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"Good faith, commercial morality and the courts"

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It might be more entertaining for you if I could put myself forward as an enthusiast for good faith and the judicial enforcement of moral standards in a commercial setting. But whilst, as you might expect, as a citizen I am in favour of both, as a judge I have reservations about them as a means of determining commercial disputes. Good faith in particular has its place in civil law but there is a danger that it will put on airs and graces if misused. It has a proper place in equitable doctrine, notably in relation to fiduciaries, and as a unifying principle underlying contract law. And of course it has become common for legislators to enact generalised requirements for good faith performance or adherence to standards, as has been done, for example, in relation to trade practices, hire purchase agreements, money lending legislation and personal property securities legislation. Naturally any judge will be reluctant to reach a conclusion which is not consonant with generally accepted notions of good faith, commercial reality and fair dealing, but the question I pose in this paper is whether it should therefore follow that a general principle requiring good faith behaviour in commercial transactions should therefore be recognised save where that is required by statute.

The concept of good faith is well-known in the civil law codes as a means of filling gaps in the codes. In that sense it seems to perform the same function as judge made law does in our jurisdictions. Good faith is also used as a gap filler in Scotland.[1] But do we need it as such in Australia and New Zealand? After all, we have a wide range

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1 Hector L MacQueen "Good Faith in the Scots Law of Contract: An Undisclosed Principle?" in Forte (ed) *Good Faith in Contract and Property Law*, (1999) 5, 18.

of other techniques which may be available when instinctively we conclude that in a particular case there is a need to avoid an unjust conclusion – one which might appear to be at odds with commercial morality. I can list some of the judicial tools which, properly deployed in an appropriate case, can be of assistance:

- unconscionability (the control of unconscientious behaviour)
- contractual mistake
- statutory prohibition on deceptive and misleading conduct in trade
- fiduciary obligations
- estoppel in its various forms
- undue influence and duress
- the tort of intimidation (threatening a breach of contract to coerce the other party)
- the doctrine of frustration of contract
- deceit and misrepresentation
- unjust enrichment
- anticipatory breach of contract
- invalidation of penalty clauses
- relief against forfeiture

Apart from these specific means, questionable behaviour by a party to a commercial transaction is also well capable of being controlled by a construction of the contract which gives effect to the objectively determined expectation of the parties at the time they entered into the contract and prevents misuse of contractual powers. There are also various statutory controls which increasingly affect the behaviour of commercial actors, particularly in relation to consumer contracts, and in the financial sector there is the availability of a ruling from a banking ombudsman.

Nevertheless, in Australia, and especially it seems in New South Wales, some need has been felt by judges for recourse to implied contractual terms of good faith, reasonableness and fair dealing. The debate over whether this is appropriate is not new. It is to be remembered that in 1766 in *Carter v Boehm*[2] Lord Mansfield

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2 3 Burr 1905 at 1910; 97 ER 1162.

announced a "governing principle...applicable to all contracts and dealings" under which:

> Good faith forbids either party by concealing what he privately knows, to draw the other into a bargain, from his ignorance of that fact, and his believing the contrary.

As a general principle that dictum did not endure, although we find in the United States that, for example, the New York Court of Appeals was able to say in 1918 in *Wigand v Bachmann-Bechtel Brewing Co*[3] that "Every contract implies good faith and fair dealing between the parties to it".

In commonwealth jurisdictions this has not been the popular view and I suggest it is because of the vagueness of the proposition. It is too imprecise to be a means of determining disputes – certainly those between commercial organisations. The prevailing view is found in the following quotation from Robert Goff LJ in *The Scoptrade*, which was cited with approval in the leading judgment of Lord Diplock when that case went to the House of Lords:[4]

> It is of the utmost importance in commercial transactions that, if any particular event occurs which may affect the parties' respective rights under a commercial contract, they should know where they stand. The courts should so far as possible desist from placing obstacles in the way of either party ascertaining his legal position, if necessary with the aid of advice from a qualified lawyer, because it may be commercially desirable for action to be taken without delay, action which may be irrevocable and which may have far-reaching consequences. It is for this reason, of course, that the English courts have time and again asserted the need for certainty in commercial transactions - for the simple reason that the parties to such transactions are entitled to know where they stand, and to act accordingly.

Similarly, the English courts have rejected the notion that they have a general equitable jurisdiction to grant relief to a contracting party on some unlimited and unfettered basis. In *Union Eagle Ltd v Golden Achievement Ltd*,[5] Lord Hoffmann, delivering the opinion of the Privy Council, saw this as a beguiling heresy which he rejected:

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3 118 NE 618 at 619.

4 *Scandinavian Trading Tanker Co AB v Flota Petrolera Ecuatoriana* [1983] 2 AC 694 at 704.

5 [1997] AC 514 at 519.

> It has the obvious merit of allowing the court to impose what it considers to be a fair solution in the individual case. The principle that equity will restrain the enforcement of legal rights when it would be unconscionable to insist upon them has an attractive breadth. But the reasons why the courts have rejected such generalisations are founded not merely upon authority...but also upon practical considerations of business. These are, in summary, that in many forms of transaction it is of great importance that if something happens for which the contract has made express provision, the parties should know with certainty that the terms of the contract will be enforced. The existence of an undefined discretion to refuse to enforce the contract on the ground that this would be "unconscionable" is sufficient to create uncertainty. Even if it is most unlikely that a discretion to grant relief will be exercised, its mere existence enables litigation to be employed as a negotiating tactic. The realities of commercial life are that this may cause injustice which cannot be fully compensated by the ultimate decision in the case.

I recognise that a modicum of uncertainty can sometimes be a force for good in the law. I instance the prohibition on "misleading or deceptive conduct in trade". This is a salutary statutory prohibition and whilst it might in theory be criticised for having a degree of uncertainty in its potential application, in my experience it encourages proper commercial behaviour because people do not wish to take the risk of offending and – the point I want to stress – in my view commercial clients can usually work out for themselves, if their minds are directed to the requirement, whether their conduct is likely in a given case to mislead or deceive. Judges and legal advisers cannot avoid ever making value judgments about the conduct of commerce – even the criminal law requires this, as when a jury has to say whether conduct was dishonest or fraudulent. But I suggest that we feel, or should feel, instinctively more comfortable with terms like misleading, deceptive, dishonest and fraudulent than with the much vaguer notions of good faith or commercial morality. What is or is not in good faith may depend upon your perspective and it may therefore be very difficult to predict how it will be viewed by a Judge. Unconscionability (or unconscientious behaviour) is not so problematic – it is descriptive of more extreme, more recognisable conduct, just as fraudulence is.

The rise of good faith in Australian contract law – and here you are as usual outrunning the United Kingdom and New Zealand – can, in part anyway, be attributed to the influence of the Uniform Commercial Code in the United States. Section 1-203 of the Code provides that "every contract or duty within this Act imposes an

obligation of good faith and fair dealing in its performance or enforcement". Good faith itself is defined in s 1-201(19) as "honesty in fact in the conduct or transaction concerned" and in s 2-103(1)(b) as "the observance of reasonable standards of fair dealing in the trade." This is reinforced by a provision in the *Restatement (2nd) of Contracts 1981* that "every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement".[6]

It is an irony that this appears to have influenced judges in a country which as yet has no PPSA. Section 25 of the New Zealand Personal Property Securities Act 1999 follows the North American model by requiring that all rights, duties or obligations that arise under a security agreement or under the Act must be exercised or discharged in good faith and in accordance with reasonable standards of commercial practice. There is no definition of the concept of good faith and it remains to be seen how much, if any, impact the section will have in practice. So far there is no relevant case law.

Justice Paul Finn is a distinguished Australian protagonist for recognition of a good faith principle. While accepting that contracts are about the pursuit of self interest, he has argued that the law also requires a contracting party to take the other party's interest into account in varying degrees. Good faith, he says, occupies the middle ground between the principle of unconscionability and fiduciary obligations. In an essay entitled "The Fiduciary Principle"[7] Finn argues:

> "Unconscionability" accepts that one party is entitled as of course to act self-interestedly in his actions towards the other. Yet in deference to that other's interests, it then proscribes excessively self-interested or exploitative conduct. "Good faith", while permitting a party to act self-interestedly, nonetheless qualifies this by positively requiring that party, in his decision and action, to have regard to the legitimate interests therein of the other. The "fiduciary" standard for its part enjoins one party to act in the interests of the other – to act selflessly and with undivided loyalty. There is, in other words, a progression from the first to the third: from selfish behaviour to selfless behaviour.

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6 s 205.

7 In Youdan (ed) *Equity, Fiduciaries and Trusts* (1989) 1, 4.

The first of the appellate decisions in New South Wales which raised the flag for a contractual principle of good faith was *Renard Constructions (ME) Pty Ltd v Minister for Public Works*[8] which concerned the exercise of power by a building owner under a construction contract. Priestley JA spent some time reviewing the position in the United States, particularly under the Uniform Commercial Code, and that led him to remark upon "the pervasive principle of the good faith obligation." He referred to use of good faith in statutes and was encouraged to say that a very large area of everyday contract law is now directly affected by statutory unconscionability provisions carrying with them broad remedies, and that people generally, including judges and other lawyers, from all strands of the community, have grown used to the courts supplying standards of fairness to contract which are wholly consistent with the existence in all contracts of a duty upon the parties of good faith and fair dealing in its performance. "In my view", he said, "this is in these days the expected standard, and anything less is contrary to prevailing community expectations." The other judges in that case were, however, rather more guarded.

Where a good faith principle attained a real head of steam was in *Burger King Corp v Hungry Jack's Pty Ltd.*[9] The joint judgment of the New South Wales Court of Appeal included a statement that courts in various Australian jurisdictions have, for the most part, proceeded upon an assumption that there may be implied, as a legal incident of a commercial contract, terms of good faith and reasonableness.[10] The court also said that obligations of good faith and reasonableness will be more readily implied in standard form contracts, particularly if they contain a general power of termination and that, if terms of good faith and reasonableness are to be implied, they are to be implied *as a matter of law*.[11] It was also said that Australian cases make no distinction of substance between the implied term of reasonableness and that of good faith.[12]

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8 (1992) 26 NSWLR 234.
9 [2001] NSWCA 187.
10 At [159].
11 At [163] and [164].
12 At [169].

I hope my judicial instincts are not markedly different from those of the Australian judges. But it does seem to me that appeals to such an implied term in these cases were unnecessary and unhelpful. Surely an application of traditional contract law would have sufficed as a means of reaching the same result. The particular cases 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? It may have been unconditionally expressed. But, objectively, was it intended only for use in particular circumstances or in a particular way? In my view appeals to good faith and reasonableness simply muddy the water. They do not assist with the necessary analysis of what, objectively, the parties intended when they wrote the contract. They may indicate an appropriate judicial cast of mind but they do no more than that.

I am not suggesting that the result in any of the cases was necessarily wrong – and I do not say this for reasons of judicial comity – only that generalised appeals to implied terms of good faith and reasonableness are in my view misguided.

What seems to be at the bottom of it all, it would seem, is the idea that a party to a contract should not be disloyal to the promises which he or she has made. But does not that simply lead 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 a matter of law, that I will not do something which is entirely inconsistent with my promise? The law has long recognised this and enforced the unspoken negative obligation. Lord Blackburn said in *Mackay v Dick.*[13]

> [A]s 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.

And Dixon J remarked in *Shepherd v Felt and Textiles of Australia Ltd*[14] that the law

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13 (1881) 6 App Cas 251 at 263.
14 (1931) 45 CLR 359 at 378.

implies a negative covenant not to hinder or prevent the fulfilment of the purpose of an express promise.

In an influential article, *Contract, Good Faith and Equitable Standards in Fair Dealing*,[15] Sir Anthony Mason referred to a principle that each party to a contract agrees, by implication, to do all things as are necessary on his or her part to enable the other party to have the benefit of the contract or to secure performance of the contract. He says this implied obligation does no more than spell out what, on the true construction of the contract, is the effect of promises and undertakings entered into by the party. And, he says, there is a corresponding obligation not to prevent or hinder fulfilment of the objects of the contract. However, Sir Anthony is also a proponent of a good faith principle, suggesting that it not only requires honesty but extends to a requirement of fair dealing:

> [W]ithin reason and in conformity with the express provisions of the contract, the exercise of power is not [to be] capricious, arbitrary, unconscionable or unreasonable even to the extent of insisting upon, in an appropriate case, taking account of the interests of the other party.[16]
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> [My emphasis]

But note the qualifications – within reason and in an appropriate case - and of course Sir Anthony acknowledges that a good faith obligation would have to be read conformably with express provisions.

There is a basic and well understood proposition that when someone grants a right in relation to their property – perhaps selling or leasing their land or selling their business or even selling goods – they are not permitted to do something which derogates from the grant of property which they have made. They may not thereafter do or permit something to be done which is inconsistent with the grant and substantially interferes with the right which has been granted. It is a principle which has been said to embody common honesty and fair dealing; a grantor having given a thing with one hand is not to take away the means of enjoying it with the other, as it was put by Bowen LJ in *Birmingham, Dudley and District Banking Co v Ross*.[17] I accept that the non-derogation from the grant principle does not depend merely on the

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15 (2000) 116 LQR 66.

16 At 77.

17 (1888) 38 Ch D 295 at 313.

construction of the document conferring the grant. It is implied to ensure the contract in which the grant is made is not frustrated or subverted.

This analogy shows us, however, an example of the long-standing general principle that the law will not permit you to subvert your promise. It is quite unnecessary to invoke good faith in order to support this principle. It is one that flows from the nature of the contractual promise or obligation. It is a matter of the common sense of the law. But in relation to contractual powers, and how and when they are exercisable, there seems to be a temptation for judges to reach up on the shelf for an implied term of good faith. Instead of doing this, why not simply construe the power in the context of the contract? In doing so, a court would examine the power having regard to the whole contractual context and would naturally say that 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. That is a matter which is determined objectively, uninfluenced by the subjective thoughts of each party.

This is essentially what the English Court of Appeal did in deciding the case of *Paragon Finance plc v Nash.*[18] I refer to this case because it seems to me to exemplify the right approach and because it was a banking case. The dispute was over variable interest clauses in certain loan agreements. They allowed the lender to charge interest at such a rate as it should from time to time apply to the category of business to which it considered a mortgage belonged. The court approached the problem of whether a proper rate had been fixed as a matter of construction of the loan agreements. It had little difficulty deciding that rates of interest must not be set dishonestly, or for an improper purpose, or capriciously or arbitrarily. An implied term of that limited kind was found to be necessary in order to give effect to the reasonable expectations of the parties. But, faced with an argument that the implied term should also cover an unreasonable use of the clause, the court was cautious. It said that it was one thing to imply a term that a lender would not exercise its

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18 [2002] 1 WLR 685.

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 dishonestly, or for an improper purpose, capriciously or arbitrarily. But it was quite another matter, the court said, to imply a term that the lender would not impose unreasonable rates. It was found not to be a breach of contract for the mortgagee to raise the interest rates in order to overcome its serious financial difficulties. Many of its borrowers had defaulted. It was therefore being charged higher rates for its own funding and was passing these costs on to its borrowers. There was no evidence that its decision to widen the gap between its rates and standard market rates was motivated by other than such purely commercial considerations. Although it was not argued in that case that there was any "good faith" obligation on the lender, it is pretty clear that the court would have answered any such submission by returning to the construction of the contract and rejecting it.

The case points up the contrast between the current state of English and Australian law. In New Zealand law, so far as I am aware, only two judges have so far shown much enthusiasm for a principle of good faith in contract law. One of them was dealing with a franchise contract governed by the law of New South Wales.[19] The other, in a dissenting judgment in the Court of Appeal, was on something of a frolic as a good faith obligation had never been mentioned in the case. The majority judgment sought to show that there were orthodox ways of dealing with any contractual malpractice.[20]

The issue of good faith did arise in a New Zealand case about tendering for a roading contract. The Court of Appeal said there was an implied duty to treat tenders equally or even-handedly in the evaluation process but no implied duty of good faith requiring the party which had called for tenders to comply with obligations not expressly incorporated in the request for tender documentation.[21] The case went to London where the unsuccessful tenderer's appeal was rather cursorily dismissed. Lord Hoffmann's judgment in passing attributes to the Court of Appeal the finding of an implied term of good faith and fair dealing (which it had not made) and calls this a

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19 *Dymocks Franchise Systems (NSW) Pty Ltd v Bilgola Enterprises Ltd* [1999] 3 NZLR 239.
20 *Bobux Marketing Ltd v Raynor Marketing Ltd* [2002] 1 NZLR 506.
21 *Transit New Zealand v Pratt Contractors Ltd* [2002] 2 NZLR 313 at [92].

"somewhat controversial question into which it is unnecessary for their Lordships to enter".[22]

Having formed an unfavourable view of the Australian developments in preparing this paper I was interested to come upon an article by Professor Carter and Dr Peden of the University of Sydney[23] which explained to me my instinctive concern. The authors state boldly that Australian contract law is in a "state of utter confusion". They speak of an "unsophisticated approach" by the Australian courts. Their thesis is that good faith is not an independent concept as much as something which is inherent in contract law itself and therefore a concept which must be taken into account when interpreting a contract, determining the scope of contractual rights and so on. It does not include a requirement of reasonable conduct. They contend that a commercial 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. Any direct good faith requirement will depend upon the terms of each contract. This is what they say:

> ...because good faith is already inherent in contract doctrines, rules and principles, if a court implies a term of good faith the court is either implying a redundant term or implying a term which, by definition, must impose a more onerous requirement. Such a term must surely be justified by reference to particular circumstances and not general principle. In other words, we do not deny that in some cases it will be appropriate to imply a term which imposes a higher standard of good faith than the law otherwise requires, but it will necessarily have to satisfy the well-established rules for implication and will be a rare phenomenon. In relation to the cases which suggest that a term of good faith is implied in law, it is sufficient to say that such an implied term merely creates a default rule, and since that default rule already exists it is also an illegitimate implication.[24]

Putting it in my own language, on this approach, 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

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22 *Pratt Contractors Ltd v Transit New Zealand* [2005] 2 NZLR 433 at [45].

23 *Good Faith in Australian Contract Law* (2003) 19 JCL 155.

24 At 163.

behaviour which is outside the range of behaviour which, from an objective standpoint, could have been expected when the contract was made. But there is no implied term requiring good faith or reasonableness.

Of course there are some areas of law in which Courts of Equity have long imposed an obligation to act in good faith. These include cases where someone is a fiduciary and therefore owes a fiduciary duty. This is a subject in its own right and I am not going to get into it, save to say that, upon analysis, the fiduciary obligation of good faith is simply a requirement of loyalty. The person who is under an obligation to act in the interests of another must be loyal to the other and must put the interests of the other before his own. You will readily see that this is not likely to be the position in the typical commercial contract although it does apply in certain types of contract – agency is an example. So is a joint venture where loyalty and co-operation between the parties is obviously fundamental. In those limited contexts, an obligation of good faith makes sense and can be enforced. But as soon as one moves away from a situation requiring loyalty or co-operation, good faith becomes problematical. Either it has to be given effect in a way which in reality goes beyond mere good faith or it is likely to be ineffectual.

This can be demonstrated, I think, by looking at an area with which you will be very familiar – at what has occurred with the mortgagee's duty of good faith. A mortgagee is not a trustee for or a fiduciary of the mortgagor. However, in order to try to stop abuse of the power of sale Courts of Equity long ago said that the mortgagee must exercise its powers in good faith. Originally this required only that there should be no sacrificing of the interests of the mortgagor – no reckless harming of the mortgagor. But this restriction was not felt to be enough – good faith simpliciter was not an effective tool – and the courts began fleshing out the concept in language which invoked reasonableness and had considerable resemblance, as things developed, to a duty of care.

So, for example, in the High Court of Australia in 1912 one judge spoke of a need to take proper precautions when selling to obtain a proper price and another said that the

mortgagee must not omit to take obvious precautions to ensure a fair price.[25] And the Privy Council soon afterwards expressed the duty of preservation of property before its sale as being one to behave as a reasonable man would behave in the realisation of his own property, so that the mortgagor could receive credit for its fair value.[26] In dicta in later decisions of the High Court of Australia in *Forsyth v Blundell*[27] and in *Australian & New Zealand Banking Group Ltd v Bangadilly Pastoral Co Pty Ltd*[28] Menzies J and Jacobs J contended that there was a duty to obtain a proper price on sale of mortgaged assets but that it was a part of the duty to act in good faith.

One could be forgiven, however, for thinking that what was being stated was more like a common law duty of care than a softer equitable duty of good faith. In England this was recognised and in *Cuckmere Brick Co Ltd v Mutual Finance Ltd*[29] the Court of Appeal held that a mortgagee must take reasonable care to obtain the true market value, this being in addition to acting in good faith. So, as I have said, good faith simpliciter had proved to be inadequate. And it is noteworthy that when in recent years legislators have wished to impose a statutory duty on mortgagees and receivers they have stated it in terms of a *Cuckmere Brick* style requirement to use reasonable care to obtain market value or the best price reasonably obtainable in the circumstance then existing, to refer to s 420A of the Corporations Act and the comparable provision in New Zealand from which it was drawn.

My conclusion, you will not be surprised to hear, is that good faith is a will-o'-the-wisp. It tempts travellers in the law to stray in to the marshes with appeals to vague and unnecessary general principle and it can prove illusory when they really need help in cases which truly require the assistance of equity.

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25 *Pendlebury v Colonial Mutual Life Assurance Society Ltd* (1912) 13 CLR 676 at 694-695 and 680, per Barton J and Griffith CJ.

26 *McHugh v Union Bank of Canada* [1913] AC 299.

27 (1973) 129 CLR 477.

28 (1978) 52 ALJR 529; 139 CLR 195.

29 [1971] Ch 949.