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

Rt. Hon Peter Blanchard
A Judge of the Supreme Court of New Zealand
Wellington

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When I had the privilege of addressing this conference four years ago on the subject of "Good faith, commercial morality and the courts", on a panel with the Chief Justice, I began with what amounted to an apology for not being able to entertain the audience by disagreeing with him and largely I find myself in the same miserable position again vis-à-vis my fellow panellists.

I want to begin by summarising where I got to four years ago. I reminded myself of the judicial tools which might make issues about good faith superfluous. They included unconscionability, fiduciary obligations, estoppel, invalidation of penalty clauses and relief against forfeiture. I noted that Lord Mansfield's view[1] that good faith was a "governing principle" had found favour in the United States[2] but not in commonwealth jurisdictions and I suggested it was because of the vagueness of the proposition – too imprecise to be a means of determining disputes between commercial organisations who need to know where they stand. The English Courts had rejected the notion that they had a general equitable jurisdiction to grant relief to a contracting party on some unlimited and unfettered basis. Although recognising that a modicum of uncertainty can sometimes be a force for good in the law, I suggested that we feel instinctively more comfortable with terms like misleading, deceptive, dishonest and fraudulent rather than with the much vaguer notions of good faith or commercial morality which depend upon one's perspective and make predictability of

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1 *Carter v Boehm* (1766) 3 Burr 1905 at 1910; 97 ER 1162.
2 *Wigand v Bachmann-Bechtel Brewing Co* (1918) 118 NE 618 at 619.

adjudication uncertain. I did, however, conclude that unconscionability (or unconscientious behaviour) was not so problematic, being descriptive of more extreme, more recognisable conduct, just as fraudulence is.

Then, having looked briefly at developments in Australia since *Renard*[3] and *Burger King*,[4] I suggested, politely I hope, that the implication of implied terms of good faith and reasonableness were unnecessary and unhelpful; that the particular cases really turned on the construction of contractual terms. It would have been orthodox simply to ask: What power was given? Was it a power restricted by purpose? Objectively, was it intended only for use in particular circumstances or in a particular way? Appeals to good faith and reasonableness did not assist with the necessary analysis of what, objectively, the parties intended when they wrote the contract.

I suggested that what seemed to be at the bottom of it all was the idea that a party to a contract should not be disloyal to the promises he or she had made. But that simply led back to what the defendant actually promised to the plaintiff. If I promise to do something, is it not implied, as a matter of fact rather than as a matter of law, that I will not do something which is entirely inconsistent with my promise? I cited in support of this proposition Lord Blackburn in *Mackay v Dick*[5] and Dixon J in *Shepherd v Felt and Textiles of Australia Ltd.*[6]

By way of analogy, I referred to the well-known principle of property law that when someone grants a right in relation to their property, they are not permitted to do something which derogates from the grant which they have made – a principle which has been said to embody common honesty and fair dealing; a grantor having giving a thing with one hand is not to take away the means of enjoying it with the other, to quote the words of Bowen LJ in *Birmingham, Dudley and District Banking Co v Ross.*[7]

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3 *Renard Constructions (ME) Pty Ltd v Minister for Public Works* (1992) 26 NSWLR 234.
4 *Burger King Corp v Hungry Jack's Pty Ltd* [2001] NSWCA 187, reported in part (2008) 69 NSWLR 558.
5 (1881) 6 App Cas 251 at p 263.
6 (1931) 45 CLR 359 at p 378.
7 (1888) 38 Ch D 295 at p 313.

This analysis shows us an example of the longstanding general principle that the law will not permit you to subvert your promise. You do not need to invoke good faith in order to support the principle. It flows from the nature of the contractual promise or obligation. It is a matter of the commonsense of the law. Instead of reaching up on the shelf for an implied term of good faith, why not simply construe the contractual provision in the context of the contract as a whole? A court would surely examine the provision in issue having regard to that context and would naturally say that, for example, a power given for a particular purpose should not be used for some extraneous or collateral purpose or in a manner that objectively went beyond any possible reasonable use of the power. The court would ask itself whether the use of the power could have been within the reasonable contemplation of both parties when they made their contract. This is what the English Court of Appeal did in *Paragon Finance plc v Nash*,[8] a banking case about the fixing of a rate of interest by the lender. The Court approached the matter as a matter of construction of the loan agreement and decided that rates of interest must not be set dishonestly, or for an improper purpose, or capriciously or arbitrarily. It did this by implying a term of that limited kind in order to give effect to the reasonable expectations of the parties. But it was not prepared to go further and extend the implied term so that it covered an unreasonable use of the power to fix the rate. It said it was one thing to imply a term that a lender would not exercise its discretion in a way that no reasonable lender, acting reasonably, would do. It was unlikely that a lender who was acting in that way would not also be acting either dishonesty or for improper purpose. But it was quite another matter to imply a term that the lender would not impose unreasonable rates. So it was found not to be a breach of contract for the mortgagee to raise interest rates in order to overcome its serious financial difficulties.

I am glad to be able to say that I supported my argument on that occasion by reference to an article of Professor Carter and Dr Peden[9] who had contended that a commercial

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8 [2002] 1 WLR 685.

9 "Good Faith in Australian Contract Law" (2003) 19 JCL 155.

construction of a contract will actually achieve a result which is consistent with an underlying requirement of good faith and that recourse to an implied term is therefore unnecessary.

I tried to put in my own language this approach, saying that when you interpret a contract – when you say whether some action is or is not authorised by its terms – you assume honest behaviour – that the contract does not contemplate action which is capricious or arbitrary or motivated by a desire to harm the other party by depriving it of the benefit of the contract. You assume, in other words, that the contract does not permit behaviour which is outside the range of behaviour which, from an objective standpoint, could have been expected when the contract was made.

Now how do things stand some four years later? In Australia, so far as I am able to determine, not too much has changed. Trial courts in New South Wales seem to be still following, or at least paying lip service, to *Renard*[10] and *Burger King*.[11] It seems that this has not given rise to any result which would not have occurred if good faith went unmentioned. No case has gone to the High Court, so that Bench has not had the opportunity to put the New South Wales Court of Appeal in its place, if it should wish to do so as it has rather firmly done on other subjects. In fact, the Court of Appeal has shown signs of pulling back in *CGU Workers Compensation (NSW) Ltd v Garcia*[12] and the Victorian Court of Appeal may have poured some cold water on the earlier New South Wales cases,[13] as Chief Justice de Jersey has noted.

In New Zealand, despite a conference[14] on good faith in contract law held in Auckland only about a month after your conference in Cairns and attended by many of the usual suspects, such as Justice Finn and the former New Zealand Court of Appeal Judge, Ted Thomas, the courts have been entirely silent on the subject.

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10 (1992) 26 NSWLR 234.
11 [2001] NSWCA 187.
12 (2007) 69 NSWLR 680 at paras [130] – [134].
13 *Esso Australia Resources Pty Ltd v Southern Pacific Petroleum N L* (2005) VSCA 228.
14 For published conference papers, see (2005) 11 NZBLQ at pp 367–503.

One English case of note of which I am aware, directly appearing to invoke good faith, is the *Socimer*[15] decision of the English Court of Appeal to which Dr Peden refers in her paper. It concerned what was required of a bank called upon by a contractual provision to determine the value of certain assets when an amount due to it had not been paid by the other party. In the leading judgment of Rix LJ, various earlier cases from the English Court of Appeal on the exercise of contractual powers are discussed. In *The "Product Star"*,[16] for example, the Court had recognised the usefulness of an analogy with judicial control of administrative action but said it must be applied with caution to the assessment of whether a contractual discretion had been properly exercised. The essential question always was whether the relevant power had been abused. The Court said that the authorities show that not only must the discretion be exercised honestly and in good faith, but as well, having regard to the provisions of the contract by which it is conferred, it must not be exercised arbitrarily, capriciously, or unreasonably.[17] Little was added by the concept of fairness which did no more than describe the result achieved by the application of that approach.

Rix LJ drew from the authorities to which he referred that:[18]

> 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: as for instance when there might be an implication of a term requiring the fixing of a reasonable price, or a reasonable time.

Two things are noticeable when the judgment is read as a whole. One, that the Court appears perhaps to be mingling concepts of construction and of the implication of a term as a matter of fact and, secondly, that although Rix LJ speaks of good faith, he seems to be using that term, even when it appears in the same sentence, as a reference

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

16 *Abu Dhabi National Tanker Co v Product Star Shipping Ltd (The "Product Star") (No 2)* [1993] 1 Lloyd's Rep 397, as cited in *Socimer* at para [61].

17 At p 404.

18 *Socimer* at para [66].

to dishonesty as if those two things were synonymous, which indeed I think they may be. In the end, when he gets to the sharp end of the judgment and discusses what the bank was obliged to do, he refers only to honesty and rationality.[19] Good faith, if it was a separate concept, slides out of view.

It is Dr Peden's argument that the standard of performance of a contract ought always to be recognised as a question of construction. In this way some obligation can be imposed that did not exist on the face of the express terms. She observes that duties and co-operation are often implied terms used to fill a gap, but that it is not easy to do this where it is helping one party only – because of the old "business efficacy" test. She makes a case, if I understand her aright, for the existence of something you can imply by construction in order to spell out an obligation which is inherent, and where accordingly you can perhaps avoid the business efficacy test.

Lord Hoffmann has recently said something that bears on this. He takes the view that indeed the process of implication of a term as a matter of fact is merely a principle of construction. He confirms this in one of his last judicial utterances in giving the reasons of the Privy Council in *Attorney General of Belize v Belize Telecom Ltd.*[20]

Having said that the court cannot introduce terms to make a contract fairer or more reasonable and that it is concerned only to discover what the contract means – objectively speaking – Lord Hoffmann stated that the question of implication arises when the contract does not expressly provide for what is to happen when some even occurs.[21] Usually the answer is nothing. But, he says, in some cases:[22]

> the reasonable addressee would understand the instrument to mean something else. He would consider that the only meaning consistent with the other provisions of the instrument, read against the relevant background, is that something is to happen. The event in question is to affect the rights of the parties. The instrument may not have expressly said so, but this is what it must mean. In such a case, it is said that the court implies a term as to what will happen if the event in question occurs. *But the implication of the term is not an addition to the instrument. It only spells out what the instrument means.*

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19 At paras [116] – [124].
20 [2009] UKPC 10.
21 At paras [16] – [17].
22 At para [18].

Lord Hoffmann then emphasises, by reference to *Trollope & Colls*,[23] that the implication of a term is "an exercise in the construction of the instrument as a whole".

There is only one question, he says: what the instrument, read as a whole against the relevant background, would reasonably be understood to mean. And then he cautions against treating the various tests like "business efficacy" as if they had a life of their own.[24] The word "business" conveys that the notional reader of the contract will take into account the practical consequences of deciding it means one thing or another: whether the apparent business purpose of the parties will be frustrated. The word "necessary" conveys the need for the court to be satisfied as to the meaning – it is not enough that the implied terms would have been something reasonable for the parties to agree to. Similarly the requirement that the implied term must "go without saying" is, Lord Hoffmann says, no more than another way of saying that, although the instrument does not expressly say so, that is what a reasonable person would understand it to mean. And it is not necessary that the need for the implied term should be obvious in the sense of being immediately apparent. He refers to the famous list of the five conditions for the implication of a term in fact found in *BP Refinery (Westerport) Pty Ltd v Shire of Hastings*,[25] but he says that the list is best regarded, not as a series of independent tests which must each be surmounted, but rather as a collection of different ways in which Judges have tried to express the central idea that the proposed implied term must spell out what the contract actually means, or in which they have explained why they did not think it did so.[26]

It is hard to know how far this approach will go in making it easier to imply terms as a matter of fact, but there does seem to be a real possibility that some liberalisation may occur and that gap filling will be undertaken on a less restrictive basis. If so, there will be even less need for resort to the vague notion of contractual good faith and, as Dr Peden contends, it can all be done by construing what has been said and this is how you fill in any gap.

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23 *Trollope & Colls Ltd v North West Metropolitan Regional Hospital Board* (1973) 1 WLR 601 at p 609.

24 *Attorney-General of Belize v Belize Telecom Ltd* at para [21].

25 (1977) 180 CLR 266 at pp 282–283.

26 At paras [26] – [27].

This development may assist in another way. If good faith is removed from the equation and we are left with a basic requirement for the performance of contracts in a way which is honest and within the bounds of rationality – restrictions which should not trouble any party to a contract – then it will become just a matter of the choice of words whether you have successfully given yourself the contractual powers which are necessary for your purpose. Indeed, the extent of the power will be construed with reference to that purpose. There will be no blurring overlay of some notion of good faith performance. Instead the court will simply ask what power or discretion was contracted for and is the action taken done honestly and within the scope of the power. So, when, for example, a financier has conferred on it by the contract a power to terminate the arrangement with the borrower and call up moneys which have been advanced "in its sole discretion" the court will ask itself whether, looking at the contract as a whole in its factual context there can be seen, objectively, to be any restriction on the circumstances in which it could be exercised or on the financier's purposes in doing so. Unless what the financier is doing is unconscionable or something that has been said or done has given rise to an estoppel or the borrower can invoke some other established doctrine under the general law or statute, the financier who acts honestly and rationally will not be impeded. On this view, the court will not interfere on some fuzzy basis of fairness which is where a successful appeal to "good faith" might otherwise lead.