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"Good faith, commercial morality and the courts"

Introduction

Courts do not generally relish making judgments based on perceptions of morality, commercial or otherwise: they are courts of law not of morals. Part of the judicial reluctance rests in the uncertainty necessarily attending such an approach. How is one to define what is commercially moral? Would any definition command broad acceptance? The stipulation Judges administer justice according to law is designed to avoid what Brennan J termed "judicial idiosyncrasy" (*Gollan v Nugent* (1988) 166 CLR 18, 35).

Commercial dealings must work within a relatively certain, predictable framework of law. I say "relatively", because the reality is issues like good faith have long played a role in our system of commercial law. Gummow J offered some examples in *Service Station Association Ltd v Berg Bennett and Associates Pty Limited* (1993) 45 FCR 84, 91-2: the obligation of a fiduciary to act in good faith towards the principal; the relationship between partners; a mortgagee exercising powers consequent on a mortgagor's default; the bona fide purchaser of a legal estate; the equitable doctrines of undue influence and unconscionability. Also, the statute law is sprinkled with references to obligations of good faith. The corporations legislation, for example, obliges directors to act in good faith in their company's interests (*Corporations Act* s 181)

The challenge facing the courts is to develop and maintain a legal framework which is nevertheless as comprehensible as possible. That challenge is more acute as courts work in an era where notions of what is commercially right or wrong are more frequently agitated, particularly with major corporate collapses: what does good corporate citizenship entail? The role of ethics generally in contemporary life is more prominent than in earlier times. The term "ethicist" has become a vogue word. Governments even, retain "integrity commissioners". The unlawful activity of convicted corporate felons is analysed, not only for its contravention of the law, but also in terms of moral culpability. When sentencing Mr Rodney Adler, Justice Dunford spoke of his "appalling lack of commercial morality".

The development of commercial law in recent years has shown some retreat from clearly defined and confined concepts, with an apparently closer embrace of less determinate notions of what is conscientious behaviour. The legislature has played a not insubstantial role in this.

There was an early common law foreshadowing in *Barclays Bank Plc v O'Brien* (1994) 1 AC 180, 188 where, dealing with what became our *Garcia* principle, Lord Browne-Wilkinson began his analysis of the law with a comprehensive discussion of policy considerations, in which he talked about contemporary social attitudes, and spoke of "sympathy for the wife threatened with the loss of her home at the suit of a rich bank". Policy discussion recurs in *Royal Bank of Scotland Plc v Etridge* (2002) 2 AC 773 (eg. p 801), which may be considered as the House of Lords' update of *Barclays Bank v O'Brien*.

A good early Australian example is provided by *Northside Developments Pty Ltd v Registrar General* (1989-90) 170 CLR 146, 165, which concerned the fashioning of the indoor management rule where a mortgage of a company's property had been forged. Excluding reliance on *Turquand's Case* (1856) 6 El and Bl 327, Mason CJ observed taking that course would "compel lending institutions to act prudently and by so doing enhance the integrity of commercial transactions and commercial morality".

While I am not suggesting courts are not in touch with their communities, the fact remains that Judges are not necessarily well-equipped to determine prevailing community values and social attitudes. It may be the people's elected representatives have a more justified claim to that role. In *Dietrich v R* (1992) 177 CLR 292, 319, Brennan J spoke of the "contemporary values" which should relevantly inform the judicial process, as not "the transient notions which emerge in reaction to a particular event or which are inspired by a publicity campaign conducted by an interest group. They are the relatively permanent values of the Australian community." Lord Steyn has spoken in the House of Lords of the fashioning of rights by reference to what a judge "reasonably believes the ordinary citizen would regard as right" (*McFarlane v Tayside Health Board* (2000) 2 AC 59, 82). The question remaining is how those relevant values are to be gauged.

Sir Samuel Griffith, in *Deakin v Webb* (1904) 1 CLR 585, 625 counselled how a court of law should not proceed:

> "I hope that the day will never come when this court will strain its ear to catch the breath of public opinion before coming to a decision in the exercise of its judicial functions. If it does so, it will be perhaps the practice, if ever there is a court weak enough, to adjourn the argument simply in order that public meetings may be held, leading articles written in the newspapers, and pressure brought to bear to compel the court to shirk its responsibility, and cast its duty upon another tribunal."

That was a case where it was suggested the court should defer to public opinion (in considering whether to grant a certificate under s 74 Commonwealth Constitution). Modern courts recognize the influence of community concerns where appropriate, and the area of criminal sentencing furnishes an example. The greater issue is how reliably to determine them. Comparably, how do courts define the scope of an obligation of "good faith", an issue on which wise minds would often differ in situations of factual subtlety? Must contracting parties be burdened with the risk of unpredictable judicial determination?

Notwithstanding these features, both the legislatures, and the courts themselves, are tending to inject indeterminate concepts more and more into the commercial equation.

Legislation

A clear example is s 51AC of the *Trade Practices Act*, inserted by amendment in 1998. This provision outlaws unconscionable conduct by corporations in the supply of goods or services, and provides that in deciding whether there has been unconscionable conduct, a court may have regard to a host of considerations including the requirements of any industry code, relative strengths of bargaining positions, the reasonableness of contractual conditions, the consumer's understanding and the supplier's disclosure, and at the end of the list, "the extent to which the supplier and the business consumer acted in good faith". There is also reference to whether "any unfair tactics" were used against the consumer.

See also s 51AA, s 51AB. These provisions have counterparts in State and Territory fair trading legislation, and the ASIC Act.

Unconscionability under these statutory provisions is probably of broader ambit than under the equitable doctrine of unconscionability. The Federal Court has said it is conduct "irreconcilable with what is right or reasonable" (*Hurley v McDonalds Australia Ltd* (2000) ATPR 41-741); something morally wrong, "serious misconduct or something clearly unfair or unreasonable" (*ACCC v Simply No Knead (Franchising) Pty Ltd* (2000) 104 FCR 253).

Section 51AC denoted an extension of the law, including enhancing the already broad concept of unconscionability to embrace absence of good faith. The legislation leaves it entirely to the court to elucidate that elusive concept.

Would good faith oblige a mortgagee bank, in possession of a valuation at a figure substantially lower than a customer purchaser is intending to pay for the property, to disclose that valuation to the customer? Could threatening to exercise a legally accrued right, in order to encourage the other party to re-negotiate a transaction, ever fall into the bad faith category? A rigorous insistence on legal rights may be considered tough, but could it ever evidence a lack of bona fides?

The contract model

Courts are careful to acknowledge that the relationship between banker and customer is a basic contractual relationship (*National Westminster Bank PLC v Morgan* (1985) 1 AC 686, 707): it is not a contract of the utmost good faith, and it does not give rise to fiduciary duties. A bank's duty is primarily owed to its shareholders.

The position expressed in the High Court in *Hospital Products Ltd v US Surgical Corporation* (1984) 156 CLR 41, 70, more than two decades ago, remains, that commercial arms lengths dealings between parties on an equal footing usually do not give rise to any fiduciary relationship. It may be added, as confirmed in *Commercial Bank of Australia Ltd v Amadio* (1982-3) 151 CLR 447, 459, that disparity in position, as between a

corporate bank and a private customer, does not of itself oblige the bank or other lender to act with any particularly tender regard for the interests of the debtor or borrower: it remains entitled to act robustly in its own commercial interests.

Sometimes more is expected. That will be so, for example, where a banker or other lender undertakes the role of investment adviser. That may well oblige the lender to disclose to the borrower information in the lender's possession which the lender would otherwise have been entitled to withhold.

Good faith

An issue which has engaged some courts in recent years has been whether contracting parties should, in the performance of their contracts, be bound in law to act in good faith; and even whether parties merely at the stage of negotiating are subject to that constraint. There is a more fundamental debate as to the parameters of the concept. How far might it impinge upon the exploitation of the parties' respective commercial interests? Often the question has been whether such an obligation should be implied into the contract.

Australian courts have taken a fairly strict approach to the implication of terms, the ultimate consideration being whether, reasonableness aside, the implication is necessary to preserve the commercial efficacy of the contract. In terms of what may generally be implied, courts have stopped short after implying "a duty to cooperate in the doing of acts...necessary to the performance...of fundamental obligations under the contract" (*Secured Income Real Estate (Australia) Ltd v St Martin's Investments Pty Ltd* (1979) 144 CLR 596, 607).

In recent years the New South Wales Supreme Court (and the Federal Court) have gone further. The New South Wales Court of Appeal in *Alcatel Australia Ltd v Scarcella* (1998) 44 NSWLR 349, 369 recognized that a duty of good faith, in performing obligations and exercising rights, may as a matter of law be implied into a contract. That was a lease case. *Alcatel* followed the earlier decision of *Renard Constructions (NE) Pty Ltd v Minister*

for Public Works (1992) 26 NSWLR 234, where Priestley JA had divined public expectations in this way (p 268):

> "People generally, including judges and other lawyers, from all strands of the community, have grown used to the courts applying standards of fairness to contracts which are wholly consistent with the existence in all contracts of the duty upon the parties of good faith and fair dealing in its performance. In my view this is in these days the expected standard, and anything less is contrary to prevailing community expectations."

He also spoke (p 271) of "the anxiety of courts, by various techniques, to promote fair and reasonable contract performance". Those utterances are strictly obiter dicta, for he determined the case by reference to the issue of reasonableness.

Burger King Corporation v Hungry Jacks Pty Ltd (2001) NSW CA 187 is a more recent example of the Court of Appeal's confirmation of that position.

The High Court has yet to consider the existence and scope of a good faith doctrine (*Royal Botanic Gardens and Domain Trust v South Sydney City Council* (2002) 76 ALJR 436, 445).

The New South Wales approach is consistent with the position in the United States, where s 1-203 of the Uniform Commercial Code provides that "every contract or duty within this Act imposes an obligation of good faith in its performance or enforcement", and s 205 of the American Law Institute's Restatement of the Law (2nd) Contracts (1981) says that "every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement".

Which brings me to the question of what good faith entails, and on this there is nothing dazzlingly clear. It would seem to differ from reasonableness, and it presumably transcends the implied obligation to cooperate to secure the fundamentals of the contract.

Honesty comes to mind, as does not acting capriciously or for an extraneous purpose (cf. *Burger King* para 159). There has been mention of acting "fairly" (*Burger King* para 160).

It is sometimes more enlightening to focus on the obverse. In *Overlook v Foxtel* (2002) NSWSC 17, Barrett J said it was "best regarded as an obligation to eschew bad faith" (para 68): it "underwrites the spirit of the contract and supports the integrity of its character" (para 67). It did not require a party to subordinate his or her own interests, provided pursuing them did not unreasonably interfere with the other party's enjoyment of contractual rights (para 65). This suggests very fine lines may have to be drawn.

Such concepts are intrinsically indeterminate. In *Service Station Association Ltd v Berg Bennett and Associates Pty Ltd* (1993) 45 FCR 84, 92 Gummow J spoke of an American view that "the good faith performance doctrine may appear as a licence for the exercise of judicial...intuition, resulting in unpredictable and inconsistent applications".

The question whether merely negotiating parties, who have not reached a binding agreement, should be bound to act in good faith is even more controversial. In *Coalcliff Collieries Pty Ltd v Sijehema* (1991) 24 NSWLR 1, the New South Wales Court of Appeal rejected an obligation, to "proceed in good faith to consult together upon the formulation of a more comprehensive and detailed joint venture agreement", as too illusory, vague and uncertain to be enforceable. Yet the court left open the possibility that depending on its precise terms, a promise to negotiate in good faith could sometimes be binding. This realm is very speculative: what agreement would have eventuated, if any, had the obligation not been breached? What damages, if more than nominal, would flow?

The United Kingdom has firmly turned its face against such an obligation. The House of Lords rejected the possibility in *Walford v Miles* (1992) 2 AC 128, holding that a duty to negotiate in good faith would be unworkable in practice, and inherently inconsistent with the position of a negotiating party, since while the parties were in negotiation either of them could break off at any time and for any reason. There is obviously much to

commend that view. The law has made substantial inroads into freedom of contract. The criminal law aside, surely there is not any need to intrude into negotiation.

Unconscionability

The injection into commercial contracts of the nebulous concept of bona fides, legislatively and by development of the common law, may be assessed against the background of *Amadio* and *Garcia v National Australia Bank Ltd* (1998) 194 CLR 395. While seen as dramatic in their day, those cases nevertheless reflected a reasonably certain and predictable development in the law, with the position of lenders helpfully mapped out. Significantly for the present, unconscionability under the general law is not established by general notions of unfairness (cf. "Women's Guarantees and all-moneys clauses", J Pascoe (2004) vol 4, no 2 QUTLJJ 245, 246).

Amadio concerned contracting parties subject to a special disability, of which the lender was aware, enlivening the lender's obligation to ensure the transaction was properly explained.

Garcia concerned a wife giving a guarantee of her husband's borrowings, from which she gained no financial benefit. That lender was obliged to ensure she understood the transaction, an instance of what is now colourfully termed "sexually transmitted debt".

Those decisions were modern expressions of long standing authority: in the former case, *Blomley v Ryan* (1956) 99 CLR 362, and for the latter, *Yerkey v Jones* (1939) 63 CLR 649. They exemplified the incremental development of the common law.

In relation to a lender's obligation to explain a transaction, "all moneys" clauses level a special challenge. Santow J interestingly described such a clause in *Karam v ANZ Banking Group Ltd* (2001) NSWSC 709, para 215 (extracted by J Pascoe, supra p 248):

> "Certainly no explanation of the effect of the 'all monies' [sic] clause was given. Its comprehensibility...would have strained the

> understanding of sophisticated lawyers let alone laypersons with limited understanding of financial matters and even less legal matters. ... The whole is characterised by tangled syntax, lengthy, unparagraphed expression and dense, legal terminology, in the least plain of English. As Professor Butt says "...no area of law is too complex for plain language. Plain language may not be able to simplify concepts, but it can simplify the way concepts are expressed" (Peter Butt "Legalese versus plain language" in Amicus Curiae, Journal of Society for Advanced Legal Studies, June/July 2001 at 30): That torrent of dense technical language is then embodied in tiny print, with minimum punctuation, on a printed form required by the Bank on a take it or leave it basis. I do not say that this Bank was obliged to provide a plain English mortgage. What I do say, is that the Bank had no reason to believe that reading it would have enlightened the Karams."

There has been some recent development in these fields. For example, in *Kranz v National Australia Bank Ltd* (2003) 8 VR 310, the Victorian Court of Appeal held the *Garcia* principle was not confined to husband and wife or other intimate family relationships, but extended generally to relationships of "trust and confidence". The Queensland Court of Appeal also tended to that view in *ANZ Banking Group Ltd v Alirezai* (2004) QCA 6.

Amadio unconscionability was reconsidered by the High Court in *Bridgewater v Leahy* (1998) 194 CLR 457, and most recently in *ACCC v C G Berbatis Holdings Pty Ltd* (2003) 214 CLR 51, establishing that "special disadvantage" does not exist simply because of inequality of bargaining power. The touchstone of unconscionability in equity remains special disability, and that does not extend to what has been termed "situational disadvantage" – not related to personal characteristics, but arising from, say, grave financial difficulty or vast discrepancy in comparative information. The High Court thereby avoided blurring what is a relatively well understood and appropriately confined doctrine.

When I say appropriately confined, I have in mind unsuccessful attempts to engraft the doctrine upon landscapes where strict rights and obligations are well-established and operate fairly. In *Tanwar Enterprises Pty Ltd v Cauchi* (2004) 217 CLR 315, the High Court rejected a contention that a vendor of real property was acting unconscionably when exercising a right to terminate a contract upon the purchaser's default in completing in

accordance with an essential time stipulation (where by the time of termination the purchaser could have completed). The question re-emerged in *Romanos v Pentagold Investments Pty Limited* (2003) 217 CLR 367, 375 where the High Court observed "equity does not intervene in such a case to reshape contractual relations in a form the court thinks more reasonable or fair where subsequent events have rendered the situation of one side more favourable than that of the other side".

In *Berbatis Holdings*, Gleeson CJ emphasized (pp 64-5) that, absent exploitation of a specially disadvantaged party, the other will not behave unconscionably by robustly asserting his or her superior bargaining position: neither would doing so offend a good (commercial) conscience. The Chief Justice said this:

> "A person is not in a position of relevant disadvantage, constitutional, situational, or otherwise, simply because of inequality of bargaining power. Many, perhaps even most, contracts are made between parties of unequal bargaining power, and good conscience does not require parties to contractual negotiations to forfeit their advantages, or neglect their own interests...
>
> Unconscientious exploitation of another's inability, or diminished ability, to conserve his or her own interests is not to be confused with taking advantage of a superior bargaining position...
>
> In the present case, there was neither a special disadvantage on the part of the lessees, nor unconscientious conduct on the part of the lessors. All the people involved in the transaction were business people, concerned to advance or protect their own financial interests. The critical advantage from which the lessees suffered was that they had no legal entitlement to a renewal or extension of their lease; and they depended upon the lessors' willingness to grant such an extension or renewal for their capacity to sell the goodwill of their business for a substantial price...
>
> Good conscience did not require the lessors to permit the lessees to isolate the issue of the lease from the issue of the claims. It is an everyday occurrence in negotiations for settlement of legal disputes that, as a term of a settlement, one party will be required to abandon claims which may or may not be related to the principal matter in issue. French J spoke of the lessors using "[their] bargaining power to extract a concession [that was] commercially irrelevant to the

> terms and conditions of any proposed new lease". A number of observations may be made about that. Parties to commercial negotiations frequently use their bargaining power to "extract" concessions from other parties. That is the stuff of ordinary commercial dealing. What is relevant to a commercial negotiation is whatever one party to the negotiation chooses to make relevant...
>
> Reference was earlier made to counsel's submission that there was here a disabling circumstance affecting the ability of the lessees to make a judgment in their own best interests. In truth, there was no lack of ability on their part to make a judgment about anything. Rather, there was a lack of ability to get their own way. That is a disability that affects people in many circumstances in commerce, and in life. It is not one against which the law ordinarily provides relief."

The inherent vagueness of the concept of good faith when given contractual force stands to be contrasted with the general law's development of the principle of unconscionability. While obviously informed by considerations of fairness and reasonableness, that field is left in a state of reasonable definition and clarity, so that contracting parties can know where they stand. Others may not agree with that assessment (cf. *B Horrigan*: "The expansion of fairness-based business regulation – unconscionability, good faith and the law's informed conscience" (2004) 32 ABLR 159, 161). I note, though, that the High Court in *Tanwar Enterprises* (p 1857), deemed parties' positions in this area may be determined by reference to what it called "well developed principles"!

Lenders' own initiatives

Discussion of this subject should acknowledge the revised Australian Bankers' Association Code of Banking Practice. Following the recommendations of an independent reviewer, the Association accepted a commitment from banks to act "fairly and reasonably...in a consistent and ethical manner" (p 2.2). While this affects only banks which tie themselves to the Code, it is nevertheless a matter for commendation that banks have developed this mechanism for self-regulation.

Maybe that is a better way of giving some significance, even primacy, to notions of good faith, than by contractual provisions of indefinite import.

Mention may also be made of the Banking and Financial Services Ombudsman, whose terms of reference oblige the Ombudsman to take into account, among other things, "fairness in all the circumstances".

***National Bank of Australia v Finding* (2001) 1 Qd R 168**

The difficulty potentially involved in injecting a general stipulation for good faith, contractually binding, may be illustrated by this decision of the Queensland Court of Appeal, on which I have previously commented at this conference.

It was not an *Amadio* special disability case, or like *Garcia*, where one spouse gained no benefit from her contractual support of the other. But it was a case where an officious bystander unversed in the law might nevertheless have suggested the lender acted unfairly.

The plaintiffs had been customers of the bank for 40 years. They were commercially experienced. They purchased a hotel from the bank as mortgagee. The bank financed their purchase. They knew the hotel had been trading at a loss. What they did not know that although they were to pay $1.375 million for the property, the bank held a valuation at only $960,000. Also unbeknown to the plaintiffs, internal bank memoranda expressed concern about the capacity of any applicant for finance to repay a loan. The matter came to court when, following default, the bank brought proceedings to recover possession of the plaintiffs' family home, which they had mortgaged to secure the debt.

Their main argument was that aspects of their relationship with the bank gave rise either to a fiduciary duty, or some lesser "special duty" binding the bank. This, they contended, was a duty either to disclose all relevant information about the transaction, including especially the valuation and the bank's concern about the servicing of any loan, or at least to insist the plaintiffs went off to obtain independent advice before proceeding. The matters they relied on were that they were long-standing customers of the bank; the bank was both

mortgagee exercising power of sale and financier of the purchase; the plaintiffs placed trust in the bank; the bank knew of the poor trading performance of the hotel; and that at the time of the transaction, the plaintiffs had $1 million on deposit with the bank.

The court noted that the relationship between banker and customer, while not recognized by law as an accepted category of fiduciary relationship, nonetheless may exist under particular circumstances which unusually give rise to fiduciary obligations.

An example of an enlarged duty is *Commonwealth Bank of Australia v Smith* (1991) 102 ALR 453, where the bank assumed the role of financial adviser. The facts of *Finding* were distinguishable in that regard, as the bank had expressly disavowed any role as financial adviser. The agreement to finance this purchase had been conditional upon the bank's not accepting that the business would trade satisfactorily into the future.

The court also held the plaintiffs had at no time placed complete faith in the bank's branch manager, settling the offer based on the male plaintiff's own experience and the information he had himself acquired.

Another question was whether the bank's failure to disclose the valuation amounted to misleading or deceptive conduct. Examining whether a duty to disclose that valuation arose, the court held that "statements which do not include a matter the representee would have expected, whether reasonably or not, to be disclosed, are not necessarily misleading or deceptive on that account...there is a gap between behaviour which is thought to be unreasonable and that which is unlawful" (p 174).

The question I raise is whether, if contractually obliged to act in good faith, that bank may have been obliged to disclose that valuation. Of course the answer would depend on the content of the obligation to act in good faith. If that concept is as incapable of precise definition as earlier discussed, and extends to notions of general fairness, the lender would be left in an intolerably uncertain situation.

Other contractual practices presently acceptable could also be thrown into doubt. "All moneys" clauses which extend the liability of a guarantor to cover future as well as present debts up to an unlimited amount are still in common use, though subject to an immense amount of criticism. This stipulation could render such provisions vulnerable.

Conclusion

I revert to my opening. While conventional morality plainly informs the law, the courts are there to determine and impose the law, not to apply subjective or idiosyncratic notions of what is just. Of course considerations of fairness arise often, but generally in fields where the intended approach of the court has been fairly well delineated.

There are some notable exceptions. In *Finding*, the Queensland Court of Appeal commented on uncertainty as to how one identifies a fiduciary relationship. The court was urged to erect a new "special duty" binding the bank, by invocation of the 'neighbour' principle. The court responded less than enthusiastically:

> "One of the disadvantages of this doctrine, as it seems to us, is that, heaping Pelion upon Ossa it produces an additional layer of uncertainty in an area of the law whose essential defect is unpredictability of operation...and two-thirds of a century of analysis have left the scope of the 'neighbourhood' rule in its original field, that of negligence, quite obscure, outside the case of direct physical damage; one wonders whether use of this vague notion in a new area would be an advance."

The legislature has given the concept of good faith statutory force and sway. Some courts have allowed it a contractually based common law operation. But its inherent uncertainty raises the risk of burdening relatively clear contractual fields with the pall of unpredictability. It is to be hoped our courts are able to avoid the American situation mentioned in *Berg Bennett*, where "the good faith performance doctrine may appear as a licence for the exercise of judicial...intuition, resulting in unpredictable and inconsistent applications..."