APPLICATIONS OF GOOD FAITH IN CONTRACTING

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PART 1

There are three distinct situations in which obligations of good faith can be imposed upon a party. These are:

1. The parties may have a statutory duty to act in good faith;
2. The parties may contract to act in good faith;
3. The courts may imply in the arrangement between the parties an obligation on them to act in good faith;

The meaning of "good faith" and the circumstances in which courts may imply a contractual or tortious duty of good faith are outlined in the following parts of this article.

The law differs in various countries in respect to the doctrine of good faith in commercial contracts. In some countries, it is presently in a state of flux.

What is good faith?

"Good faith" is by no means a novel concept in the English common law. In 1766 Lord Mansfield stated that: "good faith was the governing principle ... applicable to all contracts and dealings"[1]

Yet despite this early common law recognition of good faith, its place in common law and its exact meaning remain uncertain.

A recent Australian judicial commentary on the meaning of good faith was by Priestly JA who stated that there is a: "considerable degree of interchangeability between the expressions of fairness and good faith."[2] This is consistent with other broad definitions that have found support including: fair conduct, reasonable standards of fair dealing, decency, and reasonableness. Priestly JA goes on to say that: "there is a close association between the terms of unreasonableness, lack of good faith, and unconscionability."[3] This description of "lack of good faith" helps to illustrate what behaviour is excluded by "good faith" and is therefore of assistance in the pursuit of a conclusive definition of the term itself.

A leading United States academic, Professor Summers, has isolated decisions in which judges have recognised behaviour as not being in good faith and has provided a useful list which includes:

[1] *Carter* v. *Boehm* (1776) 3 Burr 1905.
[2] *Renard Constructions (ME) Pty. Ltd.* v. *Minister of Public Works* (1992) 26 NSWLR 234.
[3] *Op. cit.* at 265.

> "... evasion of the spirit of the deal; lack of diligence and slacking off, wilful rendering of only substantial performance (i.e., deliberately doing less than required); abuse of a power to determine compliance; and interference with, or failure to co-operate in, the other party's performance."[4]

Other commentators such as Professor Burton see the concept of good faith as a means of effecting the intentions of the parties, or to protect their reasonable expectations.[5] This argument is based on the fact that the courts have generally construed the good faith performance obligation as a limitation on an absolute discretion of a party in performance of an obligation.

There is a deal of confusion and uncertainty over the exact meaning of the concept; however, it is clear from the international experience that good faith: "is a concept that has independent meaning and substance."[6]

Implied terms of good faith

There is no clear judicial authority within Australia that an obligation of good faith will be implied into contracts, which contrasts significantly with the situation in the United States, Europe and many Asian countries.

It is helpful to give a brief overview of the current situation in the United States, Europe and Asia.

The United States

The doctrine of good faith has a statutory basis in the United States by virtue of the Uniform Commercial Code (the "UCC"). The UCC Section 1–203 provides that: "every contract or duty within this Act imposes an obligation of good faith for its performance or enforcement."

Good faith is defined in UCC Section 1–201(9) as: "honesty in fact in the conduct or transaction concerned." Good faith in relation to a merchant is defined in UCC Section 2–103(1)(b) to mean "honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade". The UCC therefore incorporates both subjective and objective standards of good faith.[7]

The Restatement of Contracts (Second), Section 205 (1979) (a document which does not have the force of a statute but which is recognised as a persuasive authority) states that: "every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement."

[4] R S Summers "The General Duty of Good Faith—its Recognition and Conceptualisation" (1982) 67 *Cornell Law Review* 810, 813.

[5] Burton "Good Faith Performance of a Contract within Article 2 of the UCC" (1981) 67 *Iowa Law Review* 1, 3.

[6] Cole "Law—All in Good Faith" (1994) 10 BCL p. 18.

[7] Cole "Law—All in Good Faith" (1994) 10 BCL p. 18 at 24.

Additionally, while there is still debate about the definition of good faith (as outlined above), it is judicially accepted in the United States that a duty of good faith is to be implied in all commercial contracts.

Europe

Many other civil law systems have codified the doctrine of good faith. Section 242 of the German Civil Code provides: "the debtor is bound to effect performance according to the requirements of good faith, giving consideration to common usage."

The French Code Civil Article 1134 provides: "Contracts must be exercised in good faith."

The Swiss Civil Code also binds every person to exercise his or her rights or fulfil his or her obligations according to the principles of good faith.

The obligation of good faith is therefore an integral part of certain contracts and requires parties to give their greatest efforts to perform the contract and restricts the parties from exercising their legal rights strictly in accordance with the contract in certain circumstances.[8]

Asia

As in Europe, many Asian countries have civil law systems with a codified doctrine of good faith. The legal system of these countries explicitly requires good faith in contract.

The Indonesian civil law system is predicated on concepts of reasonableness and justice. In the commercial context, the Indonesian legal system recognises the ability of parties to determine the terms and conditions which will govern their contractual relationship. However it is also implicit in all commercial arrangements that the parties shall, in the performance of their agreement, act towards each other in good faith. In effect, it is an implied term in every commercial agreement that the parties will act in good faith.

That concept is enshrined by the operation of Article 1338(3) of the Indonesian Civil Code which provides: "All contracts shall be carried out in good faith."[8a]

In Japan, parties in commercial negotiations place emphasis on the establishment of long term business relationships, rather than on the creation of a single agreement. The parties view the process as entering into a general course of conduct governed by a willingness to negotiate in good faith.[9] This has been codified in Article 1(2) of the Japanese Civil Code, which states that: "The exercise of rights and performance of duties shall be

[8] Cole "Law—All in Good Faith" (1994) 10 BCL (see also Goode "Some Concepts of English Commercial Law: A Reappraisal" (1982) 13 *Cambrian Law Review* 14, 15).

[8a] Editor's Note: see also Soewito at page 224 below.

[9] "Contracts and the Concept of Good Faith" by Emma Moloney in (1993) 29 *Australian Construction Law Newsletter* 32 at 35.

done in faith and in accordance with the principles of trust." This is one of the few compulsory provisions of the Japanese Code. Consequently, all juristic acts in Japan are subject to this Article, and a duty of good faith.

This general principle is also reflected in the standard form Japanese General Conditions of Construction Contract, Article 1(1): "The Owner and the Contractor shall perform this Contract sincerely through co-operation, good faith and equality."

Thailand's Civil and Commercial Code also imposes obligations of good faith on contracting parties. Section 5 states: "Every person must, in the exercise of his rights and in the performance of his obligations, act in good faith." Section 368 provides: "Contracts shall be interpreted according to the requirements of good faith, ordinary usage being taken into consideration." The term "good faith" is defined to mean the will of every party to do good in carrying out a legal act so that the result of such legal act will be achieved in a good manner.

Similarly, the Republic of China (Taiwan) follows the continental legal system in which contract law is codified in the Civil Code. It is recognised that the Code obligations may be affected by custom, juristic concepts and the rule of good faith inherent in the civil law. Article 148 paragraph 2 of the Civil Code provides that: "every person is bound to perform his obligations and to exercise his rights in accordance with the rules of honesty and good faith."

In contrast to those countries which have adopted the legal systems of the continent of Europe, Malaysia, Singapore and Hong Kong have all drawn on their British heritage, and adopted the British common law. Their courts have consequently been reluctant to imply a duty of good faith in all commercial contracts. Their court will *not* imply a term into a contract merely because it is fair and reasonable to do so, and will only imply terms into contracts within the bounds of certain rules.

In *Pasuma Pharmacal Corporation* v. *McAlister & Co Ltd*,[10] the Federal Court of Singapore did imply a term of good faith into the contract between the parties. The court justified this on the ground that the implication of this term was necessary to give business efficacy to the contract. Thompson LJ recognised that the relationship between the parties was not a fiduciary one, but that of vendor and purchaser, and that as a matter of law, there is no implied term in such a contract requiring good faith between the parties, unlike in a contract between principal and agent. However, here it was clearly contemplated that a course of dealing would exist between the parties for at least five years. In these circumstances, Thompson LJ held:

> "It is difficult to resist the conclusion that there was an implied condition that in relation to their business as covered by the contract the parties should be reasonably honest and truthful with each other."

We will have to wait and see if the courts of these jurisdictions follow the recent trend in Australia towards the implication of a duty of good faith.

[10] [1965] 1 MLJ 221.

Australia

The present position in Australia is different from the United States or European models. Some Australian legislation has utilised the concept of good faith, including:

(a) Section 52 of the Trade Practices Act 1974 (Commonwealth), provides: "A corporation shall not, in trade or commerce, engage in conduct that is misleading or deceptive or is likely to mislead or deceive."

(b) Section 232(2) of the Corporation Law provides: "An officer of a corporation shall at all times act honestly in the exercise of his or her powers and the discharge of the duties of his or her office."

(c) Section 13 of the Insurance Contracts Act 1934 (Commonwealth) provides: "A contract of insurance is a contract based on the utmost good faith and there it is implied in such a contract a provision requiring each party to act towards the other party, in respect of any matter arising under or in relation to it, with the utmost good faith."

At common law, a number of "fiduciary relationships" are recognised (e.g., agent/principle, beneficiary/trustee) in which a duty of good faith is implied. Additionally, a number of equitable doctrines currently exist which have developed from the courts' desire to avoid unfair or unreasonable outcomes, such as the doctrines of frustration, unjust enrichment, estoppel and waiver. All of these doctrines reflect the doctrine of good faith.

However, the courts are reluctant to import a duty of good faith in all commercial contracts as it is difficult to reconcile that duty with the idea that commercial entities with equal bargaining power should be free to contract as they wish.

Specific criticisms on implying a duty of good faith include:

1. It creates uncertainty in the performance and enforcement of contracts.
2. It disregards the intentions of the parties.
3. It alters the pre-agreed "risk allocation".
4. It prevents parties from freely exercising their discretions and rights pursuant to the contract.
5. It prevents parties from obtaining the best bargain they can, within the boundaries of the law.

A recent Australian case, *Renard Constructions (ME) Pty Ltd* v. *Minister for Public Works*,[11] has acknowledged that a duty of good faith may be implied into a contract. It held that a party (the Principal) had a duty to exercise a discretionary power "reasonably". Priestly JA said that this requirement had: "much in common with the notions of good faith" and "the time may be fast approaching when the idea [of good faith], long recognised as implicit in many of the orthodox techniques of solving contractual disputes, will gain

[11] (1992) 26 NSWLR 234.

explicit recognition in the same way as it has in Europe and in the United States."

Hughes Bros Pty Ltd v. *Trustee of the Roman Catholic Church for the Archdiocese of Sydney*[12] follows *Renard* in implying a duty upon the Principal to act reasonably when exercising its discretion (to issue a show cause notice) and provides some assistance on this point. Kirby J, explains at page 102:

> "a Principal should take into account any knowledge it has of the circumstances ... (and) give at least some consideration to them before exercising a power."

The courts have not yet implied a duty of good faith into an agreement. However, in our view (and this is supported by academic articles) they are becoming increasingly more likely to do so.

Tortious duty of good faith

In the United States a tortious liability for breach of a duty of good faith has emerged in some circumstances. As stated above, a body of American case law and academic writing states that a covenant of good faith and fair dealing is implied into every contract, but this implied covenant does not automatically give rise to an action in tort. Tortious liability does not stem from a breach of a contractual duty but from a duty imposed by law once the parties have entered into a relationship created by the contract.

Traditionally such actions have been confined to insurance cases where peace of mind and security are at stake (not just commercial advantage), and where there is a special relationship: "characterised by elements of public interest, adhesion, and fiduciary responsibilities."[13] An Australian court recently considered the concept of tortious liability in *Gibson* v. *Parkes District Hospital*[14] where Badgery Parker J accepted that a workers' compensation insurer and the employer may be under a duty to act in good faith when processing an injured worker's claim. After discussing American authorities, Badgery Parker J stated that: "the same approach [as in an imposition of duty of care such as to found a cause of action in negligence] is proper when one has to consider whether in the circumstances of a particular case there is imposed on one party or the other, a duty of good faith, breach of which is actionable in tort." He also stated: "the primary question will be whether the relationship between the parties is so close and direct and involves such features as to make it just and reasonable to impose on the one a duty of care to the other."

Therefore actions in tort are probably limited to cases involving relationships with characteristics similar to those found in insurance contracts. The Californian Supreme Court in *Wallis* v. *Superior Court (Kroehler*

[12] (1993) 31 NSWLR 91.
[13] *Egan* v. *Mutual of Omaha Insurance Company* (1979) 598 P 2d 452; 157 Cal. Rptr. 482.
[14] (1991) 26 NSWLR 9.

Manufacturing Company)[15] identified the features of a contract which may give rise to a liability in tort:

> "1. The contract must be such that the parties are in inherently unequal bargaining positions;
> 2. The motivation for entering the contract must be a non-profit motivation;
> 3. Ordinary contract damages are not adequate;
> 4. One party is especially vulnerable because of the type of harm it may suffer and of necessity places trust in the other party to perform; and
> 5. The other party is aware of this vulnerability."

In commercial contracts where parties are on roughly equal footing and are free to shape their own agreements, a tortious duty of good faith is incongruous and likely to intrude on the expectations of the parties.

In *Seaman's Direct Buying Service Inc* v. *Standard Oil Company of California*[16] the Californian Supreme Court stated that to extend the tort remedy from such instances of special relationships into the context of the ordinary commercial contract was to move into: "largely uncharted and potentially dangerous waters." The majority went on to say that tortious remedies would only be considered in such contracts where the conduct of a party went beyond a mere breach of contract and offended the accepted notion of business ethics.

In summary, a tortious duty of good faith may be imposed upon some parties by virtue of a "special relationship".

Remedies

It seems that even the United States cases have not established a uniform approach to providing remedies for a breach of an implied term of good faith. Presumably the most common form of remedy will be damages. It is difficult to forecast what method of calculating damages other courts would adopt or what other remedies may be provided.

PART 2

The advantages of an express "good faith" obligation, particularly in infrastructure project documents

The advantages of incorporating a good faith clause into a contract include the following:

1. The clause can impose an obligation upon both parties to act in good faith. They must then ensure that their conduct complies with the requirements of the clause and that they have sufficient evidence to

[15] (1991) 26 NSWLR 9.
[16] (1982) Cal. App., 181 Cal. Rptr. 126, 129 CA 3d 416.

support this. It does require the parties to keep better records of their "good faith" reasons but the concurrent obligations upon both parties will drive better contractual behaviour by both parties. This may facilitate more efficient performance of the contract.

2. The good faith clause can be used as a guide in unforeseen circumstances. It can act as a "mechanism" when situations arise which have not been contemplated by the contract.
3. The clause outlines the manner in which the parties must perform the contract in addition to the essential terms of the agreement.
4. The parties' legitimate expectations of documents such as "partnering agreements" may thereby be protected and facilitated. A partnering approach adopted by parties may well result in mutual expectations which one party has of the other based on representations of co-operation and good faith.[17]
5. The courts will be less likely to imply a wide and onerous duty of good faith if it is apparent that the parties have already turned their minds to the issue of good faith and expressed their respective obligations in a precise and limited good faith clause.[18]
6. If the parties expressly adopt a good faith obligation in their contract then there is likely to be less room for a court to imply an obligation to act "reasonably" or in "good faith".

Circumstances where good faith obligations are likely to be relevant

Good faith obligations are likely to arise in infrastructure projects (which have multiple parties, complex risk allocations and establish long term relationships) in three broad categories. They are:

(a) pre-contract;
(b) as an express or implied obligation in the contract, or in relationships established as an adjunct to the major contracts, but which may not themselves be contractually binding on the parties (e.g., a partnering charter), to assist in dealing with contractual performance, or to address unforeseen difficulties (e.g., *force majeure*);
(c) in relation to dispute resolution.

It will be obvious from the discussion above, but is worth stating again, that the ambit of the obligation of good faith will depend upon the country in

[17] Section 52 of the Trade Practices Act in Australia prohibits a corporation from engaging in trade and commerce in conduct which is misleading or deceptive or likely to mislead or deceive. Similar obligations are imposed by State Fair Trading Acts (see page 184 above). In Australia, an aggrieved party who perceived that it had been misled about the partnering objectives professed by the other party might seek to bring proceedings based on Section 52 or its equivalent sections.

[18] The courts in Australia are still grappling with whether or not to imply a good faith obligation. See *Renard Constructions (ME) Pty Ltd* v. *Minister for Public Works* (1992) 26 NSWLR 234 and also *Hughes Bros Pty Ltd* v. *Trustees of the Roman Catholic Church for the Archdiocese of Sydney* (1993) 31 NSWLR 91. See also "Law—All in Good Faith" by Mr Justice Cole (1994) 10 BCL 18.

which contract documents are negotiated and the system of law which governs the negotiation of the project documents.

A necessary step in considering the practical application of good faith doctrines is to specify which legal system will govern the transaction and ascertain what the obligation of good faith means in that system.

It is then also important to try to understand what the parties to the transaction themselves understand by the concept of good faith. This quite often involves a consideration of cultural and political backgrounds, as "good faith" means different things to different people.

1. Pre-Contract

It is common in infrastructure projects to find the concept of "good faith" being imported into the negotiation process itself.

This may be done by means of a stipulation in the project brief by a public sector proponent that the parties must act in good faith in submitting tenders or in being involved in the tender process.

In many infrastructure transactions, the parties' initial relationship is in a very embryonic state.

Neither party may wish to be legally bound until either the final bidder has been selected or until they are a lot more comfortable with the way in which the commercial relationship is developing.

This is the area where parties may enter into the familiar "Memorandum of Understanding" pursuant to which they may agree to continue their negotiations on a certain basis. An example of a good faith clause from a current Asian infrastructure transaction being negotiated in Thailand and Laos by an Australian contractor is the following clause:

> "The parties will co-operate and negotiate with each other in good faith, in the spirit of mutual co-operation and without unnecessary delay and in accordance with the terms of this agreement."

What each party understands by this obligation may well differ, due to the cultural background of the parties. In those circumstances it may be best, if you are advising the contractor, to assume that the obligation is not legally enforceable and to accept that political or commercial pressure will be the only factors which will give you any hope of enforcing the good faith term in question.

Parties may therefore be tempted to try to make the obligation at least contractually binding.

But pre-tender documents are notoriously difficult to structure in such a way that they are contractually binding.[19]

Also proponents of infrastructure schemes may well not wish to create a contractually binding relationship, or one that establishes even equitable obligations of good faith, as the circumstances may carry with them a

[19] See *Regalian Properties PLC and Anor* v. *London Docklands Development Corporation* [1995] 1 WLR 212.

corresponding possibility that the unsuccessful contractor may be entitled to be compensated on some broad equitable basis for having participated in the tender process. For example the contractor may claim to be entitled to be reimbursed on the basis of *quantum meruit* if unsuccessful in tendering.[20]

Legally enforceable documents generally impose obligations on *both* parties, not just one. This may not suit the public sector proponent.

In Australia there have been some interesting recent examples of attempts to impose and enforce good faith negotiation obligations prior to execution of formal project documentation.

An example is the following:

> "... The parties will forthwith proceed in good faith to consult together upon the formulation of a more comprehensive and detailed joint venture agreement (and any associated agreements) which when approved and executed will take the place of these Heads of Agreement, but the action of the parties in so consulting and in negotiating on fresh or additional terms shall not in the meantime in any way prejudice the full and binding effect of what is now agreed."

This is a clause which was held by the New South Wales Court of Appeal to be *not* binding, because it was "too vague as to be enforceable" in *Coal Cliff Collieries Pty Ltd* v. *Sijehama Pty Ltd* (1991) 24 NSWLR 1.

Attempts have therefore been made to avoid such an unsatisfactory result. An example is the following clause:

> "In view of ... [the following factors] ... Party X will pay a contribution of $[x] to the unsuccesful bidder.
>
> The contribution will be payable provided that:
>
> 1. The unsuccessful bidder has lodged a submission which complies ...
> 2. Party X concludes the transaction on a BOOT basis with another bidder; and
> 3. The unsuccessful bidder, in the opinion of the [Probity] Auditor, has at all times proceeded in good faith during its participation in the submission, evaluation and negotiation processes."

There may well be no contract in the conventional sense, however, if a contractor tendered in compliance with the procedure specified and, in fact, acted in "good faith" there is little doubt that the Australian courts would at least enforce the obligation to pay by application of equitable principles.[21]

As a corollary to the good faith obligation, proponents are requiring probity on the part of all parties in the tender process and one now commonly finds that probity protocols are established and enforced.[22]

An unsuccessful tenderer's right to be paid any costs for bidding may be conditional upon observing a good faith obligation and complying with the

[20] See *Regalian Properties PLC and Anor* v. *London Docklands Development Corporation* [1995] 1 WLR 212; *Sabemo Pty Ltd* v. *North Sydney Municipal Council* (1977) 2 NSWLR 880; *British Steel Corporation* v. *Cleveland Bridge & Engineering Co Ltd* [1984] 1 All ER 504 and *Brenner* v. *First Artists Management Pty Ltd* [1993] 2 VR 221.

[21] Either by application of estoppel—*Walton Stores (Interstate) Ltd* v. *Maher* (1988) 164 CLR 387 or on the basis of principles of restitution or unjust enrichment—*Pavey & Mathews Pty Ltd* v. *Paul* (1987) 162 CLR 221.

[22] This is certainly the case in Australia in relation to projects such as Casino developments but has also been the case on some BOOT toll road projects.

protocols. This is one strategy for ensuring that you have greater commercial flexibility and yet a high likelihood of "good faith" and "probity" without necessarily entering into a fully binding contract.

In many Asian countries, even without a contractually binding pre-tender document imposing obligations of good faith on the parties, the parties may still be subject to the obligations of good faith imposed by their Civil Codes. In contrast to the German and French Codes which provide for a requirement of good faith in the performance and enforcement of contracts, the Civil Codes in Japan, Thailand and Taiwan do not limit this obligation to contractual relationships. In these jurisdictions, every person must act in good faith in the exercise of all their rights and obligations, not just in contractual relationships. Consequently, all juristic acts, including pre-contract negotiations, are subject to this obligation of good faith.

2. Good faith as an express or implied obligation in the contract or in relationships established as an adjunct to major contracts but which may not themselves be contractually binding on the parties

An example of a relationship which may be established as an adjunct to the contract but which may not itself be intended to be contractually binding on the parties is the "partnering relationship" which is becoming more common in major contracting.

The law in relation to good faith within the contract has been canvassed above. One has to distinguish between:

(a) a duty of good faith in the bargaining process, which may not be enforceable; and
(b) a duty of good faith in the execution of the contract, which may be enforceable.

Again (as was the case above) the law which is applicable to the contract will determine whether negotiations are to be conducted in good faith and what is meant by "good faith" if the parties do not stipulate such an obligation.

There has been considerable debate in Australia about whether good faith clauses as part of a bargaining process are enforceable. Predominantly the Australian courts have followed the courts of the United Kingdom, while keeping an eye on the American decisions.[23]

The risk in Australia is that a "good faith" obligation in the bargaining process may not be enforceable,[24] but one in the execution in the contract may be, and may even be implied.[25]

[23] See "Good Faith and Fairness in Negotiation of Contracts—Part I" by J W Carter and M P Furmston in (1994) 8 *Journal of Contract Law* 1; and also "Good Faith and Fairness in the Negotiation of Contracts—Part II" by J W Carter and M P Furmston in (1995) 8 *Journal of Contract Law* 93 and the other articles published therein.

[24] See *Walford* v. *Miles* [1992] 2 AC 128, *Hooper Bailie Associated Ltd* v. *Natcon Group Pty Ltd* (1992) 28 NSWLR 194 and *Coal Cliff Collieries Pty Ltd* v. *Sijehama Pty Ltd* (1991) 24 NSWLR 1. Also *Paul Smith Ltd* v. *H & S International Holdings Inc* [1991] 2 Lloyd's Rep 127. Compare these with *Pitt* v. *PMH Asset Management Ltd* (1993) 4 All ER 961.

[25] See footnote 17.

Having said that, obligations to negotiate in good faith are commonly adopted in documents.

There is, in major infrastructure projects, and especially BOOT schemes with long concession periods, a need to have regard to some type of mechanism to resolve difficulties which may arise in the long term life of a project. As an example, there may be a need to provide a mechanism for dealing with *force majeure* events and an obligation to enter into good faith negotiations may be part of the answer.

An example is the following clause:

> (a) If the (common assumptions) change and that change materially adversely reduces the ability of either party to perform it obligations under the Contract, or has a material adverse affect on the financial consequences of the Contract for either party then party (X) and party (Y) must consult and co-operate with one another and do all such things as are reasonably necessary for the purpose of endeavouring in good faith to agree to a basis for calculating (payment) on and from the date of the relevant change (...) such that the parties are not materially financially advantaged or disadvantaged because of the change.
>
> (b) If the parties to the contract are unable to agree upon such a basis within (x) days of either of them giving notice to the other of the application of this clause, either party may give a Notice of Dispute to the other. [Dispute resolution then occurs in accordance with the dispute resolution clause.]

Another example is as follows:

> If a party reasonably considers that any of the circumstances referred to [... above ...] has had a Material Adverse Effect it may give the other party notice of that fact, including full details of that effect. [Material Adverse Effect is separately defined.]
>
> The parties shall first endeavour, in good faith, to agree the matters for determination as specified [in an earlier clause]. To this end, each party shall make itself available for negotiations as to those matters within (x days) after receipt by the recipient party of the relevant notice [under the above clauses]. Ensuing negotiations must be conducted by each party in good faith. If, however, the relevant matters are not determined by agreement between the parties within [days] of receipt of that notice, either party may notify the other that it wishes to have those matters determined [by dispute resolution mechanism specified in the contract].

Because of doubts about the validity of such clauses in Australia and other common law jurisdictions based on the United Kingdom judicial system it would be prudent to ensure that the contract makes it clear that the clause is severable *and* is to be severed if void for uncertainty. It would also be prudent to ensure that there is a broadly drafted dispute resolution mechanism which can be used to fill the vacuum in the event that the "good faith" clause is found to be unenforceable. A broadly drafted arbitration clause is recommended.

An example of a good faith clause within the contract, as part of the contract execution, is the following:

> "Where this contract provides for an action to be done or the existence of a condition to be established, based on the judgment, determination or opinion of a party, the party forming the judgment, determination or opinion must:
>
> (a) act in good faith;
>
> (b) act without discrimination;

(c) act in accordance with the best business and engineering practices where applicable;
(d) not act arbitrarily or capriciously;
(e) not base its judgment, determination or opinion on trivial, irrelevant or immaterial factors."

Both parties should realise that such a clause may be enforced against either of them. Therefore, a party's ability to exercise its discretionary rights (e.g., to terminate the contract), will be limited by its obligations to act in good faith.

Day-to-day contract administration: As a consequence of the introduction of good faith obligations into the contract, it will be necessary for a party to be able to refute any allegations of bad faith if that party decides to exercise a discretionary power. In order to do so the party should consider each action taken and a decision should be made in the exercise of a discretionary power to ensure that it was not:

(a) in bad faith;
(b) discriminatory;
(c) arbitrary or capricious;
(d) based on trivial, irrelevant or immaterial factors;

and that it was in accordance with the best technical and business practices.

These decisions should be documented as should the reasons, motivations and the decision making process itself, and also communications with the other party, and any relevant information to evidence that a party has acted in good faith and in accordance with the prescribed conduct should be recorded.

Needless to say a party will also have to prove that it was in possession of enough information to make an informed decision on the facts.

Partnering: As previously mentioned, in many projects in Australia there has been an adoption of the principles of "partnering" developed in the United States. This may be done within the contract documents or, more commonly, in documentation outside of the contract.

Partnering, as a concept, acknowledges that open communications and fair dealing and a co-operative management style are the most effective and expedient approach to major projects. Partnering usually requires both parties to agree on mutual goals which create the framework for the relationship and guide the conduct of the parties through the performance of the contract. These partnering goals provide a basis for giving effect to the agreement, but do not themselves necessarily create legally binding obligations.[26]

Due to the nature of partnering as a management style, or as a dispute

[26] An exception to the common position is where the parties in fact seek to make partnering part of the contract. A further exception may be an allegation of misleading and deceptive conduct or, negligent misrepresentation, giving rise to action in Australia under the Trade Practices Act or Fair Trading Acts or at common law for negligence.

avoidance tool, which attempts to provide greater flexibility and adaptability to overcome obstacles and avoid confrontation, it is difficult to incorporate defined or specific obligations into a construction contract. However, some recognition of the principles of partnering can be reflected in the contract to give the principles a contractual status and to reassure the parties that their objectives are protected by legally enforceable rights.

3. In relation to dispute resolution

It is in the context of dispute resolution clauses, and in particular mediation clauses, that there can be considerable scope for the imposition of obligations of good faith.

The use of amicable dispute resolution techniques is very significant in the context of construction projects in Asia, where there are strong cultural reasons for preferring an amicable settlement. As Hunter J of the Supreme Court of Hong Kong said in an address to an International Arbitration Conference in Sydney in September 1988:

> "The Asiatic approach is governed by an overriding preference for the agreed over the imposed solution. There are many reasons for this. Philosophically it stems from Confucius and the middle way. Pragmatically, commercial relations are much more readily mended if the losing party is not destroyed and emerges without total loss of face. On the few occasions when I was allowed to see the terms upon which some of my cases in court were settled, I was surprised by the generosity (by western standards) to the losing party. It was pleasant to learn that the practice of 'putting the boot in' is much less frequent than in the west because it itself carries a serious risk of loss of face."[27]

The Japanese in particular have a preference for "confer in good faith" clauses like the following:

> "If in the future a dispute arises between the parties with regard to the rights and duties provided in this contract the parties will confer in good faith."[28]

The following comes from a mediation agreement commonly used by Sir Laurence Street, a former Chief Justice of the Supreme Court of New South Wales and now a well known and well respected mediator:

> "Each party confirms that it enters into this mediation with a commitment to attempt in good faith to negotiate towards achieving a settlement of the dispute."

The courts are often not prepared to give effect to mediation clauses as they may at law be "agreements to agree" and may therefore be unenforceable.[29]

[27] Quoted in "Contracting in Asia" by Douglas S Jones, paper presented to Institution of Engineers Australia, 13 May 1992 at pp. 16–17.

[28] "Contracts in Contemporary Japan" by Veronica L Taylor in (1993) 19(2) *University Law Review* 352 at 357.

[29] See *Hooper Bailie Associates Ltd* v. *Natcon Group Pty Ltd* (1992) 28 NSWLR 194. Also *Hospital Products Ltd* v. *United States Surgical Corporation* (1984) 156 CLR 41.

Alternatively the courts may decide that such clauses are unenforceable on the basis of judicial policy.[30]

But the courts have given effect to such clauses where they satisfy certain criteria including the following:

1. The parties participation in the process must be required by conduct of sufficient certainty i.e., the process must be spelt out.
2. There may have to be a "fall-back" position to deal with the situation where the mediation fails, e.g., an arbitration clause.
3. The mediation may have to be limited as to time; so it is not an open ended "agreement to agree" for an indefinite period.

Although there is considerable scepticism in some jurisdictions about the effectiveness of mediation agreements they have shown themselves to be remarkably resilient.[31]

Some strategic considerations

The strategy for a good faith negotiation obviously depends on the context in which you are conducting such a negotiation.

The strategic interests of the parties are different at the stage before the contract is signed when there may just be a Memorandum of Understanding. While being mindful of its legal position in those circumstances a party will need to be very cognisant of its ultimate aims and the aims of the other participants in the negotiation. Background and cultural heritage will be important in determining what the parties mean by "good faith" at this stage and whether the clause provides anything more than commercial comfort is doubtful.

This can be contrasted with negotiations during the operation of a contract, when the "parties" are likely to be far fewer (with the losing tenderers by now no longer a major consideration). The parties' commercial aims are likely to be to achieve the contractual result and to ensure harmony between the parties to make sure that the result is achieved.

At the stage of post contractual dispute resolution the parties are also normally far fewer and their aims, and perceptions, again are likely to be different. Here a party must decide what its strategic objectives are. If there is a commitment to resolving the current dispute and preserving a potential, longer term relationship then one should negotiate in good faith with those objectives in mind. To haggle over the last dollar may not be conducive to doing business again in the future.

On the other hand, if there is unlikely to be any future relationship, then a party is not going to be keen to leave too many dollars lying on the table.

[30] See *Allco Steel (Qld) Pty Ltd* v. *Torres Strait Gold Pty Ltd* unreported Supreme Court of Queensland, 12 March 1990.

[31] In Victoria it is estimated that 80% of the cases in the County Court Building Cases List are settled by some form of mediation and 50% of the cases in the Supreme Court Building Case List are settled by the use of some form of mediation technique. Mediation is now being widely adopted in all of the courts of Victoria.

It is in situations like these that the parties must very realistically weigh up what they are seeking to achieve from the process.

As a general rule parties are much more likely to optimise their respective positions if they negotiate on the basis of, and their bargain is struck in a process which is designed to ensure, good faith and fair dealing with the other party. Adversarial negotiators are often reluctant to disclose fully the strengths and weaknesses of their position and the ends which they hope to achieve, for fear of appearing weak. And yet by being open with the other party, and negotiating openly and in good faith, one is often showing a strength of conviction in one's own position, and recognising openly the respective needs and aspirations of both parties.

Negotiating in good faith is a process which is likely to lead to a more enduring relationship and successful transactions.

We might leave the last word on this topic to J W Carter and M P Furmston:

> "Putting to one side the 'subject to contract' complication in cases such as *Walford* v. *Miles*, it is difficult to see who benefits from the decision to apply the rule that an agreement to negotiate is not in law an effective contract, in cases where there is consideration for the promise. If business people are prepared to reach such agreements, why should the law not enforce them?
>
> The Chief Justice of Australia, Sir Anthony Mason, has, however, suggested (extrajudicially) that the quality of '*Australian commercial life could only profit from an infusion of good faith*'."[32]

[32] "Good Faith and Fairness in Negotiation of Contracts—Part II" by J W Carter and M P Furmston in (1995) 8 *Journal of Contract Law* 93 and 113 and 118.