The 26th Annual Banking and Financial Services Law and Practice Conference

Sheraton Mirage Resort, Gold Coast

31 July -1 August 2009

Good faith in contracts in financial services

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Why Contractual Good Faith is a matter of construction

Banking and Financial Services Law Association Conference 2009

Why contractual 'good faith' ought to be seen as a matter of construction and not implication – and why it matters!

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Implied terms of good faith in relation to express contractual rights and discretions have been making life interesting for those involved in commercial litigation in Australia for almost 20 years. These rights and discretions appear in commercial contracts, where consumer legislation is not relevant and the only possible fetter on the exercise of these rights and discretions would be found in common law or equitable doctrines. From the recent cases, the two likely fetters on rights and discretions are good faith and reasonableness. With those two fetters seem to arise two areas of confusion:

- how these fetters of good faith and reasonableness are incorporated into contracts, when they are not express; and
- what these fetters mean.

In relation to the latter point, recent Australian cases support the idea that 'good faith' is synonymous with 'reasonableness'[1] or that there are two co-extensive duties, one of good faith and the other of reasonableness. There is no judicial explanation of why good faith and reasonableness should restrict rights (such as termination rights), and thereby enter the territory of relief against forfeiture and unconscionability. Yet, recent Australian cases adopt this approach.[2] Some cases even see a merging of equity and common law in the development of the fetter of the implied term of good faith.[3] It is therefore interesting that a different approach is being taken in decisions of the

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* Professor of Law, University of Sydney; Barrister, 13th Floor St James Hall, 169 Phillip Street, Sydney. This paper draws on Peden, 'Implicit good faith' - or do we still need an implied term of good faith? (2009) 25 *JCL* 50.

1 See *Renard Constructions (ME) Pty Ltd v Minister for Public Works* (1992) 26 NSWLR 234 and cases following that decision, such as *Vodafone Pacific Ltd v Mobile Innovations Ltd* [2004] NSWCA 15; *JK Keir Pty Ltd v Priority Management Systems Pty Ltd* [2007] NSWSC 789 per Rein AJ at paragraph [27]; *Mangrove Mountain Quarries Pty Ltd v Barlow* [2007] NSWSC 492 at paragraph [27] per Windeyer J. In *Nauru Phosphate Royalties Trust (Receivers and Managers appointed) & Business Australia Capital Mortgage Pty Ltd v Nauru Phosphate Royalties Trust* [2008] NSWSC 916 (5 September 2008), where Einstein J states at para [43] "The effect of the Court of Appeal … in *Burger King* [was to] … collapse any distinction between contractual obligations of good faith and obligations of reasonableness…"

2 See eg *Renard Constructions (ME) Pty Ltd v Minister for Public Works* (1992) 26 NSWLR 234.

3 See eg *Harbourside Catering Pty Ltd v TMG Developments Pty Ltd* [2007] NSWSC 1375 at para [52], where Palmer J states that the equitable principle controlling the exercise of contractual rights under the "rubric" of

English Court of Appeal, where good faith is aligned with honesty and rationality, and distinguished from reasonable care or objective reasonableness.

The second problem is the method of incorporation of restrictions of good faith or reasonableness. In both England and Australia the approach is to imply a term requiring good faith or reasonable exercise of rights or powers.[4] If, as this paper suggests, good faith is implicit or inherent in the institution of contract law, then an implication of good faith is unnecessary and confusing. If the implication incorporates a higher obligation of objectively reasonable behaviour then a clear explanation would be expected, but has not been forthcoming from the courts. Furthermore, this paper suggests that any fetter on an express right or discretion can instead be achieved by construction, rather than implication of a term.

Very recently in Singapore, the Court of Appeal decided not to imply an obligation of good faith into an agency contract for placement of shares. Having considered developments in Australia, US, England and Canada, the court explained its decision against incorporating a term of good faith:[5]

> "Much clarification is required, even on a theoretical level. Needless to say, under the theoretical foundations as well as the structure of this doctrine are settled, it would inadvisable (to say the least) to even attempt to apply it in the practical sphere."

Before this 'second problem' is tackled, it is important to consider how this issue is of relevance to the law concerning banking and financial institutions. Before the recent developments about implied terms of good faith and reasonableness, banking lawyers were familiar with the notion of 'good faith' in the context of mortgagee's powers of sale. While legislation informs what behaviour is required,[6] it is also appreciated that the mortgagee must exercise the power 'in good faith'. There has never been any discussion of implied terms in that context, nor a suggestion that 'good faith' meant 'reasonableness'.

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unconscionable conduct has been "re-labelled" the duty to act in good faith; *Vodafone Pacific Ltd v Mobile Innovations Ltd* where Giles JA states: "depending on how the content of the obligation of good faith becomes settled, if it does, contract may take over from equitable principle.": [2004] NSWCA 15, at para [217]. See also Elisabeth Peden, "When common law trumps equity: the rise of good faith and reasonableness and the demise of unconscionability" (2005) 21 *JCL* 226.

4 See eg Elisabeth Peden, *Good Faith in the Performance of Contracts*, 2003, LexisNexis Butterworths, Chapter 6.

5 *Ng Giap Hon v Westcomb Securities Pte Ltd* [2009] SGCA 19, at paragraph [60].

6 See for example, section 85 *Property Law Act* (Qld) ("duty… to take reasonable care to ensure that the property is sold at the market value"); s420A(1) *Corporations Act* 2001 (Cth) ("controller must take all reasonable care to sell the property…").

However, good faith appears in banking contexts in other areas also, such as where a discretion is provided to a contracting party, such as a bank being entitled to vary interest rates. In such contexts, it is now important to be aware of the potential impact of obligations of good faith and reasonableness.

In order to develop the argument that good faith ought to be seen as a matter of construction and not implication, this paper draws on the 2008 decision of the English Court of Appeal in *Socimer International Bank Ltd v Standard Bank Ltd*[7] as the vehicle for discussing these issues. In *Socimer*, the Court of Appeal decided that:

1. Good faith is implicit in contracts.
2. The meaning of good faith is honesty and operates to control issues of self-interest.
3. Generally, discretions will be limited by good faith or honesty.
4. A restriction on a discretion in the form of good faith or an obligation of reasonableness will be incorporated as an implied term.

Australian cases appear to disagree with all except point 4. I agree with the first 3 points, but not the 4th! These issues are dealt with below.

Socimer International Bank Ltd v Standard Bank London Ltd

Socimer concerned a discretion in the context of a positive obligation to value assets. The facts briefly were these. Socimer and Standard were international banks, which had been trading together in emerging markets securities. Standard was the 'seller' and Socimer the 'buyer'. Socimer was failing. It was put into default and owed Standard US$24.5million in what were called "Unpaid Amounts" in respect of a portfolio of forward sales of securities which it had bought. The 'termination date' was 20 February 1998. Under the agreement the "Standard Terms for Forward Sale Transactions" the creditor bank, the seller, had to "liquidate or retain" the buyer's portfolio (the "Designated Assets") to satisfy the amount that the buyer owed it. The important clause was Clause 14(a)(bb), which provided:

> "The value of any Designated Assets liquidated or retained and any losses, expenses or costs arising out of the termination or the sale of the Designated Assets shall be determined on the date of termination by Seller".

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7 [2008] 1 Lloyd's Rep 558.

Standard, the seller, did not in fact carry out a valuation under clause 14(a)(bb). Instead, it sold the parts of the portfolio that it could over months and years and credited the proceeds to the buyer "in dribs and drabs".[8]

Meanwhile a few weeks after the termination date, on 3 March 1998, Socimer went into liquidation. Socimer's liquidator brought proceedings arguing that Standard ought to have carried out the valuation at the termination date, and had it done so, Socimer would have had a surplus of US$13.8million. The trial judge, Cooke J held that:[9]

> "[O]n the proper construction of the Agreement, Standard was obliged to value the Designated Assets as at the date of termination of the Agreement for the purpose of clause 14(a) of the Agreement and to bring into account the value as assessed as a credit against the amounts payable to Standard"

Following Cooke J's decision, the parties were still unable to agree on what the valuation of the portfolio ought to have been, had Standard valued the assets as required. The parties' calculations were over US$14million apart. Valuation issues were then addressed in court before Gloster J. Socimer convinced Gloster J that Standard was bound to take reasonable care in finding the true market value of the portfolio. This approach to the discretion was argued as a matter of contractual implication or as a matter of equity by analogy with the duties of a mortgagee with a power of sale.

Standard appealed to the Court of Appeal. The issue relevant here was whether Standard's valuation obligation was to carry out reasonable, objective, valuation or only the honest, but otherwise subjective, valuation which Standard would have carried out if it had been aware of its contractual obligation to value. Rix LJ wrote the primary judgment, with whom Lloyd and Laws LLJ agreed. Lloyd LJ did add a few comments of his own.

Rix LJ spent some time methodically deconstructing the decisions of Cooke J and Gloster J. He further criticised Socimer's senior counsel for failing to plead the implied term argument about the limitation on the discretion, and for asking the court to disbelieve witnesses, whom he failed to cross-examine, merely because their evidence supported an approach different to his client's.[10]

The Court of Appeal held that the discretion to value had to be exercised in good faith, that is, honestly. This overturned the decision of Gloster J below who had required a reasonable

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8 [2008] 1 Lloyd's Rep 558 at 560 per Rix LJ.

9 [2004] EWHC 1041 (Comm), quoted at [2008] 1 Lloyd's Rep 558 at 560 per Rix LJ.

10 [2008] 1 Lloyd's Rep 558 at 582, para [90].

valuation of the assets. In the context of this, Rix LJ stated: "In my judgment, the requirements of good faith and rationality are a sufficient protection. The danger to be guarded against... is abuse caused by self-interest. That is precisely what implicit good faith deals with. Commercial contracts assume such good faith, which is why express language requiring it is so rare." [11]

What is this idea of 'implicit good faith'?

Implicit Good Faith

In my view, Rix LJ is correct that good faith is "implicit" in contract law. While there might be a suggestion that the word 'implicit' merely means 'implied' and therefore requires an implied term, that does not do justice to the context of Rix LJ's use of that word. He speaks of "assumed good faith", which is more consistent with the idea that his meaning of "implicit" was "naturally or necessarily involved in, or capable of being inferred from, something else"[12]. Thus, Rix LJ was referring to a concept of inherent good faith or honesty, which is the default standard of behaviour for contracting parties. Legal concepts that are applicable to all contracts are not achieved by implied terms, but rather through construction, as is discussed below.

Good faith can be seen in two facets of contract law. First, and on a very general level, every aspect of contract law is, or should be, consistent with good faith because good faith is the essence of contract. Secondly, good faith is seen in construction of contract and in defining the 'default standard' of behaviour required, which is where the implied term of good faith is said to operate. That 'default standard' of good faith should be seen as requiring honest adherence to the bargain.

Recent Australian cases unfortunately fail to acknowledge the good faith element of contract rules, the first aspect.[13] Elsewhere, Professor Carter and I have provided illustrations of how we see

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11 [2008] 1 Lloyd's Rep 558 at 588. Finn J has also expressed the view that there is a implied universal duty of good faith. For example, in *Hughes Aircraft Systems International v Airservices Australia* (1997) 76 FCR 151 at 192-193 he stated "... I consider a virtue of the implied duty to be that it expresses in a generalisation of universal application, the standard of conduct to which all contracting parties are to be expected to adhere throughout the lives of their contracts". Finn J's method of incorporation of this 'universal duty' is as an implied term. See also *Esso Australia Resources Pty Ltd v Southern Pacific Petroleum NL* [2005] VSCA 228 at para [4] per Warren CJ.

12 *The Oxford English Dictionary*, 2008.

13 For example, in *Insight Oceania Pty Ltd v Philips Electronics Australia Ltd* [2008] NSWSC 710, at paras [168]ff Bergin J's reasoning appears to be that 'implicit' good faith would not always accord with the parties' intentions and for that reason a term of good faith should be implied when necessary, as a term implied in fact. However, her Honour also states that "good faith seems to me to subsume the obligation to act honestly" at

that contract law is underpinned with good faith.[14] We have pointed out that it is possible to find the operation of 'implicit' good faith in all aspects of contract law. Fundamentally, good faith will also be seen in construction of contracts. Principles of what is known as 'commercial construction' ensure that effect is given to the intentions of the parties, and generally ensures that good faith considerations are given effect. This leads to the issue of the implied term of good faith.

In most Australian cases an implied term of good faith and reasonableness has been implied as an 'extra'. If good faith is implicit or inherent, then generally there would be no need for any good faith term to be implied. This may seem like a purely academic disagreement with methodology. Yet if courts take the view that good faith must be incorporated by an implied term, it provides some explanation as to why 'good faith' has been given a content more onerous than appropriate or necessary, and is arguably inconsistent with the modern operation of contract law.[15] If it is accepted that good faith is implicit, and will operate at the stage of construction of contracts to set a default standard of honesty, then it is not immediately obvious why good faith should *also* be incorporated as an implied term. Such implication only seems to be occurring where courts have decided that a discretion or termination right should not be allowed to be exercised without some control and where there is no acknowledgement of the implicit or inherent operation of good faith. These issues are now considered.

Implied fetters on discretions and powers and the meaning of 'good faith'

In *Socimer*, Rix LJ considered the existing English authority on the issue of the limitations that are placed on a party's contractual discretion to make decisions, including *Abu Dhabi National Tanker Co v Product Star Shipping Ltd (The "Product Star") (No 2)*,[16] *Ludgate Insurance Co Ltd v*

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para [178]. With respect, if good faith merely requires honesty – which seems correct - then her Honour is at cross-purposes. The obligation to behave honestly cannot be excluded, just as fraud cannot be excused by agreement. An implied term is then *only* necessary if it imposes more than honesty and extends to reasonableness, which would rarely correspond with commercial parties' intentions, as Rix LJ states. Bergin J's decision was upheld on appeal (not discussing this issue): [2009] NSWCA 119.

14 JW Carter and Elisabeth Peden, "Good Faith in the Australian Contract Law" (2003) 19 *JCL* 155; "A Good Faith Perspective on Liquidated Damages" (2007) 23 *JCL* 157.

15 See eg *Royal Botanic Gardens and Domain Trust v South Sydney City Council* (2002) 186 ALR 289 at 311-12 per Kirby J.

16 [1993] 1 Lloyd's Rep 397.

Citibank NA,[17] *Gan Insurance Co Ltd v Tai Ping Insurance Co Ltd (No 3)*[18] and *Paragon Finance plc v Nash*.[19] He concluded:[20]

> "It is plain from these authorities that a decision maker's discretion will be limited, as a matter of necessary implication, by concepts of honesty, good faith, and genuineness, and the need for the absence of arbitrariness, capriciousness, perversity and irrationality. The concern is that the discretion should not be abused. Reasonableness and unreasonableness are also concepts deployed in this context, but only in a sense analogous to *Wednesbury* unreasonableness, not in the sense in which that expression is used when speaking of the duty to take reasonable care, or when otherwise deploying entirely objective criteria."

Rix LJ was critical of the approach taken by the first instance judge, Gloster J. She had concluded that "Standard was obliged to act honestly and reasonably and to arrive at a value which properly reflected the actual value of the Designated Assets as at the termination date".[21] She went on: "I do not view the obligation to act reasonably as anything in essence different from the obligation to use good faith: it is part of the good faith obligation that Standard should conduct the valuation process in a reasonable manner, to arrive at what objectively can be said to [be] a proper value of the Designated Assets at the termination date…"[22]

This approach is very similar to that expressed by Australian courts when dealing with implied terms of good faith, where generally no distinction is drawn between good faith and reasonableness.[23] By comparison, Rix LJ stated that the reference to objective standards "plainly" go beyond concepts of good faith and rationality.[24]

Gloster J suggested during argument in court that there was perhaps a comparison to be made between Standard's obligation to value and a mortgagee's powers of sale, where in England, reasonable care must be exercised. Socimer's lawyers took up this suggestion and argued that Standard's discretion to value the assets was in a similar situation. This was rejected by the Court of Appeal on the basis that the analogy was not appropriate. Lloyd LJ concentrated on this point alone

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17 [1998] Lloyd's Rep IR 221.

18 [2002] Lloyd's Rep IR 612.

19 [2002] 1 WLR 685.

20 [2008] I Lloyd's Rep 558 at 577.

21 Quoted at [2008] 1 Lloyd's Rep 558 at 578 (para 73), at para (36) of her judgment.

22 Quoted at [2008] 1 Lloyd's Rep 558 at 578 (para 73), at para (40) of her judgment.

23 See cases cited at footnote 1.

24 [2008] 1 Lloyd's Rep 558 at 578 (para 74).

in his speech, in which he otherwise agreed with Rix LJ.[25] His view was that mortgagees have powers and obligations imposed by the law of mortgages. He compared a situation *not* involving a mortgage, where it is only possible to incorporate similar type obligations if the tests for implication of terms are satisfied. He was not convinced that the tests could be satisfied in the case and therefore agreed with Rix LJ. He states:[26]

> "It seems to me ... that [Gloster J] was led by that similarity into drawing, and applying, an analogy with mortgage law, while overlooking, on the one hand, the need to justify the implication on the basis of conventional contract law and, on the other hand the fact that, in relation to a mortgage, the duties by reference to which she drew the analogy do not derive, and cannot be derived, from such a process of implication, but are imposed as a matter of general law, which does not apply in the present case because the transaction is not a mortgage."

Again, this position can be contrasted with that in Australia, where it is well established that good faith has a role to play where a mortgagee has a power of sale. However, the meaning of 'good faith' in that context is not settled,[27] yet it does not require reasonable behaviour. Thus, in Australia while a mortgagee is not required to act reasonably when dealing with another's property, an innocent party will be required to exercise express rights to terminate reasonably, as evidenced by the decision in *Renard Constructions (ME) Pty Ltd v Minister for Public Works*,[28] which will be considered below. The opposite is the position in England, as evidenced by *Socimer*.

Finally, the method of incorporation of restrictions of good faith should be considered. Currently, the approach being taken in England and Australia is to imply a term when 'good faith performance' is required.

Implied Terms of Good Faith

Given that good faith as a concept or requirement underlies contract law and the recent statement of Rix LJ about "implicit good faith" setting a default standard of honesty and rationality, it must be

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25 [2008] 1 Lloyd's Rep 558 at 594.

26 [2008] 1 Lloyds' Rep 558 at 594.

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

28 (1992) 26 NSWLR 234. ('*Renard*').

asked whether we need an implied term of good faith? Yet *Socimer* and *Renard* both proceeded on the basis of incorporating good faith with an implied term.[29] Courts (especially in New South Wales) seem to prefer the idea that the term requiring good faith and reasonableness should be regarded as one implied in law.[30] In England, while the meaning attributed to 'good faith' is the more defensible one of 'honesty', there is a preference for using a term implied in fact, as evidenced by *Socimer*.[31]

The 'implied term approach' is misconceived. As good faith is already implicit in contract rules and construction principles, if a court implies a term of good faith the court is either implying a redundant term or implying a term which imposes a more onerous obligation. In some cases it *might* be appropriate to incorporate a requirement of a higher standard of behaviour than the law otherwise requires, but such a term must either be incorporated as a matter of construction or satisfy the rules for implication, which would be possible, but unusual. In relation to the cases which suggest a term of good faith is implied in law, the problems are that:

(a) terms implied in law create default rules, and as good faith is already the default position, this adds nothing more; and

(b) terms implied in law are incorporated as default rules for contracts dealing with particular relationships, rather than all contracts, and therefore the implied term approach cannot be appropriate to incorporate good faith into every contract.[32]

Furthermore, using an implied term approach seems a 'backwards' step. A comparison can be made with other aspects of law that developed from an implied term approach, but moved away from that

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29 See Elisabeth Peden, 'Incorporating Terms of Good Faith in Contract Law in Australia' (2001) 23 *Syd LR* 222; Elisabeth Peden, *Good Faith in the Performance of Contracts*, Butterworths, Sydney, 2003, paras 6.10-6.19.

30 See, NSW Court of Appeal decisions, such as *Burger King v Hungry Jack's Pty Ltd* [2001] NSWCA 187, at [164]; *Alcatel Australia Ltd v Scarcella* (1998) 44 NSWLR 349 at 369 per Sheller JA (with whom Powell and Beazley JJA agreed). Cf *Renard* (1992) 26 NSWLR 234 at 263 (where Priestley JA seemed to conceive of a 'hybrid' term); *Vodafone Pacific Ltd v Mobile Innovations Ltd* [2004] NSWCA 15. In *CGU Workers Compensation (NSW) Ltd (ACN 003 181 002) v Garcia* (2007) 69 NSWLR 680 in the context of insurance, the NSW Court of Appeal did state that the law has not yet gone so far as to imply a term requiring good faith performance into all contracts, but did leave open that possibility (at paras 131-136). The Court did not clarify the issue of the meaning of good faith and whether it includes reasonableness. First instances judges take differing approaches. For example, Einstein J prefers a term implied in law: see eg *PRP Diagnostic Imaging Pty Ltd v Pittwater Radiology Pty Ltd* [2008] NSWSC 701 at paras 99-104. Compare Bergin J in *Insight Oceania Pty Ltd v Philips Electronics Australia Ltd* [2008] NSWSC 710, at para [177] who preferred a term implied in fact.

31 *Socimer International Bank Ltd v Standard Bank Ltd* [2008] 1 Lloyd's Rep 558.

32 See generally Peden, *Good Faith in the Performance of Contracts*, 2003, chapter 6.

approach when it was acknowledged that such an approach was 'fictitious'. Anticipatory repudiation and frustration are examples.[33] Courts should feel confident enough to recognize implicit good faith, without recourse to implied terms.

The problem of this approach is tied up with the meaning that is being given to 'good faith'. If courts are implying a term of 'good faith' which requires objectively reasonable behaviour, as did Gloster J in *Socimer* and many Australian cases appear to do, then the courts are actually using good faith as a rationale for a specific implication that a party act reasonably when exercising an express right of termination or discretion to value. Of course, that specific implication would be difficult to reconcile with authority,[34] and the attraction of the language of 'good faith' is that it enables a judge to reach a result that authority might not otherwise permit.

In *Socimer*, the argument in favour of an implied term fettering the exercise of the discretion was that while Standard could be trusted to act in its own interest to get the best price when selling designated assets, this was not necessarily the case when valuing a retained asset. In that situation, Standard's interest was in conflict with the interests of the buyer, Socimer, because it would want to assign as low a value as possible so as to maximize potential profit on a later sale.[35] Gloster J held there should be an implied term that "imposes on Standard a duty, in doing its valuation, to take reasonable precautions to value the Designated Assets at 'the fair' or 'the true market' or 'proper' value".[36]

While Rix LJ disagreed and held that the fetter was merely to behave honestly, it is interesting that he agreed that the fetter ought to be incorporated by implication of a term.[37] He highlighted the "useful and authoritative modern restatement of the relevant principles upon which

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33 See eg in relation to frustration *Denny, Mott & Dickson Ltd v James B Fraser & Co Ltd* [1944] AC 265; *Davis Contractors v Fareham UDC* [1956] AC 696; *Codelfa Construction Pty Ltd v State Rail Authority of NSW* (1982) 149 CLR 337. In relation to anticipatory breach see M Mustill, *Anticipatory Breach*, Butterworths Lectures (1989-1990), p53; JW Carter, *Breach of Contract*, 2nd ed, 1991, paras 717-26. See also Elisabeth Peden, *Good Faith in the Performance of Contracts*, 2003, paras [2.7]-[2.12].

34 See eg *Tanwar Enterprises Pty Ltd v Cauchi* (2003) 201 ALR 399, where exercise of a right of termination for breach of an essential time clause was upheld as there was no unconscientious behaviour (and reasonableness was not considered); *Meehan v Jones* (1982) 149 CLR 571, where the High Court did not require reasonable behaviour of a purchaser given a discretion to find satisfactory finance; *White and Carter (Councils) Ltd v McGregor* [1962] AC 413, where the House of Lords did not require an innocent party to behave reasonably in deciding whether to exercise a common law right to terminate.

35 [2008] 1 Lloyd's Rep 558 at 583, para [96].

36 Quoted at [2008] 1 Lloyd's Rep 558 at 578-9, paras [74]-[75].

37 At [2008] 1 Lloyd's Rep 558 at 587, para [111], Rix LJ points out that the implied terms contended for by the parties were different.

terms may be implied"[38] of *Philips Electronique Grand Public SA v British Sky Broadcasting Ltd*,[39] which relied upon *BP Refinery (Westernport) Pty Ltd v Shire of Hastings*,[40] and the '5 point test',[41] which has been repeated in High Court decisions many times and is the standard authority for implication in fact in Australia.

Rix LJ states:[42]

> "The courts' usual role in contractual interpretation is, by resolving ambiguities or reconciling apparent inconsistencies, to attribute the true meaning to the language in which the parties themselves have expressed their contract. The implication of contract terms involves a different and altogether more ambitious undertaking: the interpolation of terms to deal with matters for which, ex hypothesi, the parties themselves have made no provision. It is because the implication of terms is potentially so intrusive that the law imposes strict constraints on the exercise of this extraordinary power."

In relation to the implication of fetters on discretion he adds:[43]

> "Implications of good faith and rationality, and lack of arbitrariness or perversity, are standard, for they represent the very essence of business (and other) relationships. Once one goes beyond them, however, the matter becomes much more uncertain."
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> "In my judgment, the requirements of good faith and rationality are a sufficient protection. The danger to be guarded against... is abuse caused by self-interest. That is precisely what implicit good faith deals with. Commercial contracts assume such good faith, which is why express language requiring it is so rare."[44]

Having stated the law this way, it is not clear why then Rix LJ felt that the fetter on the exercise of the discretion needed to be achieved by an implied term. He had concluded that express terms requiring good faith were usually unnecessary in commercial contracts and that strict constraints are placed on courts wishing to imply terms. Furthermore, he applied the test of whether it was 'necessary' to imply a term requiring reasonable behaviour, and decided that the test could not be

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38 [2008] 1 Lloyd's Rep 558 at 585.

39 [1995] EMLR 472.

40 (1977) 52 ALJR 20; (1977) 180 CLR 266.

41 "[F]or a term to be implied, the following conditions (which may overlap) must be satisfied: (1) it must be reasonable and equitable; (2) It must be necessary to give business efficacy to the contract, so that no term will be implied if the contract is effective without it; (3) it must be so obvious it goes without saying; (4) it must be capable of clear expression; (5) it must not contradict any express term of the contract".

42 [2008] 1 Lloyd's Rep 558 at 585.

43 [2008] 1 Lloyd's Rep 558 at 586.

44 [2008] 1 Lloyd's Rep 558 at 588.

satisfied, as the term was not necessary. In his view, it ran against "the vein of the agreement as a whole, which plainly gave the determination of value to Standard, in the exercise of its subjective judgment and subject to a wide discretion."[45] Nevertheless, he decided that a term could be implied in fact that the discretion be exercised in good faith, that is requiring rationality etc, but without going through the same application of the test for implication in fact.

Might it not have been possible to conclude that as the "vein of the agreement" only required good faith? That is, might it be said that Socimer's obligation to exercise the discretion to value in good faith was achieved through construction? Would that not have been, in Rix LJ's language, attributing "the true meaning to the language in which the parties themselves have expressed their contract"?[46]

With that in mind, what is the state of the law in Australia? In Australia, since the decision of *Renard* in 1992, there has been judicial support for the idea that rights of termination ought to be fettered with an implied term requiring good faith and reasonableness. The method of incorporation of the fetter is the same as that used in England, namely an implied term, yet the fetter is generally a more onerous obligation of objective reasonableness, rather than subjective honesty.

Renard Constructions (ME) Pty Ltd v Minister for Public Works

In contrast to the decision in *Socimer*, is the NSW Court of Appeal decision in *Renard*, which has led to numerous decisions implying terms of good faith and reasonableness. In *Renard* the ability of the principal under a building contract to rely on a show cause procedure was subjected by the NSW Court of Appeal to requirements of reasonableness. Priestley JA said:[47]

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

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45 [2008] 1 Lloyd's Rep 558 at 583, para [94].

46 Compare *Boat Park Ltd v Hutchinson* [1999] 2 NZLR 74 where the meaning and standard of a 'valuation' was determined by construction of the clause. At 83-4, Thomas J (on behalf of the Court of Appeal) stated: "by 'valuation' something that is recognizable as a bona fide commercial attempt to value the property is contemplated. We accept that it must be prepared in good faith. But more is required. In our view the valuation contemplated by the clause must be a proper valuation in the sense that it has been prepared by a registered valuer in accordance with basic valuation principles and basic valuation methods".

47 (1992) 26 NSWLR 234 at 258.

This requirement of reasonableness now seems to be regarded as a main ingredient of good faith in Australian cases.[48]

In *Renard*, the issue was the operation of cl 44.1 of the contract. This clause provided that if the contractor defaulted the principal was entitled to call upon the contractor, by notice in writing, to 'show cause within a period specified in the notice' why the powers set out in the clause 'should not be exercised'. Clause 44.1 required:

- Written notice;
- The notice to state it was a notice under the clause; and
- The notice to specify the default.

Had these requirements not been express, arguably good faith and commercial construction would have required the principal to provide this information to the contractor in any event. Factually, there was no need to incorporate reasonableness, as the principal had acted contrary to good faith, that is, it had failed to act honestly.

The clause further provided that if the contractor failed to show cause to the satisfaction of the principal within the time given, then the principal could take over the work or cancel the contract. The contractor did not complete the work on time, and the principal served a notice under cl 44.1. While the contractor was clearly in default, the delay was in part because the principal had not provided the contractor with necessary materials as required. The principal then purported to terminate the contract. The arbitrator found that this decision was based on "unfairly misleading, incomplete and prejudicial information".[49]

The majority of the Court of Appeal, Handley and Priestley JJA, implied a term in fact or in law, (or in what Priestley JA called a 'hybrid' of the two[50]) that the principal act in good faith and reasonably. They also held that this term had been breached by the purported termination in the circumstances. Meagher JA, on the other hand, by construing clause 44.1 found it required the principal to act on accurate information when forming a view on whether the contractor had shown

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48 See eg *Burger King Corp v Hungry Jack's Pty Ltd* [2001] NSWCA 187, reported in part (2008) 69 NSWLR 558 and cases following. See however *Hunter Valley Skydiving Centre Pty Ltd v Central Coast Aero Club Ltd* [2008] NSWSC 539 at [48].

49 (1992) 26 NSWLR 234 at 246.

50 (1992) 26 NSWLR 234 at 263.

cause. This had not occurred, and therefore the principal's purported termination was wrongful. In other words, it might be said that 'implicit' good faith required an honest use of clause 44.1.

Such implicit good faith has already been recognised by the Australian High Court for some time, but perhaps forgotten. In 1953 in *Carr v J A Berriman Pty Ltd*,[51] the High Court resorted to construction and implicit good faith, without expressly referring to them, to resolve a dispute about the operation of a contractual discretion. The relevant clause entitled an architect to use his 'absolute discretion' to omit work from a building. The principal argued that this clause entitled it to omit steel fabrication work from the contract for the purpose of having the work done by a third party (presumably more cheaply). Fullagar J acknowledged that such a clause was common and had an obvious purpose of enabling the architect to manage the construction of the building as appropriate. However, he stated:[52]

> But [the words] do not, in my opinion, authorize him to say that particular items so included shall be carried out not by the builder with whom the contract is made but by some other builder or contractor. The words used do not, in their natural meaning, extend so far, and a power in the architect to hand over at will any part of the contract to another contractor would be a most unreasonable power, which very clear words would be required to confer.

Two points might be made from Fullagar J's judgment in *Carr v Berriman*. First, he was adopting what might be called a 'good faith interpretation', just as Meagher JA did in *Renard*. In both cases interpretation was enough to determine whether the principal or architect was entitled to act in the way it had acted on the particular facts. The principal's argument in *Renard* was for what Fullagar J described as "a most unreasonable power", because it would have allowed the principal to decide that cause had not been shown without considering accurate information.

Secondly, in *Carr v Berriman* there was no recourse to implied terms to reach the result. The same might have been true in *Renard* and *Socimer*. However, the current approach taken in Australia and England appears to be a preference to incorporate good faith through an implied term. The difference between the approaches on either side of the globe is that the term being implied in England only requires honesty, and not reasonableness.

While the result in *Renard* is not problematic, the subsequent cases in which it has been applied have led Australian contract law into a peculiar situation. Commercial parties are now faced

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51 (1953) 89 CLR 327.

52 (1953) 89 CLR 327 at 347. The other members of the High Court agreed.

with the question of whether they dare to suggest in negotiations that they are not prepared to perform 'in good faith' as that may require reasonableness on their part. Alternatively, should they expressly state that they will not behave reasonably, or will that be a 'deal breaker'? Arguably this was not an issue before *Renard*, as in the words of Rix LJ, "commercial contracts assume good faith". It is only now with the uncertainty that has arisen from *Renard* that contracting parties are left with the additional negotiation and drafting problem, and possibly litigation.

It might be noted that there are two recent first instance decisions in New South Wales that question the validity of implying a term of good faith into contracts. In *Hunter Valley Skydiving Centre Pty Ltd v Central Coast Aero Club Ltd*[53] Brereton J states that "the implication of a term that a contractual right will be exercised only in good faith does not fit neatly into the structure of Australian contract law".[54] In *Agricultural & Rural Finance Pty Ltd v Atkinson*,[55] Young CJ expressed the view that there had only been a "flirting" by courts with the idea of implying terms of good faith, an idea which he rejected in the case before him. So, while such decisions provide some hope, they are far outweighed by the number of decisions that take the '*Renard* approach'.

Standards of performance

Generally we think of contract obligations as 'strict'. Thus, a seller's obligation to deliver goods is strict and the goods must be delivered. It is not an excuse that they behaved honestly or reasonably; the obligation is to deliver or they are in breach. However, sometimes the strict obligation to do some positive act must be understood in the context of what is being done and where there is a discretionary element. Then the obligation requires only good faith or honest behaviour. For example, if the contract does not specify *when* delivery is due, then the Court will require delivery 'in a reasonable time' and consider the facts as to whether that time frame was complied with or not. Or if there is an obligation to value, the method of valuation will be considered and require honest valuation. Similarly, in *Socimer*, there was an obligation to value the assets. That obligation was strict; Socimer was obliged to value the assets at the termination date. But there was still a

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53 [2008] NSWSC 539.

54 [2008] NSWSC 539 at [48].

55 [2006] NSWSC 202, reversed on other grounds: *Gardiner v Agricultural & Rural Finance Pty Ltd* [2007] NSWCA 235.

question of 'how' the valuation should have been carried out. The Court of Appeal held that it only had to be carried out honestly, not reasonably.

This approach is consistent with other contexts where powers or discretions have been construed to require good faith performance. Examples are provided in the Court of Appeal decision and include for example, *Paragon Finance Plc v Staunton; Paragon Finance Plc v Nash*,[56] where there was a discretion to change interest rates, which was similarly found by the Court of Appeal to require the party provided with the discretion to behave in good faith, or not arbitrarily, capriciously or 'unreasonably' in the sense of *Wednesbury* unreasonableness. The other 'obvious' context where a strict obligation is not required is in contracts to provide professional services. For example, an accountant is expected to exercise reasonable care in provision of his or her accountancy services.

The interesting feature in these cases is the method of incorporation of the standard of behaviour required. In both situations dealing with powers and discretions and situations importing standards of care, the courts use the method of implied terms. However, in the former, terms implied in fact are preferred, whereas in the latter, terms are implied in law. Why is there a distinction, and is it valid?

In relation to standards of care incorporated into professional contracts, courts have used the mechanism of terms implied in law, as it has been understood that this obligation is part of the nature of the particular relationship involved in the contract. In Byrne v Australian Airlines Ltd, McHugh and Gummow JJ explained:[57] "Many of the terms now said to be implied by law in various categories of case reflect the concern of the courts that, unless such a term be implied, the enjoyment of the rights conferred by the contract would or could be rendered nugatory, worthless or, perhaps, be seriously undermined".

However, there are other possible ways to view this current, and inherently appropriate, situation where the obligation is not a strict one. For example, it is possible to view the question as one of construction of the scope of the obligation itself. That is, the professional does not promise to

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56 [2002] 2 All ER 248. See also *Abu Dhabi National Tanker Co v Product Star Shipping Ltd (The "Product Star") (No 2)* [1993] 1 Lloyd's Rep 397. See also *Equitable Life v Hyman* [2000] 3 All ER 961; *Gan Insurance Co Ltd v Tai Ping Insurance Co Ltd (No 2)* [2001] 2 All ER (Comm) 299.

57 (1995) 185 CLR 410 at 450.

do any more than provide reasonable care in the provision of the services. Alternatively, it could be seen as a situation where the presumed position of a requirement of good faith or honesty has been displaced because of the nature of the contract and been replaced with a standard of reasonable care.

The standard of performance ought always be recognised as a question of construction. For example, in *Greaves & Co (Contractors) Ltd v Baynham Meikle & Partners*[58] structural engineers were engaged to design the structure of a factory, including the first floor which was to cope with the weight of forklift trucks. The English Court of Appeal held that while courts will imply a term in law into contracts with professionals that they exercise reasonable care and skill, on the particular facts of the contract, the "evidence shows that both parties were of one mind on the matter. Their common intention was that the engineer should design a warehouse that would be fit for the purpose for which it was required", and therefore such a term was implied as a matter of fact.

Approaching the standard of obligation as a question of construction is consistent with the theory that good faith underlies the institution of contract law, and yet allows freedom of contract and the parties to provide for alternative standards through express terms. Further, construction of the contract provides more appropriate standards when a good faith or honest requirement is insufficient in the particular context.

Relationship between Construction and Implication

It is therefore important to consider the 'reach' of construction in the context of implication. Construction cannot create new obligations outside the contract itself. For example, if a contract provides that X must do A, B and C, in construing that contract the court can explain what A, B and C mean, or explain the 'spirit' of these terms. Often in doing so the courts decide there is a gap, and then proceed to imply a term. If a term is implied, the court would then theoretically have to construe that term to determine its meaning and application. So there is understandably some circularity or overlap between construction and implication which can confuse the issues.[59] Another problem is that many judgments do not explain their reasoning process, which makes it difficult to

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58 [1975] 1 WLR 1095 at 1100-1 per Lord Denning MR, with whom Browne and Geoffrey Lane LJJ agreed.

59 See eg Lewison, *The Interpretation of Contracts*, 4th ed, 2007, p196, for example, notes "It may be questioned whether the determination whether any and if so what terms are to be implied into a contract is truly part of the process of construing contracts at all."

determine what has occurred.[60] It is possible that construction plays a further role in implication and that construction can, in explaining the meaning of the contract, impose some obligation that did not exist on the face of the express terms. For example, where a contract is silent as to the effort required by one party to perform an express obligation, a court can by construction determine that in the context of the particular contract the obligation must only be performed with best efforts, rather than strictly.[61]

In many situations is it unclear from the terminology and approach taken whether the courts are using 'construction' or 'implication'. *Socimer* is one such example. *Socimer* has been approved and applied in *JML Direct Ltd v Freesat UK Ltd*,[62] where in discussing the fetters of good faith and rationality, Blackburne J emphasized the "need to approach the matter as one of *contractual implication* and to avoid importing expressions appropriate to public law challenges into the *construction* of a commercial contract".

A further example of this interrelationship between construction and implication is provided by the High Court of Australia's decision in *Secured Income Real Estate (Australia) Ltd v St Martins Investments Pty Ltd*,[63] which is a case often cited in the context of the 'good faith debate'. The case concerned the sale of a building, where the purchase price was to be determined by how much of it was rented. The question was whether the purchaser was obliged to rent part of it to the vendor in order for the vendor to receive a higher price. Mason J wrote the judgment of the court. At first suggested he suggested that the duty of co-operation arises as a matter of construction of the contract, stating "it is common ground that the contract imposed an implied obligation on each party to do all that was reasonably necessary to secure performance of the contract",[64] citing Blackburn LJ in *Mackay v Dick*. But when he continued, he seemed to suggest that it was a question of implication:[65]

> "It is not to be thought that this *rule of construction* is confined to the imposition of an obligation on one contracting party to co-operate in doing all that is necessary to be

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60 See eg JW Carter, "'Commercial' Construction and the *Canada SS* Rules" (1995) 9 *JCL* 69 at 74-5.

61 For example, courts must determine whether parties promised to use best endeavours to obtain licences or undertook absolutely that a licence would be obtained. Eg *Re Anglo-Russian Merchant Traders Ltd and John Batt & Co (London) Ltd* [1917] 2 KB 679; *Brauer & Co (Great Britain) Ltd v James Clark (Brush Materials) Ltd* [1952] 2 All ER 497; *Malik Co v Central European Trading Agency Ltd* [1974] 2 Lloyd's Rep 279.

62 [2009] EWHC 616 (Ch) at paragraph [43].

63 (1979) 144 CLR 596.

64 (1979) 144 CLR 596 at 607.

65 (1979) 144 CLR 596 at 607-8. (emphasis added).

done for the performance by the other party of his obligations under the contract. As Griffith CJ said in *Butt v M'Donald*:[66]

> 'It is a general rule applicable to every contract that each party agrees, by implication, to do all such things as are necessary on his part to enable the other party to have the benefit of the contract.'

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

The italicised words are a mixture of terminology used in, and appropriate to, construction of contracts and implication of terms, and it is not clear exactly which approach is being taken. The quotation from *Butt v M'Donald* states that the obligation to co-operate is implied, and Mason J adopted this terminology at the beginning of the next paragraph. But towards the end of it he again suggested that that it was a matter of construction.

Contracts are construed in accordance with the parties' intentions and the notion of upholding the bargain. However, 'duties' of co-operation are often implied terms that are necessarily implied, because the contract contains a gap that must be filled. Thus, Mason J was correct to state that it is easy to imply such a term where it is necessary for the working of the contract, but less easy where it is purely helpful to one party, since this would not satisfy the implied term test of necessity for 'business efficacy'. This approach has been endorsed by members of the High Court in *Byrne & Frew v Australian Airlines Ltd*,[67] where it was said that "the more modern and better view is that these rules of construction are not rules of law so much as terms implied, in the sense of attributed to the contractual intent of the parties, unless the contrary appears on a proper construction of their bargain."[68]

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66 (1896) 7 QLJ 68 at 70-71.

67 (1995) 185 CLR 410 at 447-453 per McHugh and Gummow JJ. The other judges did not comment on *Mackay v Dick*.

68 (1995) 185 CLR 410 at 449.

Construction has 'expanded' to replace implied terms in relation to the doctrines of frustration.[69] While it can be argued that construction might replace implication of terms,[70] this is not the accepted view at present.[71] However, in the recent Privy Council decision of *AG of Belize & Ors v Belize Telecom Ltd & Or,* Lord Hoffman, on behalf of the Privy Council, stated:[72] "implication of the term is not an addition to the instrument. It only spells out what the instrument means.... [T]he implication of a term is an exercise in the construction of the instrument..." In his view, "there is only one question: is that what the instrument, read as a whole against the relevant background, would reasonably be understood to mean?"[73]

Construction and implication are both limited to operate within the four corners of the contract, as defined by the parties. Implication fills in missing pieces in that jigsaw, while construction gives the appropriate colour or shading to pieces that already exist to provide the picture with a realistic and workable look. For example, if there was a contract that X should go to Brisbane to deliver goods in return for money from Y, it is possible that both construction and implication would have a role. First, the term that X should go to Brisbane could be construed to determine if it was a condition or a warranty. This is not the job of implication. Then, if it were in issue, the courts might be asked whether it was part of the contract that X would deliver the goods before Wednesday 2nd. One argument would be that there might be an implied term that X would deliver the goods before Wednesday 2nd. This would require the application of the tests of implication in fact to determine whether the parties intended that this should be a term.

However, why is it not the appropriate approach to determine the issue by construction? Although at first glance it appears a 'big jump' from the express term to this term, when other facts are considered the jump is not so big and at a doctrinal level we are simply interpreting the express terms, that is, construing them. Because the jump seems large we may say it is 'implication by construction', rather than a mere 'entailment' from the express terms. The term that X deliver the goods is express. To determine whether X should perform this task before Wednesday 2nd is merely

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69 *Davis Contractors Ltd v Fareham UDC* [1956] AC 696. See further, Peden, *Good Faith in the Performance of Contracts*, 2003, paras 2.7-2.9.

70 See eg Peden, *Good Faith in the Performance of Contracts*, 2003, Chapter 7.

71 See eg *Gordon and Gotch Asutralia Pty Ltd v Horwitz Publications Pty Ltd* [2008] NSWCA 257 at para [36].

72 [2009] UKPC10, at paragraphs [18]-[19].

73 [2009] UKPC10 at paragraph [21]. Lord Hoffman was concerned that "there are dangers in treating the [tests' for implication in fact] as different or additional tests": at paragraph [21].

to add colour or detail to that term. There is no gap concerning an obligation. There is no issue as to which party must deliver the goods. The only issue is when. How is this question to be determined? The court considers the sentence and its context in the contract. It may be merely a question of order of performance. For example, the contract might state that Y needs to use or deliver the goods to Z the same day or soon after, making it clear that X must deliver the goods on Wednesday 2nd. Order of performance is always considered an issue of construction, because it is based on intention.[74] Alternatively, the court might construe the term to mean that it must be performed within a 'reasonable time', which is discussed below.

Many examples might be given of situations where courts are prepared to incorporate 'inherent' obligations through construction, rather than resorting to an implied term.[75] Examples include the following:

(a) requirement to perform in a 'reasonable time', when no time is specified;

(b) deciding which party should perform obligations, where no party is specified;

(c) implying or construing detail into an otherwise silent contract.

(a) Reasonable time.[76]

Often terms without specified times for performance are deemed to include a reasonable time limit.[77]

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74 Generally Carter, Peden & Tolhurst, *Contract Law in Australia*, 5th ed, 2007, para 28-05. See also *Brooks v Burns Philp Trustee Co Ltd* (1969) 121 CLR 432 at 463-4 per Windeyer J; *Burton v Palmer* [1980] 2 NSWLR 878 at 895, that the intention of the parties in relation to order of performance is to be "derived by implication" from the terms of the contract and any admissible evidence of surrounding circumstances. "Implication from the terms" of the contract can be seen as equivalent to stating the implication is "implicit" or "inherent" rather than relying on an implied term.

75 See for example *Legal & General Assurance Society Ltd v Expeditors International (UK) Ltd* [2007] 2 P&CR10, where Lloyd LJ implied a term, and Sedley LJ approached the matter as one of construction.

76 Other terms of 'reasonableness' are implied by construction also. Eg *Finchbourne Ltd v Rodrigues* [1976] 3 All ER 581, where the Court of Appeal held that in a tenancy agreement where the managing agents were to certify the amount the tenant was to contribute to the maintenance of the flats, there was an implied term that the costs be fair and reasonable. This term was justified with the parties' intentions. The exercise of rights under contracts and discretions are construed to require reasonableness. For example, where a ship-master was entitled to land cargo at a different port for safety reasons, it was held that the master was "bound to exercise that discretion fairly as between both parties, and not merely to do his best for the shipowners, his masters, disregarding the interests of the charterers": *Tillmanns & Co v SS Knutsford Ltd* [1908] 2 KB 385 at 406 per Farwell LJ; affirmed [1908] AC 406.

77 Generally Lindgren, *Time in the Performance of Contracts*, 2nd ed, 1982, paras 451-453.

(b) Deciding which party should perform.

Courts can, as a matter of construction, determine that one party has an obligation to carry out a task that is necessary for the contract to operate, even though it is not expressly required in the contract. For example, in in *AV Pound & Co Ltd v MW Hardy & Co Inc*[78] the judges had to decide which party to a sale of goods contract (turpentine) had to obtain an exporters' licence.[79] The contract was illegal without a licence. The House of Lords held that as a matter of construction of the contract it was the sellers' duty to obtain the licence.[80] Viscount Kilmuir LC decided this because the sellers had all the information. Viscount Simonds held that there was no express obligation on the buyers to obtain the licence, and then considered whether it was implied by construction. He could find no such obligation "according to the ordinary principles of construction".[81] Therefore, the sellers' case failed.[82] There is no problem with the result. [83] The interesting point is the use of "construction".

Viscount Simonds did not explain which "ordinary principles of construction" he was using. Since there was no express term specifying which party should obtain the licence, which was vitally necessary for the completion of the contract, this specification needed to be implied. The judges construed the contract as a whole to determine the result. In effect, they decided that the contract expressly required the buyers to do A, B and C, and this did not impliedly include the obligation to obtain the licence.

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78 [1956] AC 588.

79 See Treitel, Frustration and Force Majeure, 2nd ed, 2004, para 8-012 suggests that where a contract is silent as to which party must obtain a licence the court decides by asking which party is in a better position to obtain the licence. As regards the standard of the duty to obtain a licence, he suggests that if the contract is silent as to the need for an export licence, generally a term will be implied requiring a party to use due diligence to obtain a licence. However, where there is an express term, the standard of the duty will be determined by construction of the whole contract: paras 8-011-2. Also *Benjamin's Sale of Goods*, 7th ed, 2006, paras 18-309ff.

80 For this reason there was no need to decide the issue of frustration. See Treitel, *Frustration and Force Majeure*, 2nd ed, 2004, paras 8-020-8-022.

81 [1956] AC 588 at 606.

82 Lord Morton agreed with Viscounts Kilmuir and Simonds. Lord Reid concurred. Lord Somervell agreed in a short speech.

83 Viscount Simonds went on to assume that the obligation was the sellers' and held that in such a case, the buyers would have to co-operate by telling the seller the destination of the goods and "otherwise as may be reasonable": [1956] AC 588 at 606. This suggests an open-ended obligation to co-operate. However, this obiter statement can be explained as an expression of willingness on the part of the court to imply terms embodying the notion of co-operation as required. See also *Peter Cassidy Seed Co Ltd v Osuustukkakauppa IL*[1957] 1 WLR 273.

Why was construction rather than the tests of implication the correct tool? Could it not be argued that there was a clear gap in the contract, since there was no term expressly stating which party should obtain the licence, and the only way that gap could be filled was by implication of a term? The reason that construction was the appropriate means of solving the problem is that obtaining the licence was not a completely new obligation that was not contained within the express terms. Exporting the goods involved the procuring of a licence. Therefore, it was merely the explanation of the contract, the construction of the contract that was needed to determine whether the buyers were obliged to obtain the licence. Admittedly, the decision could be clearer, and might have been, had the buyers been suing the sellers and had the court been required to determine whether the sellers needed to obtain the licence.

(c) Implying detail.

'Implication by construction' is not limited to determining which party should perform an obligation or when an obligation must be performed. Providing that express terms in the contract provide the substance of an answer to the problem, the courts can 'imply' the detail. Using the jigsaw analogy again, this would be where the colour and detail of the pieces surrounding a missing piece sufficiently explain what the missing piece looks like. An example is provided by *Television Broadcasters Ltd v Ashton's Nominees Pty Ltd*.[84] There, the parties were to promote a circus tour. The agreement specified which expenses would be paid by the plaintiff, and which by the defendant. After expenditure, profits were to be divided equally. The circus made a loss, and the question was whether there was an implied term that losses would be borne equally, or whether each party would be responsible for those losses incurred as a result of the express expenditure obligations. The trial judge applied the test of implication from Scrutton LJ in *Reigate*,[85] and *Heimann v Cth*[86] and concluded that both parties would not have included such a term and so none could be implied in fact.

However, the Full Supreme Court of South Australia took a different view. The Court held it must have been implied that the monies would be distributed rateably between the parties and it followed that any deficit would be split rateably between the parties in proportion to the amounts

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84 (1979) 22 SASR 552.

85 [1918] 1 KB 592.

86 (1938) 28 SR (NSW) 691 at 695.

which they had agreed to spend in the contract.[87] The Court declared that "on the true construction of the agreements ... losses or expenditure should be shared or borne by the plaintiff and the defendant rateably" in proportion to their agreed expenditure. The Court did not refer to the tests of implication used by the trial judge. Instead, they thought it was clear as a matter of construction, based on intention that the parties, that they would split the losses.

The Court decided that the express provisions for the expenses and profits provided the skeleton of the answer required in the circumstances. It was possible to imply from construction of the agreement how losses would be divided.

Would an implied term have been an alternative solution? In all cases of 'implication by construction' there is no need to resort to the traditional test of implication of terms. The reason that implication proper is unnecessary is that the express terms already provide the answer. The court does not need to go further to question what the parties would have intended and whether business efficacy and obviousness require the implication of a term.

Another example is *Borys v Canadian Pacific Railway Co*[88] where the original owner of land had sold it, reserving the right to all coal, petroleum and valuable stone. The new owner refused to allow the original owner's assignee onto the land to take the petroleum. The Privy Council held that "inherently" the reservation of the substance necessarily implied the existence of a power to recover it and the right of working on the land. The express words of the contract contained the answer, and so there was no need to resort to implication tests.

Conclusion

Construction serves several purposes. Its most well-known function is to explain the legal meaning of the contract. This is important when implication is an issue, since it is by construction that the gaps in the contract are identified. It is also by construction that the parties' intentions are identified. However, construction can also be used to fill some gaps on its own. This process is sometimes

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87 (1979) 22 SASR 552 at 575.

88 [1953] AC 217. Compare a case like *Saner v Bilton* (1878) 7 ChD 815, where the lessor covenanted to keep the main walls in good repair. Fry J held at 824 that this carried an implied licence to enter the premises and occupy for a reasonable time to do what he had covenanted to do.

called 'implication by construction', but is in fact distinct from implication of terms with the traditional tests. Implication by construction is simply the interpretation of contract terms using the full range of what may be legitimately used logically and linguistically. One argument against using such a technique is that it lacks certainty and precision that is said to be provided by the tests used in implication proper. However, courts have stressed in relation to interpretation of contracts that a 'commercial' approach should be taken.[89] This suggests that when construction is used for implication, then there are already rules in place to guide courts - matrix of fact and law, common sense, commercial background, history, reasonable result, and purpose of contract. This use of construction to imply terms merely requires the courts to explain more fully what they are doing.

The construction approach is less artificial than using the implied term approach. Yet, in contexts where a 'fetter' or 'standard' is imposed, courts are imposing it as an implied term, both in England and Australia. However, it is not clear where the 'gap' in the contract is that needs to be filled. The obligation or discretion is express. The only issue is the standard, to which the obligation or discretion must be performed. If an implied term is incorporated it is not a promissory implied term with a distinct operation, but is rather 'parasitic', dependent on the primary express obligation. Generally, when courts are faced with issues about the operation of express terms they define their role in terms of construction. Therefore, when faced with an issue about the operation of an express term and the standard of performance required, the approach should be the same, that is, one of construction.

There are clear limitations on the implied term approach. First, implication of a term in fact would usually be difficult, as such a fetter will rarely be necessary for business efficacy, as the contract could work without it by either requiring strict performance, or allowing absolute subjective discretion. Courts have indicated that where it is not specified, the 'default' position is a requirement of good faith or honesty, as in *Socimer*. But had it been appropriate in the context of a particular contract for a court to construe the obligation as requiring 'reasonable' valuation, that would have been possible. An obvious situation where this would be expected would be where the party providing the valuation was a professional engaged to provide that standard of performance.

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89 Courts prefer a construction that is "reasonable or sensible, and not unreasonable, absurd or inconvenient": Carter, Peden & Tolhurst, *Contract Law in Australia*, 5th ed, 2007, para [12-01]; see also Peden & Carter, "Taking Stock: the High Court and Contract Construction" (2005) 21 *JCL* 172; Carter & Peden, "The 'Natural Meaning' of Contracts" (2005) 21 *JCL* 277.

Terms implied by law can also be seen as examples of construction instead. They are 'default' positions that are assumed to be the way the contract should operate unless the parties have expressly changed that position.

Courts seem to favour the notion of implying a term to fetter the exercise of the discretions on the basis of implication in fact, that is, the term is necessary for the business efficacy of the contract.[90] This approach seems artificial. It is difficult to conceive of why the contract does not operate effectively without a term fettering the exercise of the discretion. In fact, if the discretion was to be exercised in a way that was acceptable to both sides, no doubt the contract would operate easily and the matter would never come to court. The issue only arises because one party feels hardly done by when the other party exercises the power, which is not expressed to contain any fetter, in a way that does not suit them, or they claim is 'unfair'. The better approach would seem to be to use construction of the contract, and in particular of the discretion provided. The principle of good faith would inform this process and the issue of whether the discretion was fettered could be considered on the particular facts.

If the courts accepted that good faith underlies construction, then the discretions or powers could be construed as requiring an exercise of good faith, which would be given meaning in the particular context.[91] The standard of behaviour required by good faith would only be honesty, loyalty to the contract and a requirement to consider the interests of the other party. This would place contractual exercise of discretions in the same position as the general exercise of powers: they must be exercised for a 'proper purpose', within the meaning of the contract. This would remove the artificial reasoning concerning implied terms. This approach is really an adoption of what was

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90 See eg *Paragon Finance Plc v Staunton; Paragon Finance Plc v Nash* [2002] 2 All ER 248 at [42]; *Equitable Life Assurance Society v Hyman* [2000] 3 All ER 961 at 970-1 per Lord Steyn; *Gan Insurance Co Ltd v Tai Ping Insurance Co Ltd (No 2)*[2001] 2 All ER (Comm) 299. Contrast *In re Nicholas and Grant's Lease* (1923) 44 ALT 169, where Irvine CJ construed or "read into" the express right of a landlord to increase rent the word "reasonably".

91 See *Western Metals Resources Ltd v Murrin Murrin East Pty Ltd* [1999] WASC 257, where Templeman J construed a discretion to give consent to an assignment as requiring an obligation not to withhold consent unreasonably: [22] However, he does later talk in terms of implication on the basis of necessity at [33], [39], [40], [49ff].

proposed by Sheller JA in *Alcatel Australia Ltd v Scarcella*,[92] when referring to a 1973 statement by Barwick CJ in *Pierce Bell Sales Pty Ltd v Fraser*[93]:

> "If a contract confers power on a contracting party in terms wider than necessary for the protection of the legitimate interests of that party, the courts may interpret the power as not extending to the action proposed by the party in whom the power is vested or, alternatively, that the powers are being exercised in a capricious or arbitrary manner for an extraneous purpose, which is another was (sic) of saying the same thing. Thus a vendor may not be allowed to exercise a contractual power where it would be unconscionable in the circumstances to do so."

This approach uses construction of the contract and the particular power or discretion to determine the appropriate meaning, without drawing on implied terms and concepts of objective reasonableness. This ought to make the resort to an implied obligation of good faith and reasonableness superfluous.

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92 (1998) 44 NSWLR 349 at 368.

93 (1973) 130 CLR 575 at 587. McTiernan J agreed as did Gibbs J, adding some extra comments. This statement has been adopted in many courts including the NSW Court of Appeal in *Vodafone* [2004] NSWCA 15 at para [216].