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Good faith in contracts in financial services

The Hon Paul de Jersey AC
Chief Justice
Supreme Court of Queensland
Brisbane

SUPREME COURT
OF QUEENSLAND

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"Good faith in contracts in financial services"

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1. In her illuminating paper, Professor Peden makes a powerful case for the propositions, first, that any implication of a term into a commercial contract is unnecessary, because of the implicit obligation of good faith necessarily inherent; and second, that the now established UK position – where "good faith" means honesty and absence of caprice, together with rationality in the Wednesbury sense – is to be preferred over a developing Australian jurisprudence which extends the concept to embrace objective reasonableness as well.

2. Distinct contrast between the 1992 approach of the New South Wales Court of Appeal in *Renard Constructions (ME) Pty Ltd v Minister for Public Works* (1992) 26 NSWLR 234, equating good faith with reasonableness, and the recently expressed approach of the English Court of Appeal in *Socimer International Bank Ltd v Standard Bank Ltd* (2008) 1 Lloyd's Rep 558 will give trial judges and intermediate appeal courts in this country particular cause for concern, in the context of what the High Court said in *Farah Constructions Pty Limited v Say-Dee Pty Limited* (2007) 230 CLR 89, 151-2:

> "Intermediate appellate courts and trial judges in Australia should not depart from decisions in intermediate appellate courts in another jurisdiction on the interpretation of Commonwealth legislation or uniform national legislation unless they are convinced that the interpretation is plainly wrong. Since there is a common law of Australia rather than of each Australian jurisdiction, the same principle applies in relation to non-statutory law."

That is because much of the judicial utterance in this country, *Renard* and other New South Wales cases aside, suggests something of a preference for the English position.

3. An orthodox Australian approach to the attenuated English duty of good faith would see it arising as a matter of the construction of a contract. It is really another expression of the obligation to cooperate in the performance of a contract. That necessarily entails acting honestly, not capriciously, not irrationally. Going back to *Secured Income Real Estate (Australia) Ltd v St Martin's Investment Pty Ltd* (1979) 144 CLR 596, 607, we see Sir Anthony Mason speaking of that duty as one arising on the proper construction of the contract. He said:

> "But 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. As Lord Blackburn said in *Mackay v Dick* (1881) 6 App. Cas. 251, 263:
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> > 'As a general rule ... where in a written contract it appears that both parties have agreed that something shall be done, which cannot effectually be done unless both concur in doing it, the construction of the contract is that each agrees to do all that is necessary to be done on his part for the carrying out of that thing, though there may be no express words to that effect'.
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> 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 done for the performance by the other party of his obligations under the contract. As Griffith CJ said in *Butt v M'Donald* (1896) 7 QLJ 68, 70-1:
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> > '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.'"

4. As we know, the High Court of Australia has yet to consider this issue. It was not determined in *Royal Botanical Gardens and Domain Trust v South Sydney City Council* (2002) 186 ALR 289, because it was not a live issue in that case. The good faith sceptics might however have taken some heart from obiter remarks of two justices who have since retired. Justice Kirby said (p 312):

> "... In Australia, such an implied term appears to conflict with fundamental notions of caveat emptor that are inherent (statute and equitable intervention apart) in common law conceptions of economic freedom. It also appears to be inconsistent with the law as it has developed in this country in respect of the introduction of implied terms into written contracts which the parties have omitted to include."

And Justice Callinan said this (p 327)"

> "... It is unnecessary to answer the questions raised by the rather far-reaching contentions of the appellant, and for which, it says, *Alcatel Australia Ltd v Scarcella* and *Burger King Corp v Hungry Jacks Pty Ltd* stand as authorities: whether both in performing obligations and exercising rights under a contract, all parties owe to one another a duty of good faith; and, the extent to which, if such were to be the law, a duty of good faith might deny a party an opportunistic or commercial exercise of an otherwise lawful commercial right."

5. Professor Peden has entitled one of her essays in this area: "When common law trumps equity: the rise of good faith and reasonableness and the demise of unconscionability". It is interesting to acknowledge that the High Court has resisted attempts to engraft equitable doctrines inappropriately onto other, well-established, common law landscapes.

   In *Tanwar Enterprises Pty Limited v Cauchi & Ors* (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 purchase could have been completed).

   The question re-emerged in *Romanos & Anor v Pentagold Investments Pty Limited & Anor* (2003) 217 CLR 367, 375 where the High Court observed that "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 *ACCC v Berbatis Holdings Pty Ltd* (2003) 214 CLR 51, 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. 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 ..."

He spoke uncritically in this context of parties to commercial negotiations using their bargaining power to "extract concessions from other parties" observing "that is the stuff of ordinary commercial dealing". On one view it is odd the arguable reach of equity meant such confirmations were necessary.

6. Two years on after *Renard Constructions*, the Victorian Court of Appeal touched upon these issues in *Esso Australia Resources Pty Ltd v Southern Pacific Petroleum NL* (2005) VSCA 228. The case concerned the exercise of a right in one joint venturer to assign its interest, without consent, to a related corporation, provided it guaranteed the assignee's obligations. In this case, the assignee was a technically related corporation, and the assignment was made at a time when the assignor's guarantee was worthless, because of the imminent liquidation of the assignor. *Esso* argued that the assignor thereby breached an implied duty of good faith.

Buchanan J wrote the principal judgment and did not conclude whether such a duty was imposed, on the basis that even if it was, it was not breached because *Esso*

gained a financially viable new co-venturer, losing one which had become financially moribund. But he did say this (para 29):

> "The duty of good faith, unlike the duty imposed upon a fiduciary, is not a duty to prefer the interests of the other contracting party, but rather to have due regard to the interests of both parties and the benefits afforded by the contract."

which is rather reminiscent of what Sir Anthony Mason said in *Secured Income Real Estate*.

Chief Justice Warren echoed the concern of many when she spoke of an erosion of certainty in commercial transactions (para 3):

> "If a duty of good faith exists, it really means that there is a standard of contractual conduct that should be met. The difficulty is that the standard is nebulous. Therefore, the current reticence attending the application and recognition of a duty of good faith probably lies as much with the vagueness and imprecision inherent in defining commercial morality. The modern law of contract has developed on the premise of achieving certainty in commerce. If good faith is not readily capable of definition then that certainty is undermined."

7. 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".

Some of the issues which could arise in the commercial context are of quite serious complexion, highly relevant to day-to-day operations. For example, 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 a property to disclose that valuation to the customer? Could threatening to exercise a legally accrued right, in order to encourage the other party to renegotiate 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?

What is "fair" and what is "just" in the abstract sense, is informed by established community values. Some will argue that if these are to be identified, who better than a judge to do so. But while I am obviously 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.

In *Dietrich v R* (1992) 177 CLR 292, 319, Brennan J identified 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.

8. If a duty of good faith, inhering in a contract, is limited to the mutual obligation of the parties to cooperate to ensure its due performance, then there could be no room for complaint. Similarly, if the duty is of the English variety, commanding honesty and rationality, there could be no complaint, because they are no more than incidents of the Secured Investments type obligation. It is the importation of objective reasonableness which injects considerable potential uncertainty into a commercial contract framework.

9. 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 the 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 commercial negotiation.

10. When I refer to existing inroads, I especially have in mind obligations of good faith statutorily imposed. But there is a range of situations in commercial law where issues of good faith have long arisen. 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.

11. The topic as presented in the program also raises whether a duty of good faith which extends, say, to objective reasonableness, might effectively be excluded. I commend an interesting, comprehensive article on this subject by Dr Bill Dixon, who happens to be a Queenslander, published in (2007) 35 ABLR 110 ("Can the common law obligation of good faith be contractually excluded?").

    My present feeling is that an attempt contractually to exclude the duty to act honestly would fail. But what foolhardy entity would be prepared to contract on that basis anyway? It would fail, as would an attempt to exclude an obligation to cooperate to ensure the performance of a contract, because those obligations are essential to its being a contract: they are inherent, necessary characteristics of a contract in the sense that absent those obligations, there would be no contract. The same could be said of the obligation to act reasonably in the Wednesbury sense: that equates to an obligation to act rationally – though not necessarily with perfect reasonableness as may objectively be assessed.

    On the other hand, the possibility of contractually excluding an obligation to act reasonably in that latter objective sense is much more arguably open. Notwithstanding *Renard Constructions* and some of the following cases, it has never been the case that a contracting party is impliedly obliged to act reasonably in that sense. That is because such an implication would not be necessary to render a contract efficacious. It helps to go back to cases like *BP Refinery (Westernport) Pty Ltd v Shire of Hastings* (1977) 180 CLR 206 (as did Rix LJ in *Socimer*) for the constraint upon the implication of contractual terms as a matter of fact. It is also helpful to remember cases like *Meehan v Jones* (1982) 149 CLR 571, where the High Court powerfully debunked a contention that a purchaser was implicitly obliged to act reasonably in seeking finance to satisfy a "subject to finance" provision.

I should qualify what I have said about excluding inherent obligations to act in good faith by referring to "sole discretion" clauses. There is a recent example where such a provision was held to exclude even an obligation to act in good faith. It is *Theiss Contractors Pty Ltd v Placer (Granny Smith) Pty Ltd* (2000) 16 BCL 255, where *Placer* terminated contracts for open cut mining by *Theiss*. *Placer* was entitled to do that, for whatever reason, in which event *Theiss* would be entitled to compensation. The primary Judge rejected the contention that *Placer* was obliged to act in good faith, describing its discretion to terminate as "absolute and uncontrolled", and the primary Judge also rejected a contention that *Placer* was obliged to act reasonably. He did that as a matter of construction (p 100) rather than by reference to the implication of terms. An appeal succeeded, but on another point (2000) 16 BCL 255).

Dr Dixon raises the possibility of express provision in a contract that the parties are not constrained to act reasonably in the broader objective sense, so as to negate the implication of a contradictory obligation; though again, commercial parties may prefer not to have such a provision spelt out.

The author finally refers to "entire agreement" clauses. The authorities are in disarray as to whether such provisions are apt to exclude implicit obligations of good faith, though I venture it is doubtful that such a provision would be effective to exclude an inherent obligation to act in good faith.