability because it is judged by the standard of the perceived reasonable man, it nonetheless remains subjective. As Professor Baker noted:
Despite many judicial expeditions to find him, the reasonable man has not been reduced into captivity. In truth, as any man on the Clapham omnibus could tell us, the reasonable man does not exist at all.[57]
It is difficult to discern an objective standard of reasonableness in contracts. One cannot put the theoretical reasonable man in the shoes of the contracting parties because in that case the parties would not be in dispute. The reasonable man would, at the date of contract, have foreseen the unforeseen circumstances which have created the subject dispute, and would with the agreement of both parties, have provided an agreed

solution. If that be not so it cannot be said there is room for implication of a term of reasonable performance because it could never be said the term was "so obvious it goes without saying". The need to import the concept of reasonableness arises only because the court is of the view that the parties by explicit words have not made entirely clear how a power

(1994) 10 BCL 7 at 17

or discretion may or may not be exercised. The fact that the parties are in dispute part way through the contract regarding an exercise of power or discretion makes clear that, excluding intentional bad faith, each party had at the date of contract, a different view as to the scope or application of the contractual power. That denies the concept of the theoretical reasonable man being able to say at the date of contract that there was a mutual understanding or mutual expectation regarding the manner in which the power or discretion would be exercised.
It is into that lacuna that the law steps, at least since Renard , to impose upon both parties at the date of contract a view of the manner of implementation or operation of the contract which in truth at least one of those parties did not have. The view so imposed is said to be that of reasonableness which, in reality, is the subjective view of a court after the event as to what would be fair between the parties at the date of contract. That view, of necessity, disregards to a significant extent the commercial interest of one party.
There is much to be said for the view of Professor Baker that:
The irony of all this is that the reasonableness doctrine is far more subjective than the doctrine that the court should seek the intention of the parties from the terms of the contract and give effect to it. It is more subjective both because it enables the court to consider the facts at large and because it enables judicial review of contracts according to an indefinable standard.[58]

Footnotes | Top

1 [1962] AC 413 at 430. See also, Bunge Corp, New York v Tradax Export SA Panama (1981) *1 WLR 711*; Canberra Advance Bank Ltd v Benny (1993) *11 ACLC 148*.

2 (1992) 26 NSWLR 234; 9 BCL 40.

3 Renard has now been followed by the Court of Appeal in Hughes Bros Pty Ltd v Trustees of the Roman Catholic Church for the Archdiocese of Sydney and Anor (unreported, Court of Appeal, 15 July 1993). Note however that Kirby P, who agreed with Priestley JA did so upon the basis that as leave to reargue Renard had not been sought, he was bound by the majority view in Renard . He expressed no agreement with that view. Meagher JA, whilst agreeing with the result, maintained the view he expressed in Renard .

4 "Themes and Prospects" in P D Finn (ed), Essays in Equity (The Law Book Co Ltd, 1985), p 242.

5 Hughes Bros Pty Ltd v Trustees of the Roman Catholic Church for the Archdiocese of Sydney and Anor (unreported, Court of Appeal, 15 July 1993).

6 Clause 44 : "if the contractor defaults in the performance or observance of any covenant, condition or stipulation in the Contract or refuses or neglects to comply with any direction as defined in clause 23 but being one which either the principal of the Superintendent is empowered to give, make, issue or serve under the Contract and which is issued or given or served or made upon the contractor by principal in writing or by the Superintendent in accordance with clause 23 , the principal may suspend payment under the Contract and may call upon the contractor, by notice in writing, to show cause within a period specified in the notice why the powers hereinafter contained in this clause should not be exercised."

7 (1992) 26 NSWLR 234 at 257; 9 BCL 40 at 56.

8 Ibid at 280; 74.

9 Ibid at 275; 70.

10 (1977) 52 ALJR 20.

11 (1992) 26 NSWLR 234 at 258C; 9 BCL 40 at 57.

12 Ibid at 258E; 57.

13 Ibid at 258G; 58.

14 Ibid.

15 Ibid at 259A; 58.

16 Ibid at 258G; 58.

17 In Hughes Bros the Court of Appeal itself determined the conduct of the principal was reasonable.

18 (1992) 26 NSWLR 234 at 281A; 9 BCL 40 at 74.

19 (1973) 129 CLR 99.

20 Ibid at 109–110.

21 J H Baker, "From Sanctity of Contract to Reasonable Expectation?" (1979) Current Legal Problems 17, 24.

22 (1932) 147 LT 503.

23 Ibid at 514.

24 Armstrong v State of Victoria (No 2) (1957) *99 CLR 28* [PDF].

25 (1932) 147 LT 503 at 514.

26 (1988) 15 NSWLR 130.

27 Ibid at 145.

28 R Goode, The Concept of "Good Faith" in English Law (1992) Paper delivered at the Centro di Studi e Ricerche di Diritto Comparato e Straniero, Rome, p 3.

29 (1988) 15 NSWLR 130 at 132–133.

30 Elders Pastoral Ltd v Bank of New Zealand (1989) *2 NZLR 180*.

31 Waltons Stores (Interstate) Ltd v Maher and Anor (1988) *164 CLR 387* [PDF].

32 D Yates, Exclusion Clauses in Contracts (2nd ed, Sweet & Maxwell, 1982), p 277.

33 (1992) 26 NSWLR 234 at 261C; 9 BCL 40 at 59.

34 Ibid at 263; 61.

35 (1988) 164 CLR 387.

36 See for instance, s 52, Trade Practices Act 1974 ; Contracts Review Act 1980 (NSW) , and the common law and equitable remedies for deceit and misrepresentation.

37 Even in the US, there is no recognised duty of good faith in negotiations pre-contract. See EA Farnsworth, The Concept of Good Faith in American Law (1993) Paper delivered at the Centro di Studi e Ricerche di Diritto Comparato e Straniero, Rome, p 3.

38 Compare however, Gomba Holdings (UK) Ltd and Ors v Minories Finance Ltd and Ors (No 2) *[1992] Ch 171* where Scott LJ suggested that an express provision in a mortgage deed permitting a mortgagee to charge a mortgagor costs and expenses "improperly or unreasonably incurred or improper or unreasonable in amount" might be open to "serious question" on grounds of public policy.

39 (1992) 26 NSWLR 234 at 259; 9 BCL 40 at 58.

40 Unreported, Court of Appeal, 15 July 1993, p 12.

41 Ibid.

42 Ibid.

43 Ibid, p. 13.

44 Section 1-203 .

45 Section 1-201(19) , *Uniform Commercial Code*.

46 (1986) 141 Ill App 3d 684.

47 Farnsworth, op cit n 37, pp 4–5.

48 Biotechnology v Pace (1988) *15 NSWLR 130* [PDF].

49 (1982) 149 CLR 571.

50 Ibid at 591.

51 (1992) 26 NSWLR 234 at 279; 9 BCL 40 at 73.

52 Ibid at 281B; 74.

53 Ibid at 281D; 74.

54 [1981] 1 WLR 711.

55 Ibid at 715.

56 (1992) 26 NSWLR 234 at 258D; 9 BCL 40 at 57.

57 Op cit n 21, p 33.

58 Ibid, pp 34–35.

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