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THE COMMONWEALTH AS A MODEL CONTRACTOR? GOOD FAITH IN GOVERNMENT CONTRACTING

This note examines the development of the concept of good faith in contracting and considers where this concept might eventually lead to in the context of government contracting.

AGS *Commercial Notes* No. 27, 'Termination for convenience' (3 June 2008) examined the requirement for the Commonwealth to act in good faith in relation to termination for convenience clauses. As discussed in that note, agencies need to be aware of the risk that their right to terminate for convenience may be limited by a duty to act in good faith. The case law in the US indicates that agencies should be aware of the risk that the right to terminate for convenience may be limited by a duty to act in good faith (see, for instance, *Torncello v United States* 681 F 2d 765 (1882) and *Krygoski Construction Company v United States* 94 F 3d 1537 (1996)).

The *Trade Practices Act 1974* (Cth) addresses the concept of 'unconscionable conduct' (see ss 51AA, AB and AC), and this concept is perhaps similar to a requirement to act in good faith. However, for the purposes of this note, the focus is on the development of case law (principally in Australia but also in some overseas jurisdictions) that considers the extent to which an implied obligation to act in good faith can or may be read into contracts in Australia and the implications this may have for the Commonwealth in the future.

What is good faith?

Content of a duty of 'good faith'

The meaning of 'good faith' remains difficult to definitively express. Cases in New South Wales such as *Renard Constructions (ME) Pty Ltd v Minister for Public Works* (1992) 26 NSWLR 234 (Renard) and *Vodafone Pacific Ltd v Mobile Innovations Ltd* [2004] NSWCA 15 (Vodafone) support the idea that the term 'good faith' is synonymous with 'reasonableness'.

In *Esso Australia Resources Pty Ltd v Southern Pacific Petroleum NL (Receivers and Managers Appointed) (Administrators Appointed)* [2005] VSCA 228 (Esso) at [29], it was said that the duty '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'.

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Academics have interpreted good faith as an adaptable concept which may include the following characteristics:

— not acting arbitrarily or capriciously

— not acting with an intention to cause harm

— acting with due respect for the intent of bargain as a matter of substance, not form.[1]

It could be said that the duty might also include:

— acting for a proper purpose

— consistency in conduct

— acting honestly

— communicating openly and effectively between parties

— stating a party's position on matters at issue, and explaining that position

— cooperating with the other party

— considering the interests of the other party.

The boundaries of the duty remain unclear, but it appears that in the decided cases the emphasis has been on the contracting parties acting reasonably, at least in exercising their express rights and discretions.

Some cases (see *Burger King Corp v Hungry Jack's Pty Ltd* [2001] NSWCA 187 (*Burger King*) at 171; *Alcatel Australia Ltd v Scarcella* (1998) 44 NSWLF 349 (*Alcatel*) per Sheller JA at 367; *Hughes Aircraft Systems International v Airservices Australia* (1997) 146 ALR 1 (*Hughes*) at 37) have cited with approval the propositions of Sir Anthony Mason in his paper 'Contract, Good Faith and Equitable Standards in Fair Dealing' (2000) 116 *Law Quarterly Review* 66. Sir Anthony suggested (at 69):

> '[G]ood faith' embraces no less than the following three related notions:
>
> – an obligation on the parties to co-operate in achieving the contractual objects (loyalty to the promise itself);
>
> – compliance with honest standards of conduct; and
>
> – compliance with standards of conduct which are reasonable having regard to the interests of the parties.

However, under the traditional model of contract law, contracting parties generally act as adversaries with the sole intention of legitimately maximising their own interests. They are not restrained by 'reasonable' expectations or the legitimate interests of the other contracting party. This may appear to be at odds then with the notion of 'good faith'.

Courts and academics have been apprehensive about the notion of including a duty of good faith in contract law given the impact that the duty could have on freedom of contract and also the potential uncertainty that the duty introduces into commercial arrangements.

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The development of 'good faith' in case law

Generally, courts have taken a very cautious approach on the issue of good faith. However, it appears that a common law obligation of good faith in contractual performance and enforcement is nevertheless emerging from the decisions of the Australian lower courts.

New South Wales

There has been a strong trend in New South Wales towards recognising an implied term of good faith in contracts. It appears that the law in this jurisdiction is moving towards recognising the existence of an implied term of good faith and fair dealing in certain contracts unless the term is expressly excluded. The New South Wales Court of Appeal has delivered several decisions considering this issue.

In *Renard*, Priestley JA and Handley JA observed that, while not yet accepted in Australian law, there were many indications that the idea of good faith in Australia will gain explicit recognition in the same way that it has in Europe and the United States. Furthermore, a duty upon the parties of good faith and fair dealing in contractual performance is an expected standard and anything less is contrary to prevailing community expectations. [see 263-268]

Sheller JA in Alcatel followed the decision in *Renard*, and found that, in New South Wales, a duty of good faith in performing obligations and exercising rights may by implication be imposed upon parties as part of a contract.

In *Burger King*, the court considered *Renard*, *Alcatel* and *Hughes* and concluded (at [164]) that:

> There ... appears to be increasing acceptance ... that, if the terms of good faith and reasonableness are to be implied, they are to be implied as a matter of law.

On appeal, the Court of Appeal considered that this proposition was correct.

Victoria

In Victoria, the courts remain unsettled and doubtful regarding the application of a contractual duty of good faith.

In *Esso*, the Court of Appeal was unconvinced regarding the universal application of an implied term of good faith. Warren CJ stated (at [3]–[4]) that:

> [I]f a duty of good faith exists, it really means that there is a standard of contractual conduct which should be met. The difficulty is that the standard is nebulous ... If good faith is not readily capable of definition then that certainty is undermined ... Ultimately, the interests of certainty in contractual activity should be interfered with only when the relationship between the parties is unbalanced and one party is at a substantial disadvantage, or is particularly vulnerable ... Where commercial leviathans are contractually engaged, it is difficult to see that a duty of good faith will arise, leaving aside duties that may arise in a fiduciary relationship.

It appears that a common law obligation of good faith in contractual performance and enforcement is emerging from the decisions of the Australian lower courts.

Furthermore, Buchanan JA in *Esso* stated (at [25]):

> I am reluctant to conclude that commercial contracts are a class of contracts carrying an implied term of good faith as legal incident, so that an obligation of good faith applies indiscriminately to all the rights and power conferred by a commercial contract. It may, however, be appropriate in a particular case to import such an obligation to protect a vulnerable party from exploitive conduct which subverts the original purpose for which the contract was made.

High Court of Australia

The High Court has not ruled decisively on this issue and at this stage it has provided little guidance on the inclusion or application of the duty of good faith in contractual arrangements.

In *Royal Botanic Gardens and Domain Trust v South Sydney City Council* [2002] HCA 5, Gleeson CJ and Gaudron, McHugh, Gummow and Hayne JJ (at [40]) recognised the importance of issues concerning the existence and content of an implied obligation or duty of good faith and fair dealing. However, the court considered it inappropriate to consider those issues in that case.

It is noted that Kirby J in that case (at [87]) stated:

> [I]n Australia, such an implied term appears to conflict with fundamental notions of caveat emptor that are inherent ... in common law conceptions of economic freedoms. It ... appears to be inconsistent with the law ... in respect of the introduction of implied terms into written contracts which the parties have omitted to include.

Federal Court: first instance

The Federal Court has implied good faith in a number of cases, with Finn J and Finkelstein J playing an influential role in the development of 'good faith' in Australian law.

Most notably, Finn J in *Hughes* followed the decision in *Renard* and held (at [37]) that:

> [F]air dealing is a major (if not openly articulated) organising idea in Australian law... I consider a virtue of the implied duty to be that it expresses a generalisation of the universal application, the standard of conduct to which all contracting parties are expected to adhere throughout the lives of their contracts ... . Its more open recognition in our contract law is now warranted.

In a government context, as a result of this decision the *Commonwealth Procurement Guidelines* include specific guidance on probity considerations.[2] Also, agencies now engage probity advisers to ensure that, in government procurement, processes are defensible and able to withstand internal and external scrutiny. The aim is to achieve both accountability and transparency by providing tenderers with fair and equitable treatment.

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In *Pacific Brands Sport & Leisure Pty Ltd v Underworks Pty Ltd* [2005] FCA 288, Finkelstein J (at [61]–[65]) stated that 'the precise role of the doctrine of good faith and fair dealing in Australian contract law remains unsettled', with case law in Australia indicating a preference for the position in the United States rather than England (see *Renard*, *Hughes*, *Alcatel*, *Burger King* and *Vodafone*).

However, his Honour said that 'the duty of good faith is an incident (not an ad hoc implied term) of every commercial contract, unless the duty is excluded expressly or by necessary implication' and that 'the duty is not an independent term of the contract the breach of which would give rise to a remedy, but it operates as a fetter upon the exercise of the discretions and powers created by the contract, including the power of termination'.

Finkelstein J found that the duty 'cannot override any express or unambiguous term which is to a different effect' and, although the standard of conduct imposed by the covenant of good faith is incapable of precise definition, this does not produce an unworkable obligation. His Honour stated that 'a good starting point in any particular enquiry is to see whether the impugned conduct ... was motivated by bad faith, or was for an ulterior motive, or ... whether the defendant acted arbitrarily or capriciously'.

England

The English Court of Appeal, in the leading case of *Socimer International Bank Ltd v Standard Bank Ltd* [2008] 1 Lloyd's Rep 558, held that good faith is implicit in all contracts, with the meaning of good faith being described as 'honesty which operates to control issues of self-interest'. Furthermore, discretionary terms in contracts will generally be limited by good faith or honesty and restrictions on a discretion in the form of good faith or an obligation of reasonableness will be incorporated as an implied term.

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New Zealand

The case of *Pratt Contractors Ltd v Transit New Zealand*, Privy Council Appeal No. 84 of 2002 (delivered 1 December 2003), on appeal to the Privy Council from the Court of Appeal of New Zealand, considered competitive tendering procedures adopted for a state highway contract in New Zealand. Taking into account the judgment of Finn J in *Hughes*, the Privy Council did not consider whether there existed, in general terms, a more general obligation to act in good faith given that the parties had accepted that such a duty existed in this case. Instead, the court considered the specific content of the duty in relation to the particular acts required to be performed by the government in evaluating the tenders.

The Privy Council held (at [47]) that:

> [T]he duty of good faith and fair dealing as applied to that particular function required that the evaluation ought to express the views honestly held by the members of the [tender evaluation team]. The duty to act fairly meant that all the tenderers had to be treated equally. One tenderer could not be given a higher mark than another if their attributes were the same. But Transit was not obliged to give tenderers the same mark if it honestly thought that their attributes were different. Nor did the duty of fairness mean that Transit were obliged to appoint people who came to the task without any views about the tenderers, whether favourable or adverse.

International commercial codes

Aside from case law developments it is also worthwhile to note the approach adopted in some applicable international commercial codes.

In particular, the *UNIDROIT Principles for International Commercial Contracts 2004* mandates that the parties 'must act in accordance with good faith and fair dealing in international trade'. UNIDROIT and the Principles of European Contract Law do not permit parties to contract out of the obligation to act in good faith.

The *Uniform Commercial Code* (USA) also includes an express obligation to act in good faith (see s 1-203). 'Good faith' is defined at s 1-201(19) as 'honesty in fact and the observance of reasonable commercial standards of fair dealing'. While good faith obligations may not be disclaimed, the parties may agree on standards by which performance of the obligation is to be measured (as long as this is not manifestly unreasonable) (UCC 1-302(b)).

The future of 'good faith' in Commonwealth contracting

Noting the trend of case law in New South Wales and at Federal Court level, and having regard to Victorian judgments on this issue, it is possible that a court in the future may determine that the Commonwealth is under an obligation to act in good faith when contracting, particularly if the other party to the contract is considered by the court to be in a more vulnerable position than the Commonwealth.

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Notes

1. J W Carter, E Peden and G J Tolhurst, *Contract Law in Australia*, 5th ed, Lexis Nexis Butterworths, Sydney, 2007, pp 26–27.
2. See paras 6.17 to 6.22 of the *Commonwealth Procurement Guidelines*.

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AGS has a national team of lawyers specialising in contract development and management, including managing contractual disputes. For further information on the article in this issue, or on other contract issues please contact John Scala or Linda Richardson (development and management) or Simon Daley (disputes), the authors, or any of the lawyers listed below.

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