

A DOCTRINE OF GOOD FAITH
IN NEW ZEALAND
CONTRACTUAL RELATIONSHIPS

A thesis submitted in fulfilment of the requirements for the

Degree

of Master of Laws

in the University of Canterbury

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University of Canterbury

2009

Abstract

The majority of established legal systems are predisposed to the express recognition of good faith in contract. The apparent pressure for harmonisation of contract law arising from globalisation and political union will necessitate the Anglo-Commonwealth common law countries addressing their historical resistance to the observance of a general obligation of good faith. Accordingly this thesis appraises whether there is a requirement for a universal doctrine of good faith in New Zealand contractual relationships. The manuscript focuses on a prospective common law doctrine operating primarily as a rule of construction. It identifies the limits of such a judicial doctrine including its probable lack of application to non-contractual dealings and the likely need for a legislative duty if contracting parties are to be precluded from excluding the obligation. The characteristics of the subject doctrine are explored including the potential definition and uses of good faith. Whilst it is shown that good faith serves an important role in contract law, the analysis reveals that there is no current requirement for an express doctrine within New Zealand. The entrenched 'piecemeal' approach synonymous with Anglo-New Zealand contract law is not demonstrably deficient when gauged against the reasonable expectations of contracting parties. The current methodology is preferred to a general, unfamiliar and uncertain good faith principle which is likely to be reduced to equate with the existing New Zealand law in any event. Further, duties consonant with good faith may enhance economic efficiency but not in some instances. Good faith is therefore best imposed in specific circumstances rather than as a universal doctrine. Likewise, there is insufficient evidence to suggest that New Zealand is impaired in the international arena due to a lack of good faith despite pressure for New Zealand to accord with widespread overseas practice. The principle is of minimal utility in international trade where commercial certitude is paramount. Although an imperfect exemplar, the unresolved issues pertaining to contractual good faith in domestic American law confirms the identified reservations associated with the subject doctrine.

Acknowledgements

I am most grateful to my senior supervisor, Professor Stephen Todd, and my co-supervisor, Professor Jeremy Finn, for their guidance and comments. Their input has been invaluable. Thanks also to Associate Professor Alan Woodfield of the University of Canterbury Department of Economics and Finance for his extensive assistance in relation to the law and economics aspects of this thesis. Finally, I am obliged to John and Penny Bayley for their helpful suggestions and proof-reading of this work.

My research has been facilitated by the award of a University of Canterbury Masters Scholarship.

The citation style within this manuscript follows the Melbourne University Law Review Inc, *Australian Guide to Legal Citation* (2nd ed, 2002), which has been adopted as the ‘house style’ of the University of Canterbury School of Law.

Statement as to Prior Publication

The text of this thesis has not been published in any form prior to its submission for examination. Except for materials quoted, which quotations are indicated by the use of quotation marks or indentation, and materials attributed in the footnotes, this thesis is entirely my own work.

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Introduction

The concept of good faith is one of the most important contractual issues of this era.¹ The goal of any established system of contract law must be to promote elements of good faith and fair dealing in the making and performance of contracts.² Accordingly:

This thesis will appraise whether there is a requirement for a universal doctrine of good faith in New Zealand contractual relationships.

New Zealand does not currently recognise an explicit general obligation of good faith in the formation, performance, enforcement and discharge of contracts. However, there has been some judicial³ and academic⁴ support for such an obligation within New Zealand. Others view obligations of contractual good faith with skepticism⁵ and some with

¹ Sir Thomas Bingham in the foreword to Reziya Harrison, *Good Faith in Sales* (1997), at vi.

² Justice Johan Steyn, 'The Role of Good Faith and Fair Dealing in Contract Law: A Hair-Shirt Philosophy' in Lord Steyn, *Democracy Through the Law* (2004), at 213.

³ See the comments of Thomas J in *Livingstone v Roskilly* [1992] 3 NZLR 230. See also the observations of Master Kennedy-Grant in *Allen v Southland Building and Investment Society* (High Court, Auckland, CP 556/94, 28 July 1995).

⁴ See generally C J Walshaw, 'Good Faith and Fair Dealing' *Department of Accountancy and Business Law Discussion Paper Series 189* (1999); Matthew Conaglen, 'Duress, Undue Influence, and Unconscionable Bargains – The Theoretical Mesh' (1999) 18 *New Zealand Universities Law Review* 509, at 539; Justice Edward Thomas, 'Good Faith in Contract: A Non-Sceptical Commentary' (2005) 11 *New Zealand Business Law Quarterly* 391; David McLauchlan, 'The Agreement to Negotiate in Good Faith: A Non-Justiciable Contract?' (2005) 11 *New Zealand Business Law Quarterly* 454; Paula Baron, 'Resistance: A Consideration of the Opposition to a Duty of Good Faith in Australian Commercial Contracts' (2005) 11 *New Zealand Business Law Quarterly* 408; Justin Smith, 'Good Faith' in, *The Law of Obligations – "Contract in Context"* (New Zealand Law Society Intensive, 2007).

⁵ See generally *Savelio v New Zealand Post Ltd* (High Court, Wellington, CP 143/02, 18 July 2002, Hammond J), at [19]; *Ideal Garages Ltd v The Independent Construction Company Ltd* (High Court, Auckland, CIV 2004-404-2685, 18 November 2004, Heath J), at [205]; *Walton Mountain Ltd v Apple New Zealand Ltd* (2004) 5 NZCPR 241, at [67] per O'Regan J; *Taylor Marine Ltd v Taylor Marine Brokers (2005) Ltd* (High Court, Auckland, CIV 2005-404-6115, 16 May 2007, Cooper J), at [71]; Maree Chetwin, 'Relational Contract Theory and the Good Faith Debate' (2003) 9 *New Zealand Business Law Quarterly*

distain.⁶ Notably, there is considerably less academic comment on the issue within New Zealand than in other comparable common law countries.⁷

211; Rick Bigwood, 'Symposium Introduction: Confessions of a "Good Faith" Agnostic' (2005) 11 *New Zealand Business Law Quarterly* 371; John Burrows, Jeremy Finn and Stephen Todd, *Law of Contract in New Zealand* (3rd ed, 2007), at 20.

⁶ See James Davies, 'Why a Common Law Duty of Contractual Good Faith is Not Required' (2002) 8 *Canterbury Law Review* 529.

⁷ For recent English comment see Vanessa Sims, 'Good Faith in English Contract Law: Of Triggers and Concentric Circles' (2004) 1 *Ankara Law Review* 213; Justice Steyn, above n 2; Christian Twigg-Flesner, 'A Good Faith Requirement for English Contract Law?' (2000) 9 *Nottingham Law Journal* 80; Gunther Teubner, 'Legal Irritants: Good Faith in British Law or How Unifying Law Ends Up in New Divergences' (1998) 61 *Modern Law Review* 11; Roger Brownsword, 'Good Faith in Contracts Revisited' (1996) 49 *Current Legal Problems* 112; Malcolm Clarke, 'The Common Law of Contract in 1993: Is there a General Doctrine of Good Faith?' (1993) 23 *Hong Kong Law Journal* 318. For recent Australian comment see Bill Dixon, 'Can the Common Law Obligation of Good Faith be Contractually Excluded?' (2007) 35 *Australian Business Law Review* 110; Marcel Gordon, 'Discreet Digression: The Recent Evolution of the Implied Duty of Good Faith' (2007) 19 *Bond Law Review* 26; Geoffrey Kuehne, 'Implied Obligations of Good Faith and Reasonableness in the Performance of Contracts: Old Wine in New Bottles?' (2006) 33 *University of Western Australia Law Review* 63; Justice Robert McDougall, 'The Implied Duty of Good Faith in Australian Contract Law' (2006) 108 *Australian Construction Law Newsletter* 28; Brigid Harradine, 'Implied Duty of Good Faith: A Fetter on Powers Under Australian Construction Contracts' (2006) 1 *Construction Law International* 31; Angelo Capuano, 'Not Keeping the Faith: A Critique of Good Faith in Contract Law in Australia and the United States' (2005) 17 *Bond Law Review* 29; Bill Dixon, 'Common Law Obligations of Good Faith in Australian Commercial Contracts – A Relational Recipe' (2005) 33 *Australian Business Law Review* 87; Bill Dixon, 'What is the Content of the Common Law Obligation of Good Faith in Commercial Franchises?' (2005) 33 *Australian Business Law Review* 207; John Carter and Elizabeth Peden, 'Good Faith in Australian Contract Law' (2003) 19 *Journal of Contract Law* 155; Bruno Zeller, 'Good Faith – Is it a Contractual Obligation?' (2003) 15 *Bond Law Review* 215; Elizabeth Peden, 'The Meaning of Contractual "Good Faith"' (2002) 22 *Australian Bar Review* 235; John Carter and Andrew Stewart, 'Interpretation, Good Faith and the "True Meaning" of Contracts: The Royal Botanic Decision' (2002) 18 *Journal of Contract Law* 1; Tyrone Carlin, 'The Rise (and Fall) of Implied Duties of Good Faith in Contractual Performance in Australia' (2002) 25 *University of New South Wales Law Journal* 99; Adrian Baron, '"Good Faith" and Construction Contracts – From Small Acorns Large Oaks Grow' (2002) 22 *Australian Bar Review* 54; Jeannie Paterson, 'Good Faith in Commercial Contracts? A Franchising Case Study' (2001) 29 *Australian Business Law Review* 270; Eileen Webb, 'The Scope of the Implied Duty of Good Faith- Lessons from Commercial Retail Tenancy Cases' (2001) 9 *Australian*

Common arguments in favour of a doctrine of good faith are that it would allow bad faith conduct to be addressed in a coherent and direct manner, permit the law to protect the reasonable expectations of men and women and promote a culture of contractual cooperation leading to economic efficiency.⁸ Pitted against those views is the concern that good faith is a vague concept. It is not clear whether good faith requires honest conduct, cooperative conduct, reasonable conduct or a combination thereof. Conceivably, a general doctrine may convey an uncertain discretion on the judiciary. Further, it may lead to the demise of contractual autonomy and competitive dealing. These arguments, and others, will be examined and developed throughout the course of this thesis. An appraisal of whether a contractual good faith doctrine is desirable in New Zealand is necessarily a balancing exercise. The various arguments for and against will be weighed and a conclusion will ultimately be drawn.

Chapter 1 of this thesis is entitled ‘setting the scene.’ It provides a brief historical overview of good faith and summarises the current position in New Zealand and other jurisdictions in relation to the reception of the concept of contractual good faith. Chapter 2 considers the subject doctrine. It endeavours to identify how a doctrine of good faith could be incorporated into New Zealand law, the extent to which it might apply to the

Property Law Journal 1; Elizabeth Peden, ‘Incorporating Terms of Good Faith in Contract Law in Australia’ (2001) 23 *Sydney Law Review* 222. For recent Canadian comment see Shannon O’Byrne, ‘The Implied Term of Good Faith and Fair Dealing: Recent Developments’ (2007) 86 *Canadian Bar Review* 193; John McCamus, ‘Abuse of Discretion, Failure to Cooperate and Evasion of Duty: Unpacking the Common Law Duty of Contractual Good Faith Performance’ (2004) 29 *Advocates’ Quarterly* 72; William Tetley, ‘Good Faith in Contract: Particularly in the Contracts of Arbitration and Chartering’ (2004) 35 *Journal of Maritime Law and Commerce* 561; Joel Richler, ‘Good Faith & Construction Contracts’ (2004) 34 *Construction Law Reports* (3d) 163; David Stack, ‘The Two Standards of Good Faith in Canadian Contract Law’ (1999) 62 *Saskatchewan Law Review* 201; Shannon O’Byrne, ‘Good Faith in Contractual Performance: Recent Developments’ (1995) 74 *Canadian Bar Review* 70; S M Waddams, ‘Good Faith, Unconscionability and Reasonable Expectations’ (1995) 9 *Journal of Contract Law* 54.

⁸ See generally Roger Brownsword, ‘Positive, Negative, Neutral: the Reception of Good Faith in English Contract Law’ in Roger Brownsword, Norma Hird and Geraint Howells (eds), *Good Faith in Contract* (1999), at 32.

contracting process and whether it may be possible to contract out of the doctrine. Chapter 3 discusses how good faith under the subject doctrine could be defined and applied in practice. Chapter 4 considers the relationship between a prospective good faith doctrine and existing legal and equitable rules regulating contractual dealings. Chapter 5 applies a law and economics analysis to the subject doctrine. It appraises contractual good faith in terms of economic efficiency. Chapter 6 considers certain international factors which are relevant to the good faith debate within New Zealand. From the foregoing analysis, a conclusion will be drawn as to the desirability of a doctrine of good faith in New Zealand contractual relationships. This will be achieved by weighing up the competing arguments.

Chapter 1

Setting the Scene

1.1 Chapter Introduction:

This chapter describes the evolution of the good faith issue in contract law. It provides a background to the progression of the concept of good faith within various legal jurisdictions. Part 1.2 gives a concise historical overview of the development of good faith from Ancient Roman times to the modern English setting. Part 1.3 summarises the current position in New Zealand in relation to the proposal for a good faith doctrine. Part 1.4 identifies the state of the law relating to contractual obligations of good faith within certain other jurisdictions. Part 1.5 summarises the discussion.

1.2 Historical Overview of Good Faith – From Roman Times to Modern English Law:

1.2.1 Bona Fides in Roman Law:

The origins of good faith can be traced to Roman law. Much like equity in English law, the restrictions of formal procedure in Roman law were surmounted by measures taken by those charged with administering justice. Roman law offers the first example of a legal system adapting under the influence of equitable concepts.¹

The oldest known procedure in Roman law was subsequently named *legis actio* (act or sue according to the law).² The ritual procedure was conducted orally and divided into two parts. The first phase originally proceeded before a *pontiff* who determined whether

¹ Martin Schermaier, 'Bona Fides in Roman Contract Law' in Reinhard Zimmermann and Simon Whittaker (eds), *Good Faith in European Contract Law* (2000), at 65.

² George Mousourakis, *A Legal History of Rome* (2007), at 28 and 32.

the plaintiff could bring an action and its required form. This task was later entrusted to the *praetor* (elected magistrate) consequent on the enactment of the *leges Liciniae Sextiae* in 367 BC.³ Within this stage of the proceedings the plaintiff had to frame his claim in set words which were required to be repeated by the defendant. This formed the *legis actio*. The claim would be rejected if the plaintiff departed from the set form. In the second stage of the procedure the *iudex* (private judge) considered the evidence and decided the case within the frame set by the *praetor*. The *praetor* had no authority to permit actions to proceed which were not provided for by legislation. The stipulated actions constituted the old *ius civile* (civil law).

The *legis actiones* were later supplemented by the formulary system. These developments are thought to have occurred during the third century BC.⁴ Certainly the formulary system featured in the second century BC to the third century AD.⁵ The formulary system was more flexible than the *legis actio*. It permitted litigants to freely state the facts. The *praetor* would then issue the procedural *formula* which would describe the facts, appoint the judge, set out the programme of litigation and identify the claims and defences.

The arrangement of the *formulae* was required to be publicly announced each year by the new *praetor*. This edict provided an opportunity to expand the list of enforceable actions and develop the *ius honorarium* (*praetorian law*). The *ius honorarium* was built up by the *praetors* over a number of centuries and was eventually codified under Emperor Hadrian.⁶ The *ius honorarium* supplemented and corrected the *ius civile* and may arguably be seen as an equivalent to equity in English law.⁷ Both systems sought to overcome the strictures of form and doctrine which tended to give rise to a contradiction

³ Ibid, at 28.

⁴ Schermaier, above n 1, at 72.

⁵ Mousourakis, above n 2, at 32.

⁶ Reinhard Zimmermann, *The Law of Obligations: Roman Foundations of the Civilian Tradition* (1992), at 680.

⁷ See William Buckland, *Equity in Roman Law: Lectures Delivered in the University of London, at the Request of the Faculty of Laws* (1911), at 5; Fritz Pringsheim, 'The Inner Relationship Between English and Roman Law' (1933) 5 *Cambridge Law Journal* 347, at 357.

between positive law and justice. That contradiction was embodied by the Ancient Romans in the phrase *summum ius, summa iniuria*.⁸ The function of the *praetor* therefore bears strong analogy to the function of the Chancellor under English law.⁹

The *ius honorarium* permitted the *praetor* to refuse to grant an action which would otherwise be valid under the *ius civile*. This process was known as *denegatio actionis*. Alternatively, the *praetor* could authorise the insertion of an *exceptio* into the procedural *formula*.¹⁰ The *praetor* did not create new legal rights per se. A legal right was only recognised in legislation in Roman law. However, the *praetor* did create new de facto rights by introducing novel remedies within the *formula*.¹¹

It is not clear at what time *bona fides* became an operative element of Roman law. However, it has been demonstrated that *bona fides* was incorporated into the *ius honorarium* during the second century BC at the latest.¹²

The concept of *bona fides* can be translated to mean in accordance with good faith. *Fides* was originally understood to mean that a man should remain faithful to his word and should honour his undertakings.¹³ *Bona fides* on the other hand was utilised to ascertain the content of a concluded contract. It required the parties to act honestly and therefore influenced the manner in which a contract was performed. The qualification of *fides* as *bona fides* therefore emphasises the specificity of the standard of behaviour that was required.¹⁴

⁸ M T Cicero, *De officiis* 1, at 33.

⁹ Roscoe Dorsey, 'Roman Sources of Some English Principles of Equity and Common Law Rules' (1938) 8 *American Law School Review* 1233, at 1235.

¹⁰ Zimmermann, above n 6, at 680.

¹¹ See Mousourakis, above n 2, at 65.

¹² See Schermaier, above n 1, at 74.

¹³ C C Turpin, 'Bonae Fidei Iudicia' [1965] *Cambridge Law Journal* 260, at 262.

¹⁴ Schermaier, above n 1, at 82.

Bona fides was central to the restructuring of Roman law. The notion of *bona fides* developed at a time when the Republic was very much aware of the division between the old claims under the *ius civile* and those more modern claims under the *ius honorarium*.¹⁵ A claim based on *bona fides* could not be brought under the *ius civile*. *Bona fides* had no statutory basis. It was referred to as *iudicia sine lege*.¹⁶ Thus, the formulary process was essential to the development of the *bonae fidei iudicia*.

Historical catalogues show that certain categories of contract were subject to *bona fides* whereas others were *stricti iuris*.¹⁷ Contracts of *tutela* (guardianship), *mandatum* (mandate), *emptio venditio* (sale), and *locatio conductio* (hire of goods or services) all involved *bona fide* obligations.¹⁸ Unilateral contracts such as the *stipulatio* (where the promisor was bound to the precise object promised) were considered *stricti iuris*.¹⁹

Actiones stricti iuris required the relevant *formula* to be strictly construed. The *iudex* was only permitted to consider the matters contained within the *formula*.²⁰ *Actiones bonae fidei* on the other hand permitted the *iudex* discretion. He could take into account all the facts of the case whether or not they were stipulated in the *formula*. This power was granted by the *praetor* by appending the clause *ex fide bona* to the *formula*. As a result, the judge was permitted to scrutinise the true intention of the parties and could consider equitable defences even if they were not expressly contained within the *formula*.²¹

¹⁵ Ibid, at 68.

¹⁶ M T Cicero, *De officiis* 3, at 61.

¹⁷ See Bankton, *An Institute of the Law of Scotland* (1751-3), at [1.11.65]. For a discussion of the division see William Buckland, *A Text-Book of Roman Law: From Augustus to Justinian* (3rd revised ed, 1963), at 413.

¹⁸ Cicero, above n 16, at 70.

¹⁹ Mousourakis, above n 2, at 67.

²⁰ Buckland, above n 17, at 679.

²¹ Mousourakis, above n 2, at 67.

A case example of the role *bona fides* played in the development of Roman law is found in the writings of Cicero.²² T Claudius Centumalus owned a house on the Caelian hill. The augurs had planned to take an augury on the citadel. The house owned by Claudius was high enough to obstruct their observation of the flight of birds. Accordingly, the augurs required that Claudius demolish part of the house. Instead, Claudius sold the house to Publius Calpurnius Lanarius. Claudius did not advise Calpurnius of the demand that had been made by the augurs. Calpurnius was required to demolish part of the house shortly after acquiring it. Thereafter, Calpurnius compelled Claudius to go before the arbitrator, Marcus Porcius Cato. Calpurnius demanded compensation for his loss. The claim could not be brought under the *ius civile*. A vendor of land could only be liable under that system if he had expressly denied the existence of any defects. Calpurnius therefore initiated the claim not under the *ius civile* but instead as *bona fide iudicium*. Cato duly awarded compensation for the loss which Calpurnius had suffered as a result of the silence of Claudius. The judgment was passed around 100 BC. Neither the action nor the result was new at the time. The decision certainly emphasises how the *bonae fidei iudicia* could lead to a departure away from the principle of caveat emptor.²³

The fundamental effect which *bona fides* had on Roman law is aptly described by Martin Schermaier:

The expansion of the judicial discretion in assessing the merits of a case lay at the heart of the brilliant development of Roman contract law from the time of the late Republic until the end of the classical period. Before the introduction of the *bonae fidei iudicia* the judge was confined to determining whether the claim asserted under the procedural *formula* did or did not exist. The *bona fide* clause enabled him to consider the parties' relationship [in its origin and all its effects, within the framework of all surrounding circumstances and the conduct of the parties].²⁴

Bona fides slowly lost importance from the end of the classical period. The final codification of the *praetorian* edict by Iulianus occurred around 130 AD. This halted the

²² Cicero, above n 16, at 66. For a further analysis of the case see Zimmermann, above n 6, at 309.

²³ See Zimmermann, above n 6, at 309.

²⁴ Schermaier, above n 1, at 81-82 (citations omitted).

creative activity of the *praetors* and the *ius honorarium* lost its flexibility.²⁵ The *ius civile* and the *ius honorarium* were eventually merged. The formulary procedure was also replaced by the imperial *cognitio extra ordinem*.²⁶ This was the favoured procedure by the end of the third century AD.²⁷ In consequence, the flexible and general concepts of *aequitas*, *humanitas* and *benignitas* synonymous with the latter system began to be favoured over *bona fides*.

Nonetheless, a general body of rules had crystallised out of the numerous decisions based on *bona fides*. This collection of principles played an important role in the translation of Roman law into modern legal systems.²⁸ Thus, there can be no doubt that the historical origin of *bona fides* within Roman law has played a vital part in the acceptance of good faith within contemporary contract law.

1.2.2 Good Faith in the Medieval *Ius Commune*:

The *ius commune* had consolidated its position as part of a common Christian culture of Europe by the 14th century. This unity resulted in law and religion being closely related in late medieval writing.²⁹ The medieval jurists who studied Roman and canon law expressly recognised good faith and equity in contract.³⁰ According to the writers before Baldus, good faith and equity described three types of conduct expected of contracting parties.

Firstly, a party was required to keep his word. This was a matter of faith and equity and it applied under the *ius gentium* (a law binding upon all peoples).³¹ This obligation did not

²⁵ See Zimmermann, above n 6, at 127.

²⁶ Ibid, at 681.

²⁷ Mousourakis, above n 2, at 128.

²⁸ Schermaier, above n 1, at 88.

²⁹ Peter Stein, *Roman Law in European History* (1999), at 74.

³⁰ See James Gordley, 'Good Faith in Contract Law in the Medieval *Ius Commune*' in Zimmermann and Whittaker (eds), above n 1, at 93.

³¹ Ibid, at 95.

easily reconcile with Roman law under which only some contracts were *consensu* (binding by consent). The canonists generally adopted the approach that agreements were enforceable without regard to the Roman distinction between contracts *consensu* and contracts *re*.³² The justification was that every promise was binding on the conscience of the promisor and a failure to keep the promise was a breach of duty to God.³³

Secondly, good faith meant that neither party should mislead or take advantage of the other. Accordingly, the victim of *dolus* (deceit or fraud) should have a remedy. *Dolus* was classified as causal or incidental. Causal fraud led a man to contract who would not have done so otherwise. Incidental fraud resulted in a man contracting on less favourable terms. The victim of causal fraud was entitled to escape the contract entirely. Incidental fraud only gave rise to a remedy in damages.³⁴

Thirdly, good faith required a party to do whatever could be expected of an honest person engaged in a given type of transaction.³⁵ This reflected the belief of medieval jurists that every kind of contract has natural terms which a party must observe as a matter of good faith and equity in accordance with the *ius gentium*.

The 14th century Italian jurist Baldus has been said to have developed a more coherent conceptualisation of good faith and equity. Baldus drew on the works of Aristotle and Thomas Aquinas in order to do so. Aristotle recognised that distributive justice secured for each citizen an appropriate share of wealth that society had to divide. Commutative justice preserved that share.³⁶ As a corollary, the virtue of liberality dictated that a person disposing of his money would give the right people the right amounts at the right time.³⁷ Thomas Aquinas hypothesised that contracts could be classified as acts of liberality or

³² Ibid, at 99.

³³ See Raphael Powell, 'Good Faith in Contracts' (1956) 9 *Current Legal Problems* 16, at 20.

³⁴ See Zimmermann, above n 6, at 671.

³⁵ Gordley, above n 30, at 103.

³⁶ Aristotle, *Nicomachean Ethics* V.ii.

³⁷ Aristotle, *Nicomachean Ethics* IV.i, at [1119a]-[1120a].

commutative justice. For example, a donation would fall within the former category whereas sale and lease would fall within the latter.³⁸

Baldus utilised the philosophy of Aristotle and Thomas Aquinas to postulate that good faith and equity required that no person should be permitted to enrich himself at the expense of another. This principle of equality was the foundation of commutative justice. Baldus' principle of natural equity and good faith would therefore permit a remedy where a person received an unjust price.³⁹ It also explained why parties would be subject to certain obligations even if they were not expressly assumed. Baldus reasoned that every contract must have a *causa*. The *causa* could either be liberality or the receipt of something in return for what was given.⁴⁰ An act of commutative justice could not enrich one party at the expense of the other and an act of liberality would only lead to a sensible enrichment. Baldus thus concluded that a contract without a *causa* should not be enforceable under any law, including canon law.⁴¹

The theories of Baldus dominated the late 14th century scholarship.⁴² Baldus' views were adopted by a school of jurists based in Spain in the 16th and 17th centuries who have become known as the Late Scholastics. They discussed the duties which were thought to arise from equity and good faith. Unlike Baldus however, they were not concerned with tying their conclusions to Roman texts.⁴³

Although notions of equality of exchange have somewhat fallen out of fashion in recent times, Baldus made an important contribution to the historical development of good faith in contract. His definition was capable of providing some assistance in resolving individual cases rather than describing discrete situations in which good faith was

³⁸ See Gordley, above n 30, at 107.

³⁹ See James Gordley, *The Philosophical Origins of Modern Contract Doctrine* (1991), at 56 and 67.

⁴⁰ Gordley, above n 30, at 112.

⁴¹ See Gordley, above n 39, at 56.

⁴² See Stein, above n 29, at 73.

⁴³ Gordley, above n 39, at 39.

required.⁴⁴ His theories and those produced by his medieval successors have inevitably enhanced the understanding of the concepts of good faith and equity within contemporary contract law.

1.2.3 The Historical Development of Good Faith in English Law:

It is fundamental that the development of good faith within England is primarily attributable to the Court of Chancery. This is a natural consequence of the fact that the principles of good faith inherent in canon law were imported by the early ecclesiastical chancellors into the Court of Conscience.⁴⁵ Good faith and conscience inevitably lie deepest in the foundations of equity. W T Barbour recognises:

The chancellor was an ecclesiastic, and probably carried with him into chancery the principles and theories of the ecclesiastical court. It is notorious that the ecclesiastical court did assume jurisdiction over *laesio fidei*. What more natural than that the chancellor should have proceeded upon the ground of breach of faith?...I do not think it necessary to base the chancellor's jurisdiction on breach of faith alone; but that he did enforce gratuitous promises cannot be doubted.⁴⁶

However, the Court of Chancery was not the first or the only court in England to embrace concepts of good faith. Henry II was infamous for his quarrelling with the whole mass of bishops and clergy. It is therefore somewhat surprising that his greatest and most lasting act in the legal field was to make justices of the prelates of his church.⁴⁷ Although the clerical justices would have had only a limited acquaintance with canon law, the decision of Henry II

⁴⁴ Gordley, above n 30, at 117.

⁴⁵ See John Baker, *An Introduction to English Legal History* (3rd ed, 1990), at 123. Cf W T Barbour, 'The History of Contract in Early English Equity' in Paul Vinogradoff (ed), *Oxford Studies in Social and Legal History* (1914) vol 4, at 158.

⁴⁶ Ibid, at 163.

⁴⁷ See Sir Frederick Pollock and Frederick Maitland, *The History of English Law Before the Time of Edward I* (2nd ed, 1911) vol 1, at 132.

was the decisive event in the history of the development of good faith in the common law because it ensured the institutionalisation of the Roman canon law concept of *bona fides* in that system. Even the most superficial acquaintance with canon law would include some knowledge of that system's assimilation of the Roman law *bona fides* with the notion of Christian conscience.⁴⁸

The churchmen presiding as judges in the royal courts were thus able to apply their knowledge of the relatively coherent rules of canon law to the vague and conflicting mass of custom, tribal and feudal rules which comprised English law.⁴⁹ The canonist influence brought Roman concepts of *aequitas* and *bona fides* to bear on the early common law.

Notwithstanding, there is little evidence that conscience and good faith were matters which were relevant to decision making by the time of the reign of Edward II. Canon law and civil law had ceased to directly influence English law by the end of the 13th century.⁵⁰ The traces of equitable notions that had existed in the common law had been extinguished. That was manifest in *Le Walays v Melsamby* where Bereford, the Chief Justice, was reminded by counsel that he must not allow conscience to prevent the giving effect to the law.⁵¹ The hitherto weak attempts of the Bereford Bench to introduce some element of good faith into the *ius strictum* were abated. The common law judges therefore assumed that every man entering into a contract would protect his own interests and 'if he were outwitted or even defrauded, he was without redress.'⁵² This conclusion reflected the common law fears that notions of conscience and good faith were a matter of whim and caprice which would open the door to wanton interference with the law of the land.⁵³

The rigours of English common law contrasted markedly with the recognition of *aequitas* within Continental Europe. *Aequitas* was perceived as a means of remedying the

⁴⁸ J F O'Connor, *Good Faith in English Law* (1990), at 2.

⁴⁹ See Sir William Holdsworth, *A History of English Law* (1972) vol 2, at 177.

⁵⁰ Ibid.

⁵¹ Y.B. 1 & 2 Edw II (S.S. Vol 17, 1903), at xix.

⁵² T F T Plucknett in Y.B. 12 Edw II (S.S. Vol 65, 1950), at iv.

⁵³ Barbour, above n 45, at 156.

injustices of the *ius strictum*. In consequence, *bona fides* dominated relations between merchants during the 11th and 12th centuries. Good faith therefore became an essential strand of the medieval and early modern *lex mercatoria*.⁵⁴ Plucknett observed the effect of the contrast between the common law and *lex mercatoria* within England:

[I]t is not without significance that the Merchant has a more scrupulous conscience than the generality of landowners, for the law merchant gave a large place to conscience and good faith and introduced a considerable element of equity in the law of the city courts.⁵⁵

The inflexibility of the rules of the common law within England had significant effects. The ecclesiastical jurisdiction began to encroach on the common law of contract. The ecclesiastical courts would entertain suits to enforce a contract provided that a sworn promise could be derived from the agreement. Words to the effect of ‘by my faith’ were sufficient.⁵⁶ Contracting parties were therefore increasingly exposed to the principles of canon law.

However, the most important consequence of the rigidity of the common law was the development of an equitable jurisdiction during the 14th century. Initially the equitable jurisdiction was administered through the Court of Requests. There is no evidence of Chancery as a separate Court of Equity before 1340.⁵⁷ Thereafter, equitable ideas formerly noticeable in the common law courts began to flow through the Chancellor and Chancery during the 14th and 15th centuries.⁵⁸

The Court of Chancery was perceived more as a Court of Conscience rather than a Court of Equity during the 15th and early 16th centuries. Petitions during that time would allege

⁵⁴ See Reinhard Zimmermann and Simon Whittaker, ‘Good Faith in European Contract Law: Surveying the Legal Landscape’ in Zimmermann and Whittaker (eds), above n 1, at 17.

⁵⁵ Plucknett, above n 52, at lv.

⁵⁶ R H Helmholz, *Roman Canon Law in Reformation England* (1990), at 25.

⁵⁷ See O’Connor, above n 48, at 5.

⁵⁸ See Sir William Holdsworth, *A History of English Law* (4th ed, 1936) vol 2, at 346.

persons to have acted ‘agens faithe and good conscience’⁵⁹ and would appeal to the Chancellor to do as ‘gude faith and consens requyer.’⁶⁰ Raphael Powell appropriately observed:

In the fifteenth century [] the use of the words ‘good faith and conscience’ was probably necessary, not only to catch the eye of the Chancellor but also to put in his hands the key with which he could without qualms open his court to the petitioner. When the Chancellor dealt with the petition, he in turn emphasised the duties of good faith and conscience— especially conscience.⁶¹

The Court of Chancery had progressed and developed from a Court of Conscience to being a Court of Equity by the late 16th century. This led to the emergence of good faith as a distinct concept from conscience.⁶² Good faith began to be applied in the form of more specific rules. References were then made to good faith and equity rather than good faith and conscience.⁶³

From the late 18th century, the Court of Chancery was in decline following the growth of formalism.⁶⁴ Equity had hardened into rigid principles. Old equitable rules relating to penalties, forfeitures, mortgages and unconscionable contracts were ignored or forgotten.⁶⁵ Notwithstanding, there were signs of an emerging principle of good faith in contract law in the latter half of the 18th century.⁶⁶ This was a consequence of the desire for the law of contract to ensure a fair exchange. The idea of good faith was therefore

⁵⁹ Barbour, above n 45, at 182.

⁶⁰ A W B Simpson, *A History of the Common Law of Contract: The Rise of the Action of Assumpsit* (1975), at 397.

⁶¹ Powell, above n 33, at 22.

⁶² Simpson recognises that during the 15th century, conscience did not necessarily connote good faith but it certainly included some element of good faith: Simpson, above n 60, at 398.

⁶³ See O’Connor, above n 48, at 9.

⁶⁴ P S Atiyah, *The Rise and Fall of the Freedom of Contract* (1979), at 392.

⁶⁵ *Ibid*, at 394.

⁶⁶ *Ibid*, at 168.

congruent with the prevailing sense of morality.⁶⁷ In 1766 Lord Mansfield CJ suggested that good faith had a general application to all contracts:

The governing principle is applicable to all contracts and dealings. Good faith forbids either party by concealing what he privately knows, to draw the other into a bargain, from his ignorance of those facts, and his believing to the contrary. But either party may be innocently silent, as to grounds open to both, to exercise their judgment upon.⁶⁸

Lord Mansfield was therefore prepared to restrict the operation of the doctrine of caveat emptor by referring to a general principle of good faith.⁶⁹ The sentiments of Mansfield were shared by Lord Kenyon in *Mellish v Motteux* where he opined that in ‘contracts of all kinds, it is of the highest importance that courts of law should compel the observance of honesty and good faith.’⁷⁰ Similar views were endorsed during the early 19th century. In *Lumley v Wagner* Lord St Leonards LC, sitting in the Lord Chancellor’s Court, observed:

Wherever this court has not proper jurisdiction to enforce specific performance, it operates to bind men's consciences, as far as they can be bound, to a true and literal performance of their agreements, and it will not suffer them to depart from their contracts at their pleasure, leaving the party with whom they have contracted to the mere chance of any damages which a jury may give. The exercise of this jurisdiction has, I believe, had a wholesome tendency towards the maintenance of that good faith which exists in this country to a much greater degree perhaps than in any other...⁷¹

However, from the mid to late 19th century the notion of good faith as a governing principle was overridden by the development of law which reflected *laissez faire* economics and propounded contractual autonomy.⁷² This was a corollary of the new

⁶⁷ Ibid, at 168.

⁶⁸ *Carter v Boehm* (1766) 3 Burr 1905, at 1910.

⁶⁹ See Atiyah, above n 64, at 180.

⁷⁰ (1792) 170 ER 113, at 113-114.

⁷¹ (1852) 42 ER 687, at 693.

⁷² Harrison believes that the reaction against good faith occurred ‘roughly from the late 1870’s onwards.’: Reiza Harrison, *Good Faith in Sales* (1997), at 7.

political economy which had its heyday in the 1820s and 1830s.⁷³ The libertarian tradition recognised the economic and social efficiency of permitting competent parties to freely strike their own bargains.⁷⁴ In consequence the common law idea that parties negotiating a contract are dealing at arms length won the day.⁷⁵ The principle of caveat emptor prevailed. The scales had tipped strongly against general standards of fairness in favour of predictability.⁷⁶ Incrementalism was favoured over high principle and this was fatal to a paternalistic general doctrine of good faith.⁷⁷ Such moralistic ideals were perceived as outmoded.⁷⁸

The merger of the common law and equitable jurisdictions under the Judicature Act 1873 may have also provided a further catalyst for these developments.⁷⁹ The majority of common law judges might have found it difficult to understand and apply equitable notions of good faith. They could have therefore simply elected to ignore them. Indeed, equity had been severely crippled by around 100 years of decline by the time the Judicature Act 1873 was passed.⁸⁰

Good faith became a matter of mere marginal interest in England as a result of the prevailing school of thought.⁸¹ It has been recognised that

⁷³ See Atiyah, above n 64, at 467.

⁷⁴ See Dame Sian Elias, 'Opening Address to the 10th Annual Journal of Contract Law Conference' (2000) 6 *New Zealand Business Law Quarterly* 79.

⁷⁵ *Banque Keyser Ullmann SA v Skandia (UK) Insurance Co Ltd* [1987] 2 All ER 923, at 943 per Steyn J.

⁷⁶ See H K Lücke, 'Good Faith and Contractual Performance' in Paul Finn (ed), *Essays on Contract* (1987), at 157.

⁷⁷ See Atiyah, above n 64, at 168.

⁷⁸ Ibid.

⁷⁹ See Harrison, above n 72, at 9.

⁸⁰ See Atiyah, above n 64, at 393.

⁸¹ See Roger Brownsword, Norma Hird and Geraint Howells, 'Good Faith in Contract: Concept and Context' in Roger Brownsword, Norma Hird and Geraint Howells (eds), *Good Faith in Contract* (1999), at 2.

[w]ith the exception of Raphael Powell's inaugural lecture in 1956, good faith in contract was not a topic addressed by academics or textbook writers; nor was a violation of the principle of good faith a matter openly pleaded or addressed in litigation...⁸²

It was not until the late 20th century that the good faith debate matured. This development was principally brought about by the judgments of Steyn J in *Banque Keyser Ullmann SA v Skandia (UK) Insurance Co Ltd*⁸³ and Bingham LJ in *Interfoto Picture Library Ltd v Stiletto Visual Programmes Ltd*.⁸⁴

In *Banque Keyser* Steyn J considered a claim for a breach of good faith in the context of an insurance contract. His Honour, when discussing the long-recognised principle that a contract for insurance is a particular category of contract for which an obligation of good faith disclosure applies, recognised:

That principle, Lord Mansfield CJ said, is applicable to all contracts. To that extent Lord Mansfield CJ's generalised statement has not prevailed. Admittedly, there are other contracts which are sometimes described as contracts of the utmost good faith, such as contracts of suretyship, partnership and salvage, but the principles of disclosure applicable to those contracts cannot be equated with those applicable to contracts of insurance.⁸⁵

Critically, Steyn J went on to hold that the remedy for an insured for a breach of utmost good faith was not confined to avoidance of the contract and a return of the premium. It could extend to a claim for damages provided that the insured could show that the non-disclosure induced him or her to enter into the contract and that damages was the only effective remedy.⁸⁶ Although this point was overturned by the House of Lords⁸⁷, it led to

⁸² Andrew Grubb and Michael Furmston (eds), *The Law of Contract* (1999), at 68 (citation omitted).

⁸³ [1987] 2 All ER 923.

⁸⁴ [1988] 1 All ER 348.

⁸⁵ [1987] 2 All ER 923, at 943.

⁸⁶ *Ibid*, at 947.

⁸⁷ [1990] 2 All ER 947. Lord Templeman observed (at 959) that 'I agree with the Court of Appeal that a breach of the obligation does not sound in damages. The only remedy open to the insured is to rescind the policy and recover the premium.' In respect of the damages issue, it has been recognised that part 'of the

an increased interest in the idea that the principle of good faith could be used as a positive cause of action to obtain a remedy analogous to contractual damages.

In *Interfoto* the English Court of Appeal was required to rule on the enforceability of a particularly onerous clause which required a customer of a photo library to pay an extortionate⁸⁸ holding fee for photographs returned after the due date. The photo library had omitted to draw the attention of the customer to the clause. Bingham LJ alluded to obligations of good faith in the course of the judgment:

In many civil law systems, and perhaps in most legal systems outside the common law world, the law of obligations recognises and enforces an overriding principle that in making and carrying out contracts parties should act in good faith. This does not simply mean that they should not deceive each other, a principle which any legal system must recognise its effect is perhaps most aptly conveyed by such metaphorical colloquialisms as 'playing fair', 'coming clean' or 'putting one's cards face upwards on the table'...English law has, characteristically, committed itself to no such overriding principle but has developed piecemeal solutions in response to demonstrated problems of unfairness. Many examples could be given. Thus equity has intervened to strike down unconscionable bargains. Parliament has stepped in to regulate the imposition of exemption clauses and the form of certain hire-purchase agreements. The common law also has made its contribution, by holding that certain classes of contract require the utmost good faith, by treating as irrecoverable what purport to be agreed estimates of damage but are in truth a disguised penalty for breach, and in many other ways.⁸⁹

Bingham LJ considered that a legal system incorporating good faith would require the photo library to specifically draw the attention of the customer to the high price payable.⁹⁰ English law instead looked to the nature of the transaction in question and the

problem with the case was that, wound up with the pure insurance aspects, in terms of utmost good faith and disclosure, was a claim in tort for, in effect, pure economic loss. It arose at the time when the higher courts were cutting back on the availability of tortious remedies for pure economic loss and may have suffered accordingly, with the special insurance attributes being in effect overlooked.' John Birds, *Birds' Modern Insurance Law* (7th ed, 2007), at 140.

⁸⁸ [1988] 1 All ER 348, at 357 per Bingham LJ.

⁸⁹ Ibid, at 352 and 353. See also *National Westminster Bank plc v Rabobank Nederland* [2007] EWHC 1056 (Comm).

⁹⁰ Ibid, at 353.

character of the parties to consider what notice was given to the particular party alleged to be bound and whether it would be fair in all the circumstances to hold him or her to the bargain. However, Bingham LJ considered that the English analysis would not yield a very different result from the civil law principle of good faith.⁹¹ In fact, this bore out. The Court distinguished the case from a simple analysis of whether an offer had been made and accepted. Although there was clearly a contract, the photo library had not done what was reasonably necessary to draw the attention of the customer to the condition in question. Accordingly, the particular clause could not be said to have become part of the contract.⁹² It was unenforceable.

As a result of these decisions the debate was opened in England as to whether the common law should move away from its piecemeal approach to a unifying obligation of good faith. The libertarians stood on one side advocating freedom of contract and the classical law of contract.⁹³ That stance was best encapsulated by the famous comments of Lord Ackner in *Walford v Miles* where it was suggested that an obligation to negotiate in good faith is inherently repugnant to the adversarial position of parties engaged in contractual negotiations.⁹⁴ Natural lawyers opposed this position, favouring wider judicial responsibility and propounding the importance of fairness as a concept in the negotiation, interpretation and enforcement of a contractual bargain.

In consequence, there can be no doubt that good faith is an ideal whose time has now come.⁹⁵ It has been contended, albeit without any empirical proof, that more articles,

⁹¹ Ibid, at 357. In cases similar to *Interfoto* some English commentators have contended that ‘good faith can provide useful guidance.’: P A Chandler and J A Holland, ‘Notice of Contractual Terms’ (1988) 104 *Law Quarterly Review* 359, at 361.

⁹² Ibid, at 352 per Dillon LJ.

⁹³ See Dame Sian Elias, above n 74.

⁹⁴ [1992] 1 All ER 453, at 460.

⁹⁵ See Brownsword, Hird and Howells, above n 81, at 3.

commentaries and books are now being written on the good faith debate than any other subject in the law of contract.⁹⁶

1.3 The Current Position in New Zealand:

Case law in New Zealand supporting a doctrine of good faith is currently sparse.⁹⁷ The main judicial proponent of the doctrine was Thomas J. In *Livingstone v Roskilly* his Honour asserted, in obiter dicta, that ‘I would not exclude from our common law the concept that, in general, the parties to a contract must act in good faith in making and carrying out the contract.’⁹⁸

However, in *Isis (Europe) Ltd v Lateral Nominees Ltd* Tompkins J suggested that the trend of current authority does not support the comments of Thomas J in *Livingstone*.⁹⁹ The idea of a general obligation arising out of any contract to act fairly and in good faith could not be supported.

Notwithstanding, Thomas J did not waiver from his position. Having then been elevated to the Court of Appeal, his Honour delivered a dissenting judgment in *Bobux Marketing Ltd v Raynor Marketing Ltd*.¹⁰⁰ The contract in question was described as a relational contract. The agreement stipulated that it would continue for an indefinite period. The majority held that there was no ability to imply a right to terminate the agreement on reasonable notice. Thomas J would have implied such a right. His Honour described the

⁹⁶ David McLauchlan, ‘The Agreement to Negotiate in Good Faith: A Non-Justiciable Contract?’ (2005) 11 *New Zealand Business Law Quarterly* 454. One judge has referred to the ‘bewildering variety of opinions in the authorities and commentaries as to the implication of terms as to reasonableness and good faith in commercial contracts.’: *Council of the City of Sydney v Goldspar Australia Pty Ltd* [2006] FCA 472, at [166] per Gyles J.

⁹⁷ See generally Justice Edward Thomas, ‘Good Faith in Contract: A Non-Sceptical Commentary’ (2005) 11 *New Zealand Business Law Quarterly* 391, at 392.

⁹⁸ [1992] 3 NZLR 230, at 237.

⁹⁹ (High Court, Auckland, CP 444/95, 17 November 1995), at 6.

¹⁰⁰ [2002] 1 NZLR 506.

majority decision as a finding that carried the weight of orthodoxy but the interpretation did not make commercial sense.¹⁰¹

Thomas J engaged in a comprehensive discussion of the academic and judicial comment relating to good faith in contract law in the course of the dissenting judgment. His Honour continued to display a preparedness to recognise a duty to exercise good faith in the performance of a contractual obligation and particularly in the case of relational contracts. The good faith obligation in the latter class of contacts would supposedly hold the parties to the promise implicit in a continuing, relational commercial transaction.¹⁰²

Once more, these observations have not received support. In *Archibald Barr Motor Company Ltd v ATECO Automotive New Zealand Ltd* Allan J suggested that New Zealand courts are unlikely to incorporate an obligation of good faith into all contracts generally. This conclusion was particularly applicable to those commercial contracts where the parties have extensively spelt out their obligations and where a good faith requirement would not fit comfortably with those detailed express terms.¹⁰³

As Thomas J approached retirement from the Supreme Court he again touched on the good faith subject in the case of *Gibbons Holdings Ltd v Wholesale Distributors Ltd*.¹⁰⁴ The attempts of the appellant to propound a contractual interpretation contrary to its actual intention at the time of contracting were criticised. His Honour contended that a doctrine of good faith would likely have prevented such attempts. It was asserted that:

Notwithstanding its widespread acceptance in most common law and civil jurisdictions in the world and growing judicial support, the courts have not yet incorporated the doctrine of good faith into our law. There is a widespread belief that existing doctrines or judicial devices already encompass a requirement of good faith. It would, it is said, add nothing to the existing tools and principles of

¹⁰¹ Ibid, at 508.

¹⁰² Ibid, at 517.

¹⁰³ (High Court, Auckland, CIV 2007-404-5797, 26 October 2007), at [79].

¹⁰⁴ [2008] 1 NZLR 277.

the common law, such as estoppel and implied terms. This case serves to demonstrate that this belief is misplaced.¹⁰⁵

Few lawyers in New Zealand would dispute that the legal views and approach of Thomas J in exercising his judicial function were controversial.¹⁰⁶ His Honour developed notoriety amongst the legal fraternity for the frequency of his dissenting judgments when sitting as an appellate judge. In respect of his Honour's first instance decisions, it has been suggested that he all too frequently engaged in legal analysis on matters which should have properly been left to the Privy Council.¹⁰⁷ His appointment to the Court of Appeal was therefore supported by some on the basis that he could be outvoted by his judicial brethren where necessary.¹⁰⁸

However, it has been observed that the introduction of good faith in New Zealand may be inevitable. The future of good faith will depend on legal, cultural and attitudinal shifts that are bound to occur.¹⁰⁹ The seemingly ever-increasing need for internationalisation of commercial and contract law may well be a catalyst for these developments. The obiter dicta comments and controversial judgments of Thomas J in respect of good faith may be regarded as forward thinking in light of this pressure for change. It has been noted that:

A dissenting judgment anchored in the circumstances of today sometimes appeals to the judges of tomorrow. In that way a dissenting judgment sometimes contributes to the continuing development of the law.¹¹⁰

¹⁰⁵ Ibid, at 316-317.

¹⁰⁶ Thomas has described his own perception on the role of judges in the legal system: Justice Edward Thomas, *The Judicial Process: Realism, Pragmatism, Practical Reasoning, and Principles* (2005). See also Bevan Marten, 'Book Review: The Judicial Process: Realism, Pragmatism, Practical Reasoning and Principles' (2006) 37 *Victoria University of Wellington Law Review* 153.

¹⁰⁷ See Don Dugdale, 'An Impolite Response to Mr Thomas' [2005] *New Zealand Law Journal* 372.

¹⁰⁸ Ibid.

¹⁰⁹ See generally Rick Bigwood, 'Symposium Introduction: Confessions of a "Good Faith" Agnostic' (2005) 11 *New Zealand Business Law Quarterly* 371, at 374.

¹¹⁰ Lord Steyn, 'The Value of Dissenting Judgments: *Fisher v Minister of Public Safety and Immigration*' in Lord Steyn, *Democracy Through the Law* (2004), at 85.

Thomas J's views have not been entirely rejected in New Zealand. In *Allen v Southland Building and Investment Society*¹¹¹ Master Kennedy-Grant considered a submission to the effect that New Zealand law should recognise a legally implied term requiring good faith and fair dealing by the parties to a contract. It was held that the existence of such an obligation was, at least, arguable.¹¹² His Honour cited the views of Thomas J in *Livingstone* in support of this assertion. It was also noted that there is no New Zealand authority which precludes the argument that such a legally implied duty exists.¹¹³

In *Stanley v Fuji Xerox New Zealand Ltd* Elias J was prepared to imply an obligation of good faith wherever a contract is predicated on mutual trust and confidence.¹¹⁴ The reasoning is arguably somewhat circular. Duties of good faith and loyalty are inevitably implicit in contracts embodying mutual trust and confidence. The case does not therefore necessarily support a duty of good faith applicable to all contracts. Nonetheless, Elias J considered that a term of good faith and fair dealing was required in the particular circumstances. The parties had substituted an employment agreement for an agency agreement. Similar duties of good faith would be owed under the agency agreement as were owed under the employment agreement because the agent performed a similar function as he had performed as an employee.¹¹⁵ The implied term would give effect to the expectations of the parties to the agreement as objectively ascertained from the contract and the context.¹¹⁶

¹¹¹ (High Court, Auckland, CP 556/94, 28 July 1995).

¹¹² *Ibid*, at 17.

¹¹³ *Ibid*.

¹¹⁴ (High Court, Auckland, CP 479/96, 5 November 1997), at 55. For a discussion of the duty see Graham Rossiter, 'Independent Contractors' [2001] *New Zealand Law Journal* 99.

¹¹⁵ *Ibid*. See also Judith Cheyne and Peter Taylor, 'Commercial Good Faith' [2001] *New Zealand Law Journal* 245, at 248. However, in another case involving an owner/driver agency agreement, attempts to engraft obligations of good faith into the complete, written commercial agreement between the parties were regarded as problematic: *Savelio v New Zealand Post Ltd* (High Court, Wellington, CP 143/02, 18 July 2002, Hammond J), at [19].

¹¹⁶ *Ibid*, at 55.

Further, Hammond J was prepared to recognise an obligation to negotiate in good faith as being legally enforceable in *New Zealand Licensed Rest Homes Associated Inc v Midland Regional Health Authority*.¹¹⁷ The contract was for the provision of rest home services. It expressly required the parties to negotiate in good faith for a new agreement prior to the termination date of the existing contract. Hammond J considered that the clause imposed some restriction on the raw and undiluted pursuit of individual self-interest.¹¹⁸ The substantive findings of his Honour were upheld on appeal in *Residential Care (New Zealand) Inc v Health Funding Authority*.¹¹⁹

The *Rest Homes* case must however be compared with the decision of the Court of Appeal in *Wellington City Council v Body Corporate 51702 (Wellington)*.¹²⁰ The appellant Council was a lessor of premises. It undertook to negotiate in good faith for the sale of its leasehold interests to existing lessees at not less than the current market value of those interests. The respondent lessee claimed that there was a valid process contract which was breached by the Council. In particular, the Council was alleged to have failed to respond to offers made by the lessee and sold the relevant leasehold interest to a third party on substantially the same terms offered by the lessee. Tipping J, delivering the judgment of the Court, recognised that a process contract will be enforceable if it specifies the way in which negotiations are to be conducted with enough precision to determine what the parties are required to do.¹²¹ In the present context it was said that good faith was a subjective criterion. The Court had no objective means of determining whether the parties were negotiating in good faith and accordingly the matter was not justiciable.¹²²

¹¹⁷ (High Court, Hamilton, CP 34/97, 15 June 1999), at [154].

¹¹⁸ *Ibid*, at [144].

¹¹⁹ (Court of Appeal, CA 170/99; 268/99, 17 July 2000).

¹²⁰ [2002] 3 NZLR 486.

¹²¹ *Ibid*, at 496.

¹²² *Ibid*, at 495-496.

Tipping J did not address the *Rest Homes* case in *Wellington City Council*. The decisions are difficult to reconcile. However, in the course of the judgment Tipping J did recognise Canadian authority¹²³ upholding a contractual clause within an already concluded contract which required the parties to negotiate implicitly in good faith for a specific contract outside the existing contract.¹²⁴ The *Rest Homes* case might conceivably fall within this line of authority given that there was a pre-existing negotiation clause within the original contract. Nonetheless, certain commentators have argued that the *Rest Homes* case has been impliedly overruled or ‘trumped’ by *Wellington City Council*.¹²⁵

Preliminary agreements to negotiate in good faith will be considered in more detail in Chapter 2. However, it could be reasoned from *Wellington City Council* that if the judiciary is generally unwilling to give effect to the concept of good faith when parties have expressly agreed to negotiate in good faith, it is unlikely that it will receive more favourable treatment when attempts are made to imply or import an obligation of good faith into a contract.¹²⁶

That said, it is evident that good faith is not foreign to New Zealand law. Clearly however the above authorities which have been referred to in support of Thomas J’s views often fall short of a preparedness to recognise a general doctrine of good faith in New Zealand. There currently remains a distinction between a universally applicable doctrine of good faith and an implied term of good faith depending on the nature of the contract or the relationship between the contracting parties. Whilst the New Zealand courts are prepared to recognise the latter, the former has not yet been accepted.

However, there is no authority expressly rejecting such a universal doctrine. It remains to be substantively tested. Accordingly, in *Vero Insurance New Zealand Ltd v Fleet Insurance & Risk Management Ltd* Asher J observed:

¹²³ *Empress Towers Ltd v Bank of Nova Scotia* (1990) 73 DLR (4th) 400.

¹²⁴ [2002] 3 NZLR 486, at 495.

¹²⁵ See generally Thomas, above n 97, at 392.

¹²⁶ *Ibid.*

Although a number of New Zealand cases have considered the circumstances in which a term of good faith will be implied [], the application and meaning of good faith in contracts has not as yet been thoroughly considered in New Zealand.¹²⁷

Seemingly there is a very real possibility that the issue of a good faith doctrine in New Zealand will soon need to be addressed by the appellate courts. In *Prime Commercial Ltd v Wool Board Disestablishment Company Ltd* the Supreme Court, although declining leave to appeal on the basis that the substantive case was unlikely to succeed, considered that the issue of contractual good faith in New Zealand was a matter of general importance capable of qualifying for a grant of leave.¹²⁸ Based on these comments it appears that the Supreme Court may be willing to entertain the issue of whether a universal doctrine of good faith may be required in New Zealand.

1.4 Other Jurisdictions:

1.4.1 Australia:

Australia is currently in a similar position to New Zealand in relation to contractual good faith. It is only quite recently that there has been discussion of the extent to which Australian law does, or should, endorse a universal doctrine of contractual good faith.¹²⁹

In *Service Station Association Ltd v Berg Bennett & Associates Pty Ltd* Gummow J recognised that there is no Australian authority for the proposition that there is a general

¹²⁷ (High Court, Auckland, CIV 2007-404-1438, 21 May 2007), at [44]. The issue of good faith in contracts has been described as a ‘developing area of the law.’: *Culverden Retirement Village v Hill* (High Court, Auckland, CIV 2008-404-5281, 27 August 2008, Lang J), at [21].

¹²⁸ [2007] NZSC 9, at [2].

¹²⁹ See generally David Harland, ‘Unconscionable and Unfair Contracts: An Australian Perspective’ in Brownsword, Hird and Howells (eds), above n 81, at 262.

obligation of good faith and fair dealing in the performance and enforcement of a contract.¹³⁰

However, there have been judicial murmurings favouring an obligation of good faith. In *Renard Constructions (ME) Pty Ltd v Minister for Public Works* Priestly JA suggested that good faith is implicit in many of the orthodox techniques for solving contractual disputes despite the fact that notions of good faith prevailing within the civil law systems of Europe and the United States have not yet been overtly accepted in Australia. His Honour contended that there are a number of indications that the time is fast approaching when the idea of good faith will take on more explicit recognition in Australia.¹³¹

These observations have been supported. In *Hughes Aircraft Systems International v Airservices Australia*¹³² Finn J considered a pre-award tender contract. The plaintiff tenderer claimed that the selection of the successful tenderer was not in accordance with a fair process and defined procedures. Finn J held that a term would be implied in fact into the process contract to the effect that the inviting public body defendant would consider the tenders fairly so as to ensure equal opportunity between the two remaining tenderers.¹³³ It was also held that a term of fair dealing would be implied in law into the contract.¹³⁴ The classification of the contract and the fact that a public body was a contracting party gave rise to the implication in law.¹³⁵ During the course of the judgment, his Honour made obiter dicta comments to the effect that obligations of fair dealing and good faith could have application in all contracts. It was opined that good faith is a fundamental principle and that its more open recognition in Australian contract law is now warranted.¹³⁶

¹³⁰ (1993) 117 ALR 393, at 401-407.

¹³¹ (1992) 26 NSWLR 234, at 264.

¹³² (1997) 146 ALR 1.

¹³³ *Ibid*, at 35.

¹³⁴ *Ibid*, at 38.

¹³⁵ *Ibid*, at 39.

¹³⁶ *Ibid*, at 37.

Despite these broad observations, Finn J was forced to concede in *South Sydney District Rugby League Football Club Ltd v News Ltd* that Australian law has not yet committed itself unqualifiedly to a principle that every contract requires of each party a duty of good faith and fair dealing in its performance and enforcement.¹³⁷

Nonetheless, in *Garry Rogers Motors (Aust) Pty Ltd v Subaru (Aust) Pty Ltd* Finkelstein J sought to expand the positive views of Finn J. It was contended that recent cases make it clear that a term of good faith will ordinarily be implied in an appropriate contract and perhaps even in all commercial contracts.¹³⁸

However, to date there is no clear decision from the High Court of Australia on the issue. In *Royal Botanic Gardens & Domain Trust v South Sydney City Council* the High Court made mention of the debate concerning the existence and content of an implied obligation or duty of good faith and fair dealing in contracts and particularly in the exercise of

¹³⁷ [2000] FCA 1541, at [238]-[239].

¹³⁸ (1999) ATPR ¶41,703, at 43,014. For recent cases considering an implied obligation of good faith see *Council of the City of Sydney v Goldspar Australia Pty Ltd* [2006] FCA 472; *Meridian Retail Pty Ltd v Australian Unity Retail Network Pty Ltd* [2006] VSC 223; *ACI Operations Pty Ltd v Berri Ltd* [2005] VSC 201; *Dockpride Pty Ltd v Subiaco Redevelopment Authority* [2005] WASC 211; *Hoppers Crossing Club Ltd v Tattersalls Gaming Pty Ltd* [2005] VSC 114; *Biscayne Partners Pty Ltd v Valance Corp Pty Ltd* [2003] NSWSC 874; *Golden Sands Pty Ltd v Davegale Pty Ltd* [2003] VSC 458; *Automasters Australia Pty Ltd v Bruness Pty Ltd* [2002] WASC 286; *Central Exchange Ltd v Anaconda Nickel Ltd* [2002] WASCA 94; *Commonwealth Development Bank of Australia Pty Ltd v Cassegrain* [2002] NSWSC 965; *Cubic Transportation Systems Inc v State of New South Wales* [2002] NSWSC 656; *Hudson Resources Ltd v Australian Diatomite Mining Pty Ltd* [2002] NSWSC 314; *Softplay v Perpetual* [2002] NSWSC 1059; *State of New South Wales v Banabelle Electrical Pty Ltd* (2002) 54 NSWLR 503; *Apple Communications v Optus Mobile* [2001] NSWSC 635; *Bamco Villa Pty Ltd v Montedeen Pty Ltd* [2001] VSC 192; *Commonwealth Bank of Australia v Renstell Nominees Pty Ltd* [2001] VSC 167; *East Van Villages Pty Ltd v Minister Administering the National Parks and Wildlife Act* [2001] NSWSC 559; *Edensor Nominees Pty Ltd v Anaconda Nickel Ltd* [2001] VSC 502; *LMI Australasia Pty Ltd v Boulderstone Hornibrook Pty Ltd* [2001] NSWSC 886; *Radly Corp Ltd v Suncorp Metway Ltd* [2001] VSC 272; *Asia Television Ltd v Yau's Entertainment Pty Ltd* (2000) 48 IPR 283; *De Pasquale v The Australian Chess Federation* [2000] ACTSC 94; *Dickson Property Management Services Pty Ltd v Centro Property Management (Vic) Pty Ltd* (2000) 180 ALR 485.

contractual rights and powers.¹³⁹ Ultimately it was determined that the case was inappropriate for a discussion of the existence and scope of a good faith doctrine. Nonetheless, the importance of these issues was recognised.¹⁴⁰ Indeed, there were subtle indications from Kirby J as to his stance on a doctrine of good faith. It was suggested that such a doctrine appears to conflict with the fundamental notion of caveat emptor and economic freedom.¹⁴¹ Further reluctance was expressed in respect of implying terms which contractual parties have omitted to include.¹⁴²

Notwithstanding, the question of whether a doctrine might be introduced has been left open in Australia. This has fueled a considerable amount of academic writing on the issue. It certainly appears that Australian commentators are leading the way in the good faith debate in Australasia in terms of the sheer quantity of literature.

1.4.2 Canada:

Canada is also in a similar position to New Zealand and Australia. The Supreme Court of Canada has recognised specific categories of contract for which a duty of good faith may apply, for example, employment agreements.¹⁴³ However, there is no acceptance of a generalised common law duty of good faith applying to all contracts as yet.¹⁴⁴ In *Mesa Operating Ltd Partnership v Amoco Canada Resources Ltd* the Alberta Court of Appeal observed that a general obligation of good faith is not an obvious part of contract law either in England or Canada.¹⁴⁵

¹³⁹ (2002) 186 ALR 289, at 301 per Gleeson CJ, Gaudron, McHugh, Gummow and Hayne JJ.

¹⁴⁰ Ibid.

¹⁴¹ Ibid, at 312.

¹⁴² Ibid.

¹⁴³ *Wallace v UGG* [1997] 3 SCR 701. See also Judy Fudge, 'The Limits of Good Faith in the Contract of Employment: From *Addis* to *Vorvis* to *Wallace* and Back Again' (2007) 32 *Queen's Law Journal* 529.

¹⁴⁴ See Brenda Johnson, 'The Duty of Good Faith in Contractual Performance' (2005)

<www.bennettjones.ca/Images/Guides/update613.pdf>, at 21 April 2008.

¹⁴⁵ (1994) 149 AR 187, at 191 per Kerans JA.

However, art 1375 of the Quebec Civil Code, *Code Civil du Québec*, imposes an obligation of good faith on parties to all qualifying contracts in the following terms:

The Parties shall conduct themselves in good faith both at the time the obligation is created and at the time it is performed or extinguished.

Some proponents have argued that such codification supports the argument for a general common law doctrine of good faith within Canada.¹⁴⁶ Nonetheless, caution is required when comparing the civil law in Quebec with the Canadian common law of contract. The drafters of the Civil Code in Quebec were guided largely by French civil law.¹⁴⁷ Despite Quebec law being influenced by the common law doctrines of sister law provinces¹⁴⁸, it does not follow that those common law provinces would be more willing to adopt good faith merely to achieve consistency with Quebec. The fact that the civil law in Canada utilises good faith is therefore unlikely to be a compelling argument for Canadian common law jurists and lawyers.

A general duty of good faith has been supported in trial decisions in Canada. In *Gateway Realty Ltd v Arton Holdings Ltd (No 3)* Kelly J opined:

The insistence of a good faith requirement in discretionary conduct in contractual formation, performance and enforcement is only the fulfillment of the obligation of the courts to do justice in the resolution of disputes between contracting parties.¹⁴⁹

Likewise, in *Elite Specialty Nursing Services Inc v Ontario Meehan J* said:

¹⁴⁶ See Joel Richler, 'Good Faith & Construction Contracts' (2004) 34 *Construction Law Reports* (3d) 163, at [10].

¹⁴⁷ See David Angus, 'Abuse of Rights in Contractual Matters in the Province of Quebec' (1961) 8 *McGill Law Journal* 150. For a comprehensive discussion of good faith under the Quebec Civil Code and its origins see George Rosenberg, 'The Notion of Good Faith in the Civil Law of Quebec' (1960) 7 *McGill Law Journal* 2.

¹⁴⁸ *Ibid*, at 154.

¹⁴⁹ 106 NSR (2D) 180, at 192.

[E]xplicitly recognizing the doctrine of good faith makes the law more certain, more understandable and, of course, more fair...Rather than having to go through various interpretive contortions to get the desired result, a judge could [] simply state that a discretion under a contract must be exercised in good faith, and if it is not so exercised, find that the contract has been breached.¹⁵⁰

These observations have attracted criticism. They are seen as a loose application of notions of good faith to restrict contractual behaviour.¹⁵¹ Much of the support at trial court level for good faith emanates from obiter dicta comments or in cases involving particular contracts where an implied obligation of good faith is recognised under the existing law.¹⁵²

However, there also appears to be a degree of extra-judicial support for good faith in Canadian contract law. The Ontario Law Reform Commission has observed:

While good faith is not yet an openly recognised contract law doctrine, it is very much a factor in everyday contractual transactions. To the extent that the common law of contracts, as interpreted and developed by our courts, reflects this reality, it is accurate to state that good faith is a part of our law of contracts.¹⁵³

Whilst it may be correct to say that obligations of good faith are implicit in Canadian contract law, the case for explicit recognition is not particularly strong. Certainly there does not yet appear to be any robust judicial support for a doctrine of good faith from the appellate level. The position was appropriately summarised by the Ontario Court of Appeal in *Transamerica Life Inc v ING Canada Inc* where it was noted:

...Canadian courts have not recognized a stand-alone duty of good faith that is independent of the terms expressed in a contract or from the objectives that

¹⁵⁰ 116 ACWS (3d) 51, at [90] and [52].

¹⁵¹ See Richler, above n 146, at [19].

¹⁵² Ibid, at [38].

¹⁵³ Ontario Law Reform Commission, *Report on Amendment of the Law of Contract* (1987), at 166.

emerge from those provisions. The implication of a duty of good faith has not gone so far as to create new, unbargained-for, rights and obligations.¹⁵⁴

The current Canadian approach is therefore similar to the New Zealand position. Obligations of good faith may be implied where required in the particular circumstances, but as yet there is no general overarching doctrine. Nonetheless, one notable Canadian contract text suggests that there is undoubtedly some momentum in the direction of embracing a universal doctrine.¹⁵⁵

1.4.3 United States:

Unlike the majority of the common law countries, the United States has accepted a doctrine of contractual good faith. The doctrine derives from three principal sources.¹⁵⁶ The first is the Uniform Commercial Code. It stipulates obligations of good faith in 60 of its 400 sections and provides a general good faith definition and definitions specific to particular sections. Secondly, s 205 of the American Law Institute's Restatement (2d) of Contracts 1981 provides that every contract imposes on each party a duty of good faith and fair dealing in its performance and its enforcement. Thirdly, art 7(1) of the United Nations Convention on Contracts for the International Sale of Goods, which the United States has ratified, suggests the observance of good faith in international trade.

Reliance on codification may not be required in some cases. There is evidence to suggest that the United States courts have restricted the exercise of contractual discretion by imposing a common law obligation of good faith applying to contractual performance in circumstances where the Uniform Commercial Code clearly does not apply.¹⁵⁷

¹⁵⁴ (2003) 234 DLR (4th) 367, at [53] per O'Connor ACJO. See also *Muhammad v Mental Health Program Services of Metropolitan Toronto* (Ontario Superior Court of Justice, 18 August 2006).

¹⁵⁵ See John McCamus, *The Law of Contract* (2005), at 807.

¹⁵⁶ See generally E Allan Farnsworth, 'Good Faith in Contract Performance' in Jack Beatson and Daniel Friedman (eds), *Good Faith and Fault in Contract Law* (1995), at 155.

¹⁵⁷ *Ibid*, at 159.

The doctrine operates on a number of levels. Good faith is treated as an implied provision in the contract. It imposes obligations on the contracting parties that are perceived to be in the interests of justice. The obligation of good faith ensures that the intent of the contracting parties is not frustrated.¹⁵⁸ The good faith obligation does not only proscribe conduct. It may also mandate or require affirmative action.¹⁵⁹

It is important to note that the doctrine is generally perceived as a default standard in the United States. It cannot be used to effect ‘an end-run around the unequivocal and express terms of the contract.’¹⁶⁰ However, it is not possible to completely contract out of the doctrine in most cases.¹⁶¹

The United States experience relating to the doctrine of good faith is discussed in more detail in Chapter 6.

1.4.4 Europe:

The civil law systems within Europe are familiar with a doctrine of good faith. The majority of the Continental Civil Codes incorporate the concept of good faith.¹⁶² For example, art 1134 of the French Code, *Code Civil*, provides that agreements must be performed in good faith. Similarly § 242 of the German Civil Code, *Bürgerliches Gesetzbuch*, requires observance of *treu und glauben* (fidelity and faith). The Italian Civil Code, *Codice Civile*, refers to good faith and fair dealing in contractual negotiation (art 1337), interpretation (art 1366) and performance (art 1375).

¹⁵⁸ *John B Conomos Inc v Sun Co*, 831 A2d 696, at 706 per Lally-Green J (Pa Super Ct, 2003).

¹⁵⁹ Farnsworth, above n 156, at 160.

¹⁶⁰ Emily Houh, ‘The Doctrine of Good Faith in Contract Law: A (Nearly) Empty Vessel?’ [2005] *Utah Law Review* 1, at 16.

¹⁶¹ Section 1-102(3) Uniform Commercial Code.

¹⁶² Thomas, above n 97, at 407.

As a result of the establishment of the European Community, the Commission on European Contract Law has, since 1982, been preparing the Principles of European Contract Law (“PECL”). The PECL are intended to apply as general rules of contract law within the European Union.¹⁶³ They have been developed as a possible first step towards a generalised European Civil Code.¹⁶⁴ Article 1:102 of the 1999 text provides:

- (1) Parties are free to enter into a contract and to determine its contents, subject to the requirements of good faith and fair dealing, and the mandatory rules established by these Principles.

Further, art 1:201 states:

- (1) Each party must act in accordance with good faith and fair dealing.
- (2) The parties may not exclude or limit this duty.

The obligation to act according to good faith extends to negotiations as well as performance of the contract. Article 2:301 stipulates:

- (1) A party is free to negotiate and is not liable for failure to reach an agreement.
- (2) However, a party who has negotiated or broken off negotiations contrary to good faith and fair dealing is liable for the losses caused to the other party.
- (3) It is contrary to good faith and fair dealing, in particular, for a party to enter into or continue negotiations with no real intention of reaching an agreement with the other party.

The express recognition of a good faith principle within Continental Europe is reflective of jurisprudential preferences. Anglo-Antipodean common law favours specific doctrines to give effect to good faith. Jurists within civil law systems are more at home with the

¹⁶³ See art 1:101(1) Principles of European Contract Law.

¹⁶⁴ See Justice James Douglas, ‘Exploring the Recent Uncertainty Surrounding the Implied Duty of Good Faith in Australian Contract Law: The Duty to Act Reasonably – Its Existence, Ambit and Operation’ *Lexis Nexis Contract Law Master Class* (2006), at [13].

express recognition of general principles. European lawyers apparently trust their judges to know how far to go in their law making.¹⁶⁵ Civil lawyers therefore accept that the express recognition of good faith does not necessarily require a particular result. Instead, it allows the possibility of a particular result by giving the Court the discretion to decide whether or not it should be brought about.¹⁶⁶

In light of this partiality for general principles, the concept of good faith is regarded in many European legal systems as a vitally important ingredient for the modern law of contract.¹⁶⁷ A substantial body of case law relating to contractual good faith has developed in various European countries.¹⁶⁸ Unlike common law countries, the civil law jurisdictions of Europe appear to be more settled on the intended functions of a doctrine of good faith. However, the fact remains that the application of the doctrine within the civil law is not without its uncertainties.¹⁶⁹

1.4.5 Scotland:

Scots law is a mixed legal system. It has both common law and civil law origins.¹⁷⁰ Scotland is therefore apparently in a unique position in light of the contrast between the common law and civil law attitudes to contractual good faith. It might naturally be assumed that contractual good faith would be an ongoing issue within Scots law having regard to the competing jurisprudential pressures and influences emanating from England and Continental Europe.

¹⁶⁵ See Reinhard Zimmermann and Simon Whittaker, 'Coming to Terms With Good Faith' in Zimmermann and Whittaker (eds), above n 1, at 689.

¹⁶⁶ Ibid, at 687.

¹⁶⁷ Zimmermann and Whittaker, above n 54, at 13.

¹⁶⁸ See Werner Ebke and Bettina Steinhauer, 'The Doctrine of Good Faith in German Contract Law' in Beatson and Friedman (eds), above n 156, at 171.

¹⁶⁹ Ibid.

¹⁷⁰ For a discussion of the origins of Scots contract law see Hector MacQueen, 'Scots Law and the Road to the New Ius Commune' (2000) 4.4 *Electronic Journal of Comparative Law* <<http://www.ejcl.org/ejcl/44/art44-1.html>>, at 23 September 2008.

Nonetheless, contractual good faith in Scotland passed largely unnoticed until the decision in *Smith v Bank of Scotland*.¹⁷¹ The judgment of the House of Lords in *Smith* had the effect of extending the principle laid down in the English case of *Barclays Bank plc v O'Brien*.¹⁷²

The decision in *Smith* focused on duties owed by a creditor to disclose to an intending cautionary and to recommend that the prospective cautioner take independent advice. The duties arose in the context of an inter-spousal transaction where the debtor husband sought to compel his wife to provide security over their family home in order to obtain a business loan from the defendant bank. Lord Clyde suggested that a basic element of good faith underpinned the obligations of the creditor to take steps in the interest of the cautioner.¹⁷³ His Lordship thought that a principle of good faith was the better means of justifying the obligation under Scots law than the principle of constructive notice which was the basis of the English decision in *O'Brien*.¹⁷⁴ Little authority was advanced or relied upon to support these views.¹⁷⁵ Whilst the observations of his Lordship were focused on the contract of cautionry, it appears that he did not consider that the requirement was limited to that particular context.¹⁷⁶

The speech of Lord Clyde has certainly fueled debate as to whether a doctrine of contractual good faith should be recognised in Scots law. General notions of good faith have been latent and inarticulate to date.¹⁷⁷ Authority for a duty of good faith

¹⁷¹ 1997 SC(HL) 111. See generally Angelo Forte (ed), *Good Faith in Contract and Property Law* (1999), at 1.

¹⁷² [1993] 4 All ER 417. For a discussion of the *O'Brien* case see John Burrows, Jeremy Finn and Stephen Todd, *Law of Contract in New Zealand* (3rd ed, 2007), at 351-352.

¹⁷³ 1997 SC(HL) 111, at 118.

¹⁷⁴ *Ibid*, at 121. See also *Royal Bank of Scotland v Wilson* 2004 SC 153.

¹⁷⁵ Joseph Thompson, 'Good Faith in Contracting: A Sceptical View' in Forte (ed), above n 171, at 75.

¹⁷⁶ Hector MacQueen, 'Good Faith in Scots Law of Contract' in Forte (ed), above n 171, at 6.

¹⁷⁷ *Ibid*, at 13 and 33. See also Angelo Forte, 'Good Faith and Utmost Good Faith' in Forte (ed), above n 171, at 97.

performance is limited.¹⁷⁸ It is therefore apparent that the common law ideology has greatly outweighed the approach that emanates from Roman and civilian roots.¹⁷⁹ Although many Scots lawyers would accept that good faith plays an interstitial role in contract, the recognition of a general doctrine is less likely to be supported.¹⁸⁰

Some opponents have challenged the reliance by supporters of good faith on the judgment of Lord Clyde. Notably, in *Braithwaite v Bank of Scotland* Lord Hamilton considered that the obligation on the creditor arose only if it was apparent that the wife was suffering from undue influence or was the victim of misrepresentation occasioned by her husband.¹⁸¹ Accordingly, it has been argued that the concept of good faith endorsed by Lord Clyde is unlikely to extend beyond inter-spousal security transactions.¹⁸² Opponents therefore contend that the speech of Lord Clyde cannot support a general principle of good faith contracting in Scots law. The extent of the doctrine certainly remains to be tested.¹⁸³

Nonetheless, there is increasing support for recognition of a universal good faith doctrine within Scots law.¹⁸⁴ A recurring argument in support of good faith in Scots law is the need to achieve comity with other jurisdictions and harmonisation of commercial law. The case for good faith is strongly expressed by Angelo Forte:

As we move into the next millennium, perhaps the greatest challenge to be faced, whether in a devolved or independent Scotland, will be to adapt our domestic law to models of commercial contract law which are not exclusively indigenous and in which good faith will play a central role. And so we now face a simple choice of action. We can bury our heads in the sand and hope that good faith will go away,

¹⁷⁸ See generally Sandra Eden, 'Cautionary Tales – The Continued Development of *Smith v Bank of Scotland*' (2003) 7 *Edinburgh Law Review* 107, at 114.

¹⁷⁹ MacQueen, above n 176, at 13.

¹⁸⁰ Forte, above n 177, at 80.

¹⁸¹ 1999 SLT 25, at 33.

¹⁸² See Thompson, above n 175, at 75.

¹⁸³ See Eden, above n 178, at 144.

¹⁸⁴ See Forte, above n 177.

which it will not, or we can acknowledge its operation and [] make a start on a systematic analysis and statement of its application. If arguments of principle do not appeal as motivating factors, utilitarian ones must.¹⁸⁵

Contractual good faith is undoubtedly a real issue in Scots law. Arguments for unity with Continental Europe now apply throughout the United Kingdom and particularly with the advent of the European Union. It might however be reasoned that Scotland is more prone to succumb to the European influence than England due to its civil law roots.¹⁸⁶

1.5 Summary:

The concept of good faith can be traced back to Ancient Rome. It is universally recognised as a fundamental principle. Good faith has informed the development of the modern system of law now prevailing in the United Kingdom, New Zealand, Australia and Canada. However, whilst a doctrine of good faith is expressly recognised in European civil law and in the United States, contractual good faith is not an explicit and established doctrine in New Zealand. Clearly there is an increasing recognition within New Zealand and her larger Commonwealth counterparts of the arguments for and against a universal doctrine of contractual good faith. The appraisal within this thesis of a requirement for a doctrine of good faith in New Zealand contractual relationships is therefore a current and highly relevant issue.

¹⁸⁵ Ibid, at 101. See also Niall Whitty, 'From Rules to Discretion: Changes in the Fabric of Scots Private Law' (2003) 7 *Edinburgh Law Review* 281, at 324.

¹⁸⁶ It has been recognised that the mixed system of Scots law would have fewer adjustments to make than many other legal systems in respect of the attainment of a unified law of contract in Europe: Hector MacQueen, 'Remedies for Breach of Contract: The Future Development of Scots Law in its European and International Context' (1996) 1 *Edinburgh Law Review* 200, at 215.

Chapter 2

The Subject Doctrine

2.1 Chapter Introduction:

This chapter examines how an obligation of good faith could be incorporated into New Zealand law and the extent to which it might apply to the process of contractual formation and execution. Attention will also be drawn to the likely practical limitations of the proposed doctrine.

Parts 2.2 and 2.3 examine the potential mechanisms under which a universal doctrine of good faith may be introduced by the New Zealand courts into contract law. Part 2.2 considers whether good faith should become part of New Zealand contracts by way of an implied term. Part 2.3 evaluates an alternative approach, namely that the doctrine of good faith should be incorporated not necessarily as an implied term but instead as an element of construction of the contract. The distinction between the two methods and the preferable approach is appraised. Part 2.4 discusses whether, and how, the subject doctrine might extend to pre-contractual negotiations. That analysis necessarily involves a consideration of whether the doctrine would be confined to the common law of contract or whether it may also assume equitable characteristics. Similarly, in the context of pre-contractual negotiations, the relationship between good faith and agreements to negotiate and process contracts is considered. Part 2.5 addresses the issue of whether contracting parties could be able to limit or exclude the application of the subject doctrine. The potential need for the legislature to implement contractual good faith rather than the courts in order to avoid contractual exclusion is briefly explored. Part 2.6 summarises the findings, giving an overview of the subject doctrine and the arguments for and against an obligation of good faith advanced within the chapter.

2.2 An Implied Term of Good Faith?

There is a common perception, particularly amongst Australian judges and commentators, that a general doctrine of good faith would be incorporated into the law of contract by way of an implied term.¹

There are essentially two ways in which a term may be implied into a contract by the courts. These methods are ordinarily described as a term implied by way of law or a term implied by way of fact.²

2.2.1 Term Implied in Law:

A term implied in law is one which is implied as a matter of course into all contracts of a particular class.³ It is implied because it is needed to give efficacy to that specific class of contracts.⁴ The term should ensure that the rights conferred by the contract are not rendered nugatory or worthless.⁵ Traditionally, there are two fundamental requirements for the implication of a term in law. Firstly, the contract in question must be of a defined type. Secondly, the implication of the term must be necessary.⁶

¹ See *Garry Rogers Motors (Aust) Pty Ltd v Subaru (Aust) Pty Ltd* (1999) ATPR ¶41,703, at 43,014 per Finkelstein J. It has been noted that ‘the duty of good faith is often conceived of as an implied term.’: Jeannie Paterson, ‘Good Faith in Commercial Contracts? A Franchising Case Study’ (2001) 29 *Australian Business Law Review* 270, at 273. See also Marcel Gordon, ‘Discreet Digression: The Recent Evolution of the Implied Duty of Good Faith’ (2007) 19 *Bond Law Review* 26.

² Terms may also be implied by custom or by statute. See John Burrows, Jeremy Finn and Stephen Todd, *Law of Contract in New Zealand* (3rd ed, 2007), at 171.

³ *Ibid*, at 175.

⁴ See Butterworths, *Commercial Law in New Zealand*, (at 10 April 2008), at [4.4.1]. See generally *Liverpool City Council v Irwin* [1976] 2 All ER 39; *Williams v Gibbons* [1994] 1 NZLR 273.

⁵ *Byrne v Australian Airlines Ltd* (1995) CLR 410, at 450 per McHugh and Gummow JJ.

⁶ *El Awadi v BCCI* [1989] 1 All ER 242, at 253 per Hutchinson J.

Contracts of a defined type or class will encompass relationships which are of common occurrence.⁷ For example, qualifying relationships include vendor and purchaser⁸, owner and hirer⁹, master and servant¹⁰, landlord and tenant¹¹ and solicitor and client.¹²

Whether a term is deemed necessary is not a question which is solely linked to the essential functioning of the contract.¹³ The test may encompass broader considerations such as those of justice and social policy.¹⁴

Critically, a term implied in law is not dependent on the actual or presumed intention of the parties.¹⁵ Instead the question is one of status.¹⁶ It involves more general considerations than the intention to be derived from the wording of the particular contract.¹⁷

2.2.2 Term Implied in Fact:

A term implied in fact differs from a term implied in law. The Court is concerned with the particular contract rather than what is reasonable and necessary in a class of contracts.¹⁸ The task of the Court is to ascertain the presumed intention of the parties

⁷ *Shell UK Ltd v Lostock Garage Ltd* [1977] 1 All ER 481, at 487 per Lord Denning MR.

⁸ *Barrett v IBC International Ltd* [1995] 3 NZLR 170.

⁹ *Fowler v Lock* (1872) LR 7 CP 272; *Southland Harbour Board v Vella* [1974] 1 NZLR 526.

¹⁰ *Hivac Ltd v Park Royal Scientific Instruments Ltd* [1946] 1 All ER 350; *Lister v Romford Ice and Cold Storage Co Ltd* [1957] 1 All ER 125; *Matthews v Kuwait Bechtel Corp* [1959] 2 All ER 345.

¹¹ *Liverpool City Council v Irwin* [1976] 2 All ER 39.

¹² *Clark v Kirby-Smith* [1964] 2 All ER 835.

¹³ See Andrew Grubb and Michael Furmston (eds), *The Law of Contract* (1999), at 465.

¹⁴ *The Star Texas* [1993] 2 Lloyd's Rep 445, at 526 per Slade LJ. See also Elizabeth Peden, 'Policy Concerns in Terms Implied in Law' (2000) 117 *Law Quarterly Review* 459.

¹⁵ *Shell UK Ltd v Lostock Garage Ltd* [1977] 1 All ER 481, at 487 per Lord Denning MR.

¹⁶ *Lister v Romford Ice and Cold Storage Co Ltd* [1957] AC 555, at 576 per Simonds VC.

¹⁷ *Luxor (Eastbourne) Ltd v Cooper* [1941] 1 All ER 33, at 52 per Lord Wright.

¹⁸ *Shell UK Ltd v Lostock Garage Ltd* [1977] 1 All ER 481, at 488 per Lord Denning MR.

from the words of the agreement and the surrounding circumstances.¹⁹ In *BP Refinery (Westernport) Pty Ltd v Shire of Hastings* the Privy Council said that a term will be implied in fact if the following conditions (which may overlap) are 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 that “it goes without saying”; (4) it must be capable of clear expression; (5) it must not contradict any express term of the contract.²⁰

It was previously thought that a term implied in fact should satisfy all of the criteria set out in *BP Refinery*.²¹ Ultimately however, the criteria set down are only guidelines. They are not classifications of art.²² In *Vickery v Waitaki International Ltd* Cooke P opined that implied terms are ‘categories or shades in a continuous spectrum’ and that ‘it may be doubted whether tabulated legalism will ever produce an exhaustive or rigidly discrete classification.’²³

More recent authority suggests that a term may be implied in fact simply where it is needed to give business efficacy to the contract or where the term to be implied represents the obvious, but unexpressed, intention of the parties.²⁴ Notwithstanding, the *BP Refinery* test has been followed on so many occasions within New Zealand that it is

¹⁹ *Ali v Christian Salvesen Food Services Ltd* [1997] 1 All ER 721, at 726 per Waite LJ.

²⁰ (1977) 16 ALR 363, at 376 per Lord Simon. The dictum has been treated as defining law in New Zealand: *Devonport Borough Council v Robbins* [1979] 1 NZLR 1; *Prudential Assurance Co Ltd v Rodrigues* [1982] 2 NZLR 54; *Aotearoa International Ltd v Scancarriers A/S* [1985] 1 NZLR 513. For tests for implication in fact see also *The Moorcock* [1886-90] All ER Rep 530; *Brodie v Cardiff Corporation* [1919] AC 337; *Hughes v Greenwich Borough Council* [1993] 4 All ER 577.

²¹ See John Burrows, Jeremy Finn and Stephen Todd, *Law of Contract in New Zealand* (2nd ed, 2002), at 193.

²² Donald Westlake Greig and J L R Davis, *The Law of Contract* (1987), at 517.

²³ [1992] 2 NZLR 58, at 64.

²⁴ *McNeill v Gould* (2002) 4 NZ ConvC 557, at [25]-[27] per Hammond J. See also *Stuart v Armourguard Security Ltd* [1996] 1 NZLR 484; *Hunan Holdings Ltd v Virionyx Corporation Ltd* (High Court, Auckland, CIV 2005-404-1480, 13 December 2005, Winkelmann J).

likely to continue to be employed where the agreement in question is a detailed written contract.²⁵

2.2.3 Good Faith Implied in Law or Good Faith Implied in Fact?

If a doctrine of good faith were to be incorporated into contract law by utilising implied terms, it is debatable whether this should be achieved by way of a term implied in law or, alternatively, a term implied in fact.

Prima facie, the obligation of good faith would appear to be more suited to a term implied in law if it is a term to be implied into all contracts.²⁶ The rationale justifying this assertion is that a term implied in fact can never be a matter of universal application. The doctrine would rarely be invoked unless the obligation of good faith was implied in law.

Notwithstanding, it has been suggested that the implication of good faith is more analogous to the implication of a term in fact because the conduct required of the parties under a duty of good faith is likely to differ depending on the circumstances of the case.²⁷ The implication in law methodology would not be as sensitive to the particular circumstances of the contracting individuals or the wording utilised within the contract itself because it is not dependent on the intention of the parties.²⁸ In the result, the individual mechanisms within the contract could not be assessed to determine whether an obligation of good faith would be appropriate for the particular contract at hand. The duty of good faith would be unconfined. Without regard to the circumstances of the parties or the wording of the contract, there would be little context in which to determine the

²⁵ Burrows, Finn and Todd, above n 2, at 184. For cases favourably citing *BP Refinery* see *Bilgola Enterprises Ltd v Dymocks Franchise Systems (NSW) Ltd* [2000] 3 NZLR 169; *CBD Motors Ltd v Concrete Properties Ltd* (2004) 5 NZCPR 22; *Calvery v PriceWaterhouseCoopers* (2004) 21 NZTC 18,792. Where there is no formal contract the test will be based on whether the term is necessary for the reasonable or effective operation of the agreement: *Byrne v Australian Airlines Ltd* (1995) 185 CLR 411.

²⁶ See Paterson, above n 1, at 273.

²⁷ Ibid.

²⁸ See Gordon, above n 1, at 31.

content of the obligation.²⁹ A doctrine of good faith incorporated into contract law by way of a term implied in fact would allow judges to examine the factual matrix and determine the appropriate conduct required to discharge the good faith obligation as the particular case requires.³⁰ Good faith would take shape from the circumstances and contractual terms in question instead of deriving some abstract and vague principle.

However, there are limits to the merits of this argument. Whilst terms implied into contracts of a particular class may be relatively generic, the conduct required of the parties in relation to the implied term may be highly dependent on the particular context. So, for example, the conduct required to discharge an implied term of reasonable care and skill on the job in a contract of employment³¹ or in a contract of architectural supervision³² will inevitably depend on the particular circumstances of the case. The contractual obligations arising from a term implied in law are not therefore divorced from the facts of the case. A term of good faith implied in law could still require different conduct in different circumstances.

Nonetheless, it is clear that either implied term category presents certain benefits and flaws in relation to the other. However, it is submitted that incorporating a doctrine of good faith into New Zealand law either by way of a term implied in law or a term implied in fact presents serious impediments. Those difficulties may inhibit the ability of the courts to utilise the implied term methodology as the vehicle for the potential introduction of a doctrine of contractual good faith. These observations are explored below.

²⁹ Ibid.

³⁰ Ibid, at 31 and 32.

³¹ *Harmer v Cornelius* [1843-1860] All ER Rep 624.

³² *Bagot v Stevens Scanlan & Co* [1964] 3 All ER 577.

2.2.4 Problems Applicable to Both Implied Term Methodologies:

Some proponents of good faith assert that the ability to contract out of a doctrine of good faith should be limited or precluded. This objective could not be achieved within the bounds of the existing law relating to implied terms. It is a logical and well-established rule that parties are ordinarily free to exclude terms which would otherwise be implied by law by using express words within their contract.³³ Similarly, a term will not be implied in fact if it is inconsistent with the express terms of the contract, let alone if the parties have expressly excluded it. The *BP Refinery* criterion would not be satisfied.

The extent to which contracting parties should be free to contract out of or limit an obligation of good faith is contentious. The issue is discussed in more detail later in this chapter. However, if there is to be any fetter on that right under a general doctrine then there would exist a clear inconsistency with the right to contract out of an implied term if the subject doctrine were to be incorporated into New Zealand law using that methodology.

Another significant concern is that the doctrine of good faith would be considerably limited in scope if it were only to be treated as an implied term of the contract. Conceivably the obligation of good faith under the doctrine might extend to pre-contractual negotiations. Again this issue is extensively considered further below. Suffice to say, a term implied *ex-post* may not be capable of extending to dealings between the parties prior to contracting.

2.2.5 Problems Applicable to the Term Implied in Fact Methodology:

It was noted above that the primary problem with the term implied in fact methodology is that an obligation of good faith would not be of universal application. An introduction of the doctrine by way of a term implied in fact would not satisfy the *BP Refinery* criterion in the majority of cases. It will be open to one of the contracting parties to argue that

³³ See Burrows, Finn and Todd, above n 2, at 176.

good faith is not necessary to give business efficacy to the contract and that the agreement could be effective without the term.

It is evident under the current law that the courts take the position that the majority of contracts can operate without the need for an obligation of good faith. In *Saxby Bridge Mortgages Pty Ltd v Saxby Bridge Pty Ltd* Simos J declined to imply a term of good faith into a contract to incorporate a new company because the alleged term was neither necessary nor obvious.³⁴ Likewise in *Chan v Lun NG Associate* Judge Doogue rejected the implication in fact of a term of good faith into an agreement for the sale and purchase of land.³⁵ The contract was transactional rather than relational. As such there was no basis on which it might be thought necessary to imply an obligation to carry out the exchange in good faith. According to the Associate Judge, the posited duty would be unlikely to meet any of the hurdles in *BP Refinery* except, perhaps, the fifth.

Additionally it may be reasoned that a term of good faith is not capable of clear expression. This is a necessity under the fourth *BP Refinery* criterion. In *Dovey v Bank of New Zealand* Tipping J suggested that the term must not only be capable of clear expression but also uncontroversial expression in order to satisfy the test.³⁶ Few would contend that the meaning of good faith is uncontroversial. In *Hungry Jack's Pty Ltd v Burger King Corp*³⁷ Rolfe J was asked to imply a term of reasonableness into the contract. It was observed that meaning and content could only be given to a concept of reasonableness by judicial assessment. That would not necessarily match what the contracting parties would consider to be reasonable. Accordingly, his Honour contended that reasonableness may not be capable of clear expression in the context of implied terms.³⁸ If the courts are unwilling to deem reasonableness as capable of clear expression

³⁴ [2000] NSWSC 433, at [62]-[64].

³⁵ (High Court, Auckland, CIV 2007-404-6226, 28 March 2008), at [34], [37] and [41]. See also *Walton Mountain Ltd v Apple New Zealand Ltd* (2004) 5 NZCPR 241.

³⁶ [2000] 3 NZLR 641, at 654.

³⁷ [1999] NSWSC 1029.

³⁸ *Ibid*, at [432].

then it is likely that good faith, which is less familiar to the common law, will receive similar treatment.

It is therefore submitted that to incorporate a doctrine of good faith by way of a term implied in fact would be to disregard the prevailing legal rules of implication. The implication in fact of a general obligation of good faith would be inconsistent with the existing law of contract.³⁹

2.2.6 Problems Applicable to the Term Implied in Law Methodology:

The current law relating to implied terms dictates that the implication of a term in law depends on the nature of the particular contract in question. This does not accord with the desire for a general good faith doctrine to apply to all contracts, irrespective of the category or characteristics of the particular contract. It has been correctly recognised that:

[T]erms implied by law are, supposedly at least, limited to implied obligations that inhere in a class of contracts. This would preclude an implication of universal application.⁴⁰

Some commentators and judges, particularly in Australia, have suggested that a term could potentially be implied into every contract. Supposedly the law aspires to formulate terms which may be implied into all contracts in addition to implying terms into particular classes of contracts.⁴¹ Indeed, one notable Australian contract text devotes an entire subsection under implied terms to ‘universal terms.’⁴² Popular candidates for a universally implied term in law are the duty to cooperate and the duty of good faith.⁴³

³⁹ See generally Elizabeth Peden, ‘Incorporating Terms of Good Faith in Contract Law in Australia’ (2001) 23 *Sydney Law Review* 222.

⁴⁰ Justice Paul Finn, ‘Good Faith and Fair Dealing: Australia’ (2005) 11 *New Zealand Business Law Quarterly* 378, at 383.

⁴¹ See Michael Bryan and M P Ellinghaus, ‘Fault Lines in the Law of Obligations: *Roxborough v Rothmans of Paul Mall Australia Ltd*’ (2000) 22 *Sydney Law Review* 636, at 651.

⁴² Nicholas C Seddon and M P Ellinghaus, *Law of Contract* (9th ed, 2008), at 442-460.

⁴³ See Bryan and Ellinghaus, above n 41, at 651.

However, within New Zealand and England the obligation to cooperate is not universal. It will only be implied where necessary to make the contract workable.⁴⁴ There is no current authority within New Zealand suggesting that an implied term can apply to all contracts. The contention that a term may be generally implied in every contract does not therefore reflect the law in New Zealand.

Further, in Australia there is not widespread acceptance of the notion of a universally implied term. In *Vodafone Pacific Ltd v Mobile Innovations Ltd* Giles JA rejected the contention that commercial contracts were a class of contracts capable of justifying a term of good faith implied in law.⁴⁵ Seemingly the breadth and indeterminacy of that class would militate against the courts taking such a drastic step.

Peden is perhaps the most prominent opponent of the introduction of a universal good faith doctrine through implied terms. She concludes:

No terms are implied into all contracts. If the courts want the notion of good faith to apply in all situations, what they should be looking to do is use good faith as a principle or tool of construction. That is, to construe all contracts on the basis that there is an expectancy of good faith in all terms...Unlike terms implied in fact or law, which apply specifically to a contract or class of contracts, rules of construction apply generally to all contracts.⁴⁶

These observations are consistent with the views of proponents of the good faith doctrine who advocate that it should serve a wider purpose than simply being treated as an implied term of the contract. For example, good faith might be used as a conceptual basis for the construction and interpretation of the contract.⁴⁷ It is therefore appropriate to examine what has been labeled the ‘constructivist’ approach.⁴⁸

⁴⁴ *Equipment Co v Rhodesia Railways Ltd* [1949] 2 All ER 1014, at 1018 per Devlin J. See generally *Devonport Borough Council v Robbins* [1979] 1 NZLR 1. See also John Burrows, ‘Contractual Co-Operation and the Implied Term’ (1968) 31 *Modern Law Review* 390.

⁴⁵ [2004] NSWCA 15, at [191].

⁴⁶ Peden, above n 39, at 230.

⁴⁷ Justice Edward Thomas, ‘Good Faith in Contract: A Non-Sceptical Commentary’ (2005) 11 *New Zealand Business Law Quarterly* 391, at 394.

2.3 Good Faith as a Rule of Construction?

It has been suggested that an obligation of contractual good faith cannot be introduced by the common law courts unless it is implemented through an implied term. In *GEC Marconi Systems Pty Ltd v BHP Information Technology Pty Ltd* Finn J opined:

There is not yet agreement in this country as to the province of good faith in contract law...Part of our difficulty arises from the fact that, express or implied term apart, we have no other available common law device for imposing obligations on parties that are contractual in character. We do not have the facility, for example, to treat the duty as simply a mandatory rule of contract law as do many European legal systems.⁴⁹

It is submitted that this rationale is too limited. It is arguable that the courts do have the ability to incorporate a universal doctrine of good faith into contract law without necessarily having to resort to the restrictive implied terms approach. It is within the bounds of conventional judicial methodology to articulate the concept of good faith as a general principle of law applicable to all contracts.⁵⁰

One of the means of departing from the implied term methodology and achieving a general principle of law would be to adopt a doctrine of good faith as a rule of construction. All contracts could be construed to require good faith under the constructivist approach.⁵¹

There are already a number of well-known rules of construction within contract law. For example, words will generally be given their natural and ordinary meaning⁵², the contract

⁴⁸ See Paula Baron, 'Resistance: A Consideration of the Opposition to a Duty of Good Faith in Australian Commercial Contracts' (2005) 11 *New Zealand Business Law Quarterly* 408, at 424.

⁴⁹ (Federal Court of Australia, NG 733 of 1997, 12 February 2003), at [920].

⁵⁰ See Thomas, above n 47, at 395.

⁵¹ See generally Peden, above n 39, at 224.

⁵² *Investors Compensation Scheme Ltd v West Bromwich Building Society* [1998] 1 All ER 98, at 115 per Lord Hoffmann; *Benjamin Developments Ltd v Robt Jones (Pacific) Ltd* [1994] 3 NZLR 189. Cf *Yoshimoto v Canterbury Golf International Ltd* [2001] 1 NZLR 523; *Mount Joy Farms Ltd v Kiwi South Island Co-*

will be construed as a whole⁵³, the Court will avoid an unreasonable construction that flouts business common sense⁵⁴ and the Court will look to the matrix of fact to achieve an appropriate construction.⁵⁵ Further, rules of construction are not necessarily limited to the interpretation of the words of the contractual document. Such principles can be used to determine the intention of the parties, complete and save contracts, contextualise contracts and apply contracts to particular factual situations.⁵⁶

There does not appear to be any compelling reason why a doctrine of good faith could not be treated as a principle of construction. It is not against permitted judicial reasoning to introduce a rule of law as a matter of construction. For example, the doctrine of frustration was once thought to be based on an implied term but is now viewed as an instance of construction.⁵⁷ In *Davis Contractors Ltd v Fareham Urban District Council* Lord Reid suggested that frustration depends on a true construction of the contract rather than adding any implied term.⁵⁸ The Court should examine the wording of the terms, the nature of the contract and the relevant surrounding circumstances when the contract was made to determine whether it is frustrated.

Accordingly, frustration has evolved from implication to become an integral and independent rule of the common law.⁵⁹ Conceivably good faith could undergo the same development. Indeed, there are other examples to support the introduction of good faith

operative Dairies Ltd (Court of Appeal, CA 297/00, 6 December 2001); *Mannai Investment Co Ltd v Eagle Star Life Assurance Co Ltd* [1997] 3 All ER 352.

⁵³ *SGS (NZ) Ltd v Quirke Export Ltd* [1988] 1 NZLR 52, at 58 per Somers J.

⁵⁴ *The Antaios* [1984] 3 All ER 229, at 233 per Lord Diplock; *The Fina Samco* [1995] 2 Lloyd's Rep 344, at 350 per Neill LJ.

⁵⁵ *Prenn v Simmonds* [1971] 3 All ER 237; *L Schuler AG v Wickman Machine Tool Sales Ltd* [1974] AC 235; *Boat Park Ltd v Hutchinson* [1999] 2 NZLR 74; *Pyne Gould Guinness Ltd v Montgomery Watson (NZ) Ltd* [2001] NZAR 789.

⁵⁶ See Elizabeth Peden, *Good Faith in the Performance of Contracts* (2003), at 24.

⁵⁷ Thomas, above n 47, at 395.

⁵⁸ [1956] 2 All ER 145, at 153.

⁵⁹ See Gordon, above n 1, at 40.

as a general principle of contract law. The requirement for a reasonable time for performance and the doctrine of repudiation have been cited as illustrations.⁶⁰

Under the constructivist approach it is envisaged that good faith would become a term of the contract in the event that it were to be used to create a positive obligation requiring affirmative action.⁶¹ The constructivist approach could therefore potentially subsume the implied term methodology.

In *Vodafone* Giles JA criticised this reasoning. His Honour suggested that a process of construction is only capable of placing a gloss on an express term. It cannot be used to create a free-standing obligation which exists independently of the existing contractual terms.⁶²

With respect, these concerns are overstated. The implication of a term in fact is itself a process of construction.⁶³ Accordingly, if a contract was construed under the doctrine of good faith to require a stand-alone term of good faith there should be no reason why such a term could not be incorporated into the contract as a natural incidence of that construction. The rationale is logically stated by Peden:

Construction, in the interpretation sense, most simply provides the meaning of words. If taken even further, construction can be used to imply terms. This is ‘implication by construction’, and it is suggested that all these processes are informed by the general principle of good faith...[T]he principle of good faith can be applied in construction that results in implying a new term. There is no need to imply in fact or in law a term that the parties should cooperate or act in good faith.⁶⁴

⁶⁰ See Thomas, above n 47, at 395.

⁶¹ Peden, above n 39, at 232.

⁶² [2004] NSWCA 15, at [206].

⁶³ *Codelfa Construction Pty Ltd v State Rail Authority of New South Wales (Action Nos 71 and 72 of 1981)* (1982) 41 ALR 367, at 376 per Mason J.

⁶⁴ Peden, above n 56, at 113-114. Peden goes on to suggest (at 140) that ‘the only situation when “good faith” needs to be implied as an actual term is when it is going to be used as a positive obligation requiring

It is therefore submitted that the constructivist approach could be utilised to create a free-standing obligation of good faith if the circumstances so require. Clearly however this would not render good faith a matter of universal application in all contracts. Some contracts would not necessitate a separate term of good faith.

Universality would be achieved under the constructivist approach by interpreting the express terms of all contracts with reference to good faith.⁶⁵ For example, contractual powers could be construed to require their exercise in good faith. That outcome would serve as a restriction on the destruction of positive obligations under the contract.⁶⁶ Consistent with the notion that good faith is most often encountered in the field of contractual performance⁶⁷, a construction based on good faith would endeavour to align contractual performance with the mutual intention of the parties. In essence, the doctrine of good faith would apply to matters of contractual substance, procedure and process.

An obvious benefit of the constructivist approach is that it could permit the incorporation of good faith into a contract either by way of a free-standing obligation or as a method of construing express terms. The former would be case dependent and the latter would be of universal application. The manner in which good faith is incorporated into a contract might therefore be more sensitive to the content and nature of the obligation required in the particular circumstances of the case.

The constructivist approach is susceptible to similar criticisms of the implied term methodology. For example, it may be possible to avoid the application of a rule of

some positive action, independent of any terms...' In all other cases 'contractual rights would be construed to require them to be exercised in good faith.'

⁶⁵ This is the methodology under which the doctrine of good faith predominantly operates in the United States. It has been observed that 'courts generally utilize the good faith duty as an interpretive tool to determine "the parties' justifiable expectations...": *Duquesne Light Co v Westinghouse Electric Co*, 66 F3d 604, at 617 per Judge Greenberg (1995, US App).

⁶⁶ Peden, above n 39, at 232.

⁶⁷ See Michael Bridge, 'Doubting Good Faith' (2005) 11 *New Zealand Business Law Quarterly* 426, at 434.

construction by express agreement just as an implied term can be contractually excluded. Likewise, a rule of construction is unlikely to have any influence on pre-contractual conduct.

Another problem with the constructivist approach is that it may only be of meaningful application to written contracts. It might be of little effect in contracts which are wholly oral or partly oral and partly written. The implied term methodology may be preferred in these circumstances.⁶⁸

The distinction between incorporating a good faith doctrine in New Zealand as a process of construction rather than incorporation by way of an implied term is also somewhat elusive.⁶⁹ Some suggest that favouring a technique of construction over the implied term methodology is simply a re-branding exercise. It only perpetuates a false dichotomy.⁷⁰ Certainly the subject doctrine may have limited or no practical effect on contracts in which an obligation of good faith is already implied under the current law. The constructivist approach would not have any benefit over the implied term methodology in this scenario.

One of the primary criticisms of the constructivist approach is that it requires an unrealistic derivation of the intention of the parties. In *Vodafone* Giles JA suggested that implication is a preferable use of language to construction because implication denotes that an obligation of good faith is being imposed by the law.⁷¹ Unlike the constructivist approach, the term implied in law methodology does not proceed on a fiction that the intention of the parties is being found by a process of construction. Indeed, in most cases a manifest intention of good faith is not likely to be evident. Thus, if the good faith

⁶⁸ There is no reason why an obligation of good faith could not be implied into an oral agreement. Terms have sought to be implied in wholly oral agreements. See for example *Condon v Parkinson* (High Court, Christchurch, CIV 2007-409-832, 22 September 2008, French J), at [51] and [52].

⁶⁹ See Sir Anthony Mason in the foreword to Peden, above n 56, at 3.

⁷⁰ See Gordon, above n 1, at 39.

⁷¹ [2004] NSWCA 15, at [206].

doctrine is to be of general application, the courts would be obliged to construe a contract to require an obligation of good faith where the contract does not overtly reveal such an intention. For example, commercial parties may, in practice, intend that an express right is to be exercised according to the unrestrained volition of one or other of the parties.⁷² The implication approach may therefore be preferable to the constructivist approach because it indicates that it is the common law which considers the good faith obligation necessary rather than the contracting parties.⁷³

These criticisms, although valid, may be overestimated. It is true that the objective in construing any contract is to ascertain the mutual intentions of the parties at the time of contracting.⁷⁴ However, there is no reason why the law cannot, as a rule of construction, determine that the parties intend to perform their contract in good faith in the absence of evidence to the contrary. Admittedly this approach might alter the existing understanding of the function of contractual construction. Notwithstanding, it is generally accepted that a substantial part of contract law derives from *ex lege* principles which contracting parties may only deviate from if they can show a different contractual intention.⁷⁵ The challenge to the autonomy of the parties is minimised so long as the good faith rule of construction is based on a default position.⁷⁶

On balance it is submitted that a universal doctrine of contractual good faith would be better implemented through a rule of construction rather than by way of an implied term if it is to be incorporated within New Zealand law. The subject doctrine of good faith does not fit neatly into either methodology. However, the constructivist approach accords

⁷² See Geoffrey Kuehne, 'Implied Obligations of Good Faith and Reasonableness in the Performance of Contracts: Old Wine in New Bottles?' (2006) 33 *University of Western Australia Law Review* 63, at 96.

⁷³ Ibid.

⁷⁴ *River Wear Commissioners v Adamson* (1877) 2 App Cas 743; *The Nema* [1981] 2 All ER 1030, at 1035 per Lord Diplock.

⁷⁵ See generally Jack Beatson and Daniel Friedman, 'From Classical to Modern Contract Law' in Jack Beatson and Daniel Friedman (eds), *Good Faith and Fault in Contract Law* (1995), at 16.

⁷⁶ Roger Brownsword, 'Positive, Negative, Neutral: the Reception of Good Faith in English Contract Law' in Roger Brownsword, Norma Hird and Geraint Howells (eds), *Good Faith in Contract* (1999), at 37.

better with the notion of a rule of universal application. Critically, the existing law relating to the implication of terms would remain unaffected. It was recognised above that the prevailing law within New Zealand relating to implication would be contradicted if good faith were to be introduced as a universally implied term. That contradiction would inevitably have significant consequences. It would facilitate the implication of terms in contracts more aggressively than the traditional doctrines on implied terms currently permit.⁷⁷ The existing law relating to implied terms may lose impetus. Terms may be implied in an ad hoc and unprincipled fashion. Further, the instances in which implied terms are pleaded in undeserving cases is liable to increase if litigants perceive the courts as being prepared to relax the rules relating to implication.

It is conceded that the constructivist approach has certain drawbacks. However, these are not insurmountable and certainly are not as fundamental as those relating to implied terms. Ultimately, the method of incorporation of good faith may not result in significant practical consequences for litigants pleading a breach of the obligation. Notwithstanding, if good faith is to become a universal doctrine, its manner of incorporation into New Zealand contract law should be clearly articulated as a matter of principle.

Whilst the constructivist approach is supported as the proper rationale under which a doctrine of good faith could be introduced into contract law, it may not necessarily address the rights of the parties engaged in pre-contractual negotiations and particularly where no contract comes into existence. The application of the good faith doctrine to pre-contractual negotiations requires further consideration.

⁷⁷ John McCamus, 'Abuse of Discretion, Failure to Cooperate and Evasion of Duty: Unpacking the Common Law Duty of Good Faith Contractual Performance' (2004) 88 *The Advocates' Quarterly* 72, at 101.

2.4 Pre-Contractual Negotiations:

2.4.1 Where no Contract is Formed:

In advancing the case for a universal doctrine of good faith in New Zealand law, Thomas suggests that good faith requires that a party to contractual negotiations is genuinely seeking a contract.⁷⁸ A negotiating party may not therefore withdraw from the bargaining for reasons which are capricious or arbitrary. However, this reasoning overlooks how a principle of good faith would aid the victim of such conduct in the event that no contract comes into existence. The doctrine could only apply subsequent to contractual formation if it were to be introduced as a principle of construction. Clearly a wronged party in terminated negotiations would have no cause of action in contract on which to found a claim for a breach of good faith.

A broad principle of good faith conduct tends to blur the distinction between contractual and non-contractual obligations.⁷⁹ The idea that a doctrine of good faith would encompass a pre-contractual duty to bargain in good faith whose breach may, at a minimum, justify an award of reliance damages, seemingly compromises the dividing line between contractual and non-contractual obligations previously thought to be axiomatic in New Zealand jurisprudence.⁸⁰

Therefore, a critical issue for consideration is whether the subject doctrine can appropriately extend to regulate pre-contractual negotiations. Traditional reasoning would suggest that a distinction must be made between where there is an enforceable agreement and where there is no enforceable agreement. In the latter situation instances of bad faith conduct may give rise to remedies in tort, equity and statute, but not in

⁷⁸ Thomas, above n 47, at 393.

⁷⁹ See Friedrich Juenger, 'Listening to Law Professors Talk About Good Faith: Some Afterthoughts' (1995) 69 *Tulane Law Review* 1253, at 1254.

⁸⁰ Similar comments have been made in respect of other common law jurisdictions: *Ibid*.

contract. The liability arises from an extra-contractual obligation.⁸¹ Indeed, if a plaintiff complains that he or she believed that a contract would ensue and relied on that belief to his or her detriment, the claim is, in reality, one relating solely to detrimental reliance rather than expectation loss. The action would fall more naturally within a tortious action for deceit rather than any cause of action associated with contract. The equitable doctrine of promissory estoppel may also provide a measure of protection in relation to pre-contractual promises and representations. The doctrine in New Zealand is not limited to dealings between parties who have prior contractual rights *inter se*.⁸² Conceivably s 9 of the Fair Trading Act 1986 (“FTA”) might also be relied upon by a victim of misleading and deceptive conduct in pre-contractual bargaining where the defendant is engaged in trade. The most obvious way for New Zealand lawyers to frame pleadings which seek to impose liability for bad faith discontinuation of negotiations may be to allege misleading and deceptive behaviour under s 9 of the FTA.⁸³

The fact that a good faith doctrine may not extend to regulate pre-contractual conduct may not be a satisfactory outcome for proponents of good faith. It appears that the law of tort is unlikely to serve as an adequate substitute for good faith in the negotiation of contracts. A somewhat restrictive approach has been adopted in tort jurisprudence in

⁸¹ William Tetley, ‘Good Faith in Contract: Particularly in the Contracts of Arbitration and Chartering’ (2004) 35 *Journal of Maritime Law and Commerce* 561, at 565. See also Nadia E Nedzel, ‘A Comparative Study of Good Faith, Fair Dealing, and Precontractual Liability’ (1997) 12 *Tulane European and Civil Law Forum* 97, at 155.

⁸² *Burberry Mortgage Finance and Savings Ltd v Hindsbank Holdings Ltd* [1989] 1 NZLR 356, at 359 per Cooke P. See also *Waltons Stores (Interstate) Ltd v Maher* (1988) 76 ALR 513.

⁸³ A similar situation is encountered by Australian lawyers. See generally John Carter and Michael Furmston, ‘Good Faith and Fairness in the Negotiation of Contracts: Part II’ (1995) 8 *Journal of Contract Law* 93, at 99. The damages that might be awardable for a bad faith discontinuation of negotiations under the Fair Trading Act 1986 may be limited. Conceivably damages might be claimed for wasted expenditure falling under the head of reliance loss. It is however contentious whether damages for loss of a chance to enter into a substantive contract could be sought as this may fall within the head of expectation loss which, it is generally accepted, cannot be claimed under the Fair Trading Act 1986. See *Cox & Coxon Ltd v Leipst* [1999] 2 NZLR 15. See below for a further discussion of the distinction between reliance and expectation loss in the context of pre-contractual negotiations.

relation to claims for pure economic loss.⁸⁴ There is also a general reluctance to extend the duty of care principle in pre-contractual dealings because of the potential to subvert the law of offer and acceptance under classical contract law theory.⁸⁵ In applying tort law, the courts will be cautious not to override the freedom not to contract. Indeed, there appears to be a general reluctance for the principles of tort law to interfere with the well-established rules of contract. Ordinarily there is no duty of care between business parties negotiating at arms length.⁸⁶

This rationale was confirmed by the Supreme Court of Canada in *Martel Building Ltd v Canada*.⁸⁷ The plaintiff was led to believe that the defendant would renew a lease at a specific rental but the defendant ultimately awarded the lease to a competitor. The plaintiff sued alleging, inter alia, breach of a duty of care in negotiations. The Supreme Court of Canada held that policy reasons militated against such a duty of care. The Court recognised that the very purpose of contractual negotiations is to ensure the most advantageous bargain. This is often at the expense of the other negotiating party. To impose a duty would hobble the marketplace and dissipate commercial advantage derived from privately acquired information. The retention of self-vigilance was said to be a necessary ingredient of commerce. The Court also considered that there are sufficient other causes of action in the pre-contractual forum without the need for a duty of care. To impose the duty would lead to wasted litigation.⁸⁸

⁸⁴ See Paula Giliker, 'A Role for Tort in Pre-Contractual Negotiations? An Examination of English, French and Canadian Law' (2003) 52 *International Comparative Law Quarterly* 969.

⁸⁵ See Stephen Todd (ed), *The Law of Torts in New Zealand* (4th ed, 2005), at 185.

⁸⁶ B S Markesinis and Simon F Deakin, *Tort Law* (4th ed, 1999), at 93; John Cartwright, *Misrepresentation, Mistake and Non-Disclosure* (2007), at 569.

⁸⁷ [2000] 2 SCR 860. See also *Banque Financière de la Cité SA v Westgate Insurance Co Ltd* [1989] 2 All ER 952; *Ontario Ltd v Cornell Engineering Co* (2001) 198 DLR (4th) 615; *Gross v Great-West Life Assurance Co* [2002] ABCA 37; *Prime Commercial Ltd v Wool Board Disestablishment Company Ltd* (Court of Appeal, CA 110/05, 18 October 2006), at [39] per William Young P.

⁸⁸ *Ibid*, at [62]-[71] per Iacobucci and Major JJ. See also Todd (ed), above n 85, at 185.

Accordingly, it cannot be said that a party to negotiations assumes responsibility for the other. It is not usually reasonable for one party engaged in bargaining to depend on the other. Each negotiating party must rely on his or her own judgment or a third party opinion. Tort lawyers generally take the view that parties to pre-contractual negotiations will primarily worry about their own interests rather than those of the counterparty.

Notably however, the Court in *Martel* recognised that its reasons were restricted to whether a tortious duty of care should be extended to contractual negotiations. The notion of a duty of good faith in negotiations was a matter that was expressly left open.⁸⁹

Like tort law, it is also evident that the doctrine of estoppel and the FTA may not necessarily coincide with a doctrine of contractual good faith. For example, those remedies may not give rise to positive obligations to disclose certain matters in pre-contractual negotiations which an obligation of good faith may be understood to require.⁹⁰ Further, the existing equitable and statutory remedies do not necessarily prevent a party from withdrawing from negotiations without regard to the interests of the other negotiating party. Therefore, whilst the application of the doctrine of promissory estoppel may be tantamount to a judicial declaration that negotiating parties must not bargain in bad faith, there is no evidence to substantiate the development or existence of a

⁸⁹ Ibid, at [73] per Iacobucci and Major JJ.

⁹⁰ The respective relationships between a doctrine of good faith, estoppel and the Fair Trading Act 1986 are discussed in Chapter 4 below. In relation to non-disclosure in pre-contractual negotiations, it is possible that the test for misleading and deceptive behaviour under the Fair Trading Act 1986 may be developed to include bare non-disclosure. In this respect, the Fair Trading Act 1986 may, to some extent, be perceived as an alternative to a good faith obligation of disclosure. For the prevailing test in New Zealand as to non-disclosure under the Fair Trading Act 1986 see *Unilever NZ Ltd v Cerebos Greggs Ltd* (1994) 6 TCLR 187 where the Court of Appeal suggested (at 192 per Gault J) that silence must affirmatively convey a false meaning. But see *Hieber v Barfoot & Thompson Ltd* (1996) 5 NZBLC 104,179. As to good faith and obligations of disclosure, see generally Nicola Palmieri, 'Good Faith Disclosures Required During Precontractual Negotiations' (1993) 24 *Seaton Hall Law Review* 70, at 179; Muriel Fabre-Magnan, 'Duties of Disclosure and French Contract Law: Contribution to an Economic Analysis' in Beatson and Friedman (eds), above n 75; S M Waddams, 'Pre-Contractual Duties of Disclosure' in Peter Cane and Jane Stapleton (eds), *Essays for Patrick Atiyah* (1991).

duty to negotiate in good faith under the current law.⁹¹ It may be wrong to rationalise the existing equitable doctrines and statutory provisions as necessarily requiring good faith behaviour in contractual negotiations.

The existing law within New Zealand can be contrasted with the civil law codifications in Europe. The latter clearly provide a remedy for an aggrieved party where negotiations are unjustifiably terminated.⁹² The obligation of good faith would be diluted to some extent if a good faith doctrine were introduced in New Zealand that did not accommodate a similar right. As a result, proponents of good faith are liable to suggest that the envisaged doctrine should extend to pre-contractual negotiations even where no contract is formed. This is the inference that can be drawn from the views of Thomas. Conceivably it would be necessary for the doctrine to assume equitable characteristics in addition to a foundation in the common law of contract if the ambit of the doctrine were to extend that far. The jurisprudential implications of this potential outcome require scrutiny.

The relationship between equity and the common law is a contentious issue. Under the Supreme Court Act 1860, the New Zealand Supreme Court had, since its inception, the jurisdiction to recognise actions at law and suits in equity. Legal and equitable remedies could also be granted in the same set of proceedings.⁹³ However, it was unclear, as it was in England under the Judicature Act 1873, whether there had simply been a merger of the administration of equity and the common law or whether there had been a fusion of the substantive principles, rules and doctrines of equity and the common law.⁹⁴ The latter phenomenon might support a doctrine of good faith which comprises both legal and equitable elements.

⁹¹ See Jane Edwards, 'Negotiating Parties and Equitable Estoppel: Is There a Duty of Good Faith?' (1999) 27 *Australian Business Law Review* 300, at 300 and 318.

⁹² See for example art 2:301(2) Principles of European Contract Law. It has been observed that 'English law knows no general obligation of good faith in pre-contractual negotiations. In this respect it differs from civilian systems.': *Agnew v Lansförsäkringsbolagens AB* [2000] 1 All ER 737, at 770 per Lord Millett.

⁹³ Andrew S Butler (ed), *Equity and Trusts in New Zealand* (2003), at 14.

⁹⁴ *Ibid*, at 15.

In *United Scientific Holdings Ltd v Burnley Borough Council* Lord Diplock, one of the most forceful exponents of fusion⁹⁵, opined that:

[T]o perpetuate a dichotomy between rules of equity and rules of common law which it was a major purpose of the Supreme Court of Judicature Act 1873 to do away with, is, in my view, conducive to erroneous conclusions as to the ways in which the law of England has developed in the last 100 years...[T]he waters of the confluent streams of law and equity have surely mingled now.⁹⁶

In *Aquaculture Corporation v New Zealand Green Mussel Co Ltd* Cooke P, when considering whether a monetary compensation could be awarded for a breach of the duty of confidence, suggested that equity and the common law are mingled or merged.⁹⁷ As a result a full range of remedies could be available whether they originated in common law, equity or statute. Likewise, in *Elders Pastoral Ltd v BNZ* Somers J suggested that neither the common law nor equity is stifled by its origin.⁹⁸ Because the two strands of law have been administered by one Court in New Zealand, each has borrowed from the other and that outcome has furthered the harmonious development of the law as a whole.

It is clear in New Zealand that breach of a legal obligation may give rise to an equitable remedy and vice versa in appropriate cases. However, the granting of remedies such as an injunction to restrain a tort or an order of specific performance of a contract is simply an exercise of the concurrent jurisdiction of the common law and equity rather than evidence of fusion.⁹⁹ It is still debatable whether the distinction between legal and equitable causes of action and legal and equitable duties continues to exist or remains relevant. This is the critical issue pertaining to the good faith doctrine.

⁹⁵ See John Dyson Heydon, W M C Gummow and Robert P Austin, *Cases and Materials on Equity and Trusts* (4th ed, 2003), at 27.

⁹⁶ *Cheapside Land Development Co Ltd v Messels Service Co* [1977] 2 All ER 62, at 68.

⁹⁷ [1990] 3 NZLR 299, at 301.

⁹⁸ [1989] 2 NZLR 180, at 193.

⁹⁹ See Jill Martin, *Hanbury & Martin Modern Equity* (17th ed, 2005), at 24.

The learned authors of *Equity and Trusts in New Zealand* have suggested that there is enough evidence of fusion to show that there have been moves towards an overarching law of obligations within New Zealand.¹⁰⁰ A law of obligations implies that the law should be applied by focusing on the substance of legal obligations rather than on their historical origins, be it common law or equity.¹⁰¹ The process is essentially one of legal ecumenicism.¹⁰² Conceivably a plaintiff may have a cause of action and a potential remedy regardless of whether a contract has come into existence if the doctrine of good faith were to be informed under a law of obligations which could subsume equitable elements.

However, there are strong reasons against the courts introducing a doctrine of good faith which assumes both legal and equitable characteristics under the guise of a general law of obligations. Arguably the point has not yet been reached in New Zealand law where it is immaterial whether a breach of duty is of a common law or an equitable duty.¹⁰³ Equitable doctrines supplement common law doctrines¹⁰⁴ but the traditionally distinct causes of action have not been merged. It would be dangerous to substantively modify principles under one branch of the New Zealand legal jurisdiction by foreign concepts that are imported from another branch.¹⁰⁵ Accordingly, Meagher, Heydon and Leeming oppose a law of obligations:

Those who commit the fusion fallacy announce or assume the creation by the Judicature system of a new body of law containing elements of law and equity but in character quite different from its components. The fallacy is committed

¹⁰⁰ See Butler (ed), above n 93, at 22. For arguments in favour of assimilation see Andrew Burrows, 'We Do This At Common Law But That In Equity' (2002) 22 *Oxford Journal of Legal Studies* 1.

¹⁰¹ Ibid, at 21.

¹⁰² Gary Muir, 'Contract and Equity: Striking a Balance' (1986) 10 *Adelaide Law Review* 153, at 183.

¹⁰³ See generally Martin, above n 99, at 25.

¹⁰⁴ Peter Birks, 'Equity in the Modern Law: An Exercise in Taxonomy' (1996) 26 *University of Western Australia Law Review* 1, at 52.

¹⁰⁵ See generally Roderick Pitt Meagher, John Dyson Heydon and Mark James Leeming, *Meagher, Gummow & Lehane's Equity: Doctrines and Remedies* (4th ed, 2002), at 54.

explicitly, covertly and on occasion with apparent inadvertence. But the state of mind of the culprit cannot lessen the evil of the offence.¹⁰⁶

There are definite risks associated with the introduction of a good faith doctrine under a law of obligations. The courts must be hesitant to prevent quasi-contract rules being utilised as a means of bypassing contractual principles.¹⁰⁷ There would be a serious risk that the doctrine could be used to undermine traditional common law contractual rules if good faith could apply independently of the common law of contract. The requirement for offer, acceptance and consideration is a prime example.

Similarly, the remedies for a breach of a non-contractual obligation generally are, and should remain, distinct from a breach of a contractual obligation. A good faith obligation extending to pre-contractual conduct may undermine the distinction between reliance loss and expectation loss. Undoubtedly there is an overlap between the two measures of damage. However, in *Cox & Coxon Ltd v Leipst* the majority of the Court of Appeal recognised that expectation loss may only be claimed where there is an obligation to perform.¹⁰⁸ Thus, expectation loss is perceived as peculiar to contract law.¹⁰⁹ It would be dangerous to permit a plaintiff to recover on the basis that he or she lost the benefit of a contractual bargain as a result of a breach of good faith where there is no pre-existing bargain.¹¹⁰ Pre-contractual damages do not therefore readily fit into a regime of gain based damages.¹¹¹ To award contractual damages where there is an incomplete contract would ignore the risks of the negotiation process.¹¹² This suggests that contractual good

¹⁰⁶ Ibid. There is evidence to suggest that the distinction between law and equity is receiving renewed prominence. See Anthony Duggan, 'Is Equity Efficient?' (1997) 113 *Law Quarterly Review* 601.

¹⁰⁷ See generally Samuel Jacob Stoljar, *The Law of Quasi-Contract* (2nd ed, 1989).

¹⁰⁸ [1999] 2 NZLR 15, at 26 per Henry J.

¹⁰⁹ See Burrows, Finn and Todd, above n 2, at 330.

¹¹⁰ Conceivably damages might be claimed for loss of a chance. Analogy might be drawn with claims for loss of a chance to reach a settlement agreement in litigation. See *Maden v Clifford Coppock & Carter (a firm)* [2005] 2 All ER 43.

¹¹¹ Giliker, above n 84, at 972.

¹¹² Ibid, at 973.

faith should remain distinguishable from notions of pre-contractual good faith. Each attracts distinct relief.

Further, if pre-contractual equitable duties and common law contract principles are to be subsumed into a general law of obligations¹¹³ under the rubric of good faith it may be necessary for that to occur through legislative codification rather than judicial pronouncement. For example, in New Zealand the common law and equitable rules relating to contractual mistakes were integrated not by the judiciary but instead by the legislature under the Contractual Mistakes Act 1977.¹¹⁴ It has also been recognised that the assimilation of the common law doctrine of duress and the equitable doctrines of undue influence and unconscionability is essentially a legislative task.¹¹⁵ Accordingly, the merger of legal and equitable duties in the field of contract law is arguably a matter that should properly be left to Parliament. The courts simply may not be competent to introduce a general and unifying doctrine of good faith which can give rise to contractual and non-contractual liability.

Therefore, the scope of the doctrine being appraised within this thesis should, and will, be kept within the bounds of conventional methodology. The subject doctrine is to be perceived as grounded in the common law of contract. It is not the function of this thesis to consider an equitable doctrine of good faith. The latter could well have application in areas of the law in addition to contractual negotiation and enforcement. However, whilst the subject doctrine will be recognisable as legal, it is entirely possible and acceptable that its development may be informed with reference to existing equitable principles. The development of legal rules within New Zealand has, on occasion, been influenced by established equitable doctrine. This should be welcomed provided it occurs on a principled basis and the distinction between the common law and equity is maintained.¹¹⁶

¹¹³ See Edwards, above n 91, at 316.

¹¹⁴ See generally Tiong Yeo, 'Unilateral Mistake in Contract: Five Degrees of Fusion of Common Law and Equity' [2004] *Singapore Journal of Legal Studies* 224, at 233.

¹¹⁵ *National Westminster Bank plc v Morgan* [1985] 1 All ER 821, at 830 per Lord Scarman.

¹¹⁶ Martin, above n 99, at 23.

Indeed, when formulating a doctrine of contractual good faith it is logical that cognisance should be taken of existing equitable rules.

Ultimately, the fact that the doctrine of good faith would be grounded in the common law may not necessarily prevent it from applying to pre-contractual conduct. However, a cause of action for breach of good faith will only exist in respect of pre-contractual conduct where a binding contract has come into force. Further, the loss which the plaintiff claims must relate to the contract itself and cannot arise independently of the contract. For example, a claim for breach of good faith based on non-disclosure during contractual negotiations must logically have affected the ultimate agreement reached between the parties. That outcome is consistent with the law of misrepresentation which requires that the pre-contractual misconduct induce the contract. The breach is essentially treated as a breach of a term of the contract itself.¹¹⁷ More will be said on this issue in Chapter 4. Suffice to say that the circumstances in which a doctrine of contractual good faith will sanction pre-contractual conduct will be limited.

Whilst many contracts within New Zealand will not involve any extensive element of pre-contractual negotiation, the foregoing findings suggest that a doctrine of good faith may not have the wide ranging effect that proponents envisage and desire should it be introduced by the New Zealand courts. Again, this result may suggest that good faith would be better incorporated into New Zealand law through the legislature rather than by the judiciary under a common law doctrine if the obligation is required to fully extend to pre-contractual and non-contractual dealings. The analysis serves to demonstrate that the subject common law doctrine of good faith may be restricted in its scope and application.

2.4.2 Agreements to Negotiate and the Good Faith Doctrine:

It is conceivable that a doctrine of good faith may apply to pre-contractual negotiations where no final or substantive agreement eventuates provided there is some legally

¹¹⁷ Section 6 Contractual Remedies Act 1979. However, see the discussion contained within Chapter 4 as to the difficulties of treating bare non-disclosure as a 'term' of the contract which has been breached.

binding contract governing the negotiations between the parties. The legal enforceability of an agreement to negotiate is in itself the subject of much debate. In *Hillas & Co Ltd v Arcos Ltd* Lord Wright contended that:

[I]n strict theory, there [can be] a contract (if there is good consideration) to negotiate, though in the event of repudiation by one party the damages may be nominal, unless a jury think that the opportunity to negotiate was of some appreciable value to the injured party.¹¹⁸

However, the dictum of Lord Wright was disapproved by the English Court of Appeal in *Courtney and Fairbairn Ltd v Tolaini Brothers (Hotels) Ltd*.¹¹⁹ Lord Diplock suggested that the statements, although an attractive theory, had to be rejected as bad law.¹²⁰ The rationale was explained by Lord Denning MR:

If the law does not recognise a contract to enter into a contract (when there is a fundamental term yet to be agreed) it seems to me it cannot recognise a contract to negotiate. The reason is because it is too uncertain to have any binding force. No court could estimate the damages because no one can tell whether the negotiations would be successful or would fall through; or if successful, what the result would be. It seems to me that a contract to negotiate, like a contract to enter into a contract, is not a contract known to the law.¹²¹

That position was confirmed by the House of Lords in *Walford v Miles*.¹²² Lord Ackner asserted that an agreement to negotiate lacks the necessary certainty. The Court cannot be expected to determine on a subjective basis whether a proper reason exists for the termination of negotiations.¹²³ Accordingly, a party would be able to withdraw from negotiations at any time for any reason. A bare agreement to negotiate simply has no legal content.

¹¹⁸ (1932) 43 Ll L Rep 359, at 369.

¹¹⁹ [1975] 1 All ER 716.

¹²⁰ *Ibid*, at 720.

¹²¹ *Ibid*.

¹²² [1992] 1 All ER 453.

¹²³ *Ibid*, at 461.

In *Wellington City Council v Body Corporate 51702 (Wellington)*¹²⁴ the Court of Appeal adopted *Walford*. It was noted in Chapter 1 that the Court did not completely reject the notion of an agreement to negotiate. It was conceded that an agreement could be enforceable as a contract if it specifies the way in which the negotiations are to be conducted with enough precision for the Court to be able to determine what the parties are obliged to do.¹²⁵ However, it was suggested that an agreement to negotiate essential terms in good faith does not give rise to a sufficiently certain objective criterion under which the Court can decide whether there has been a breach.¹²⁶ Accordingly, the matter could not be justiciable.

That reasoning does not however appear to accord with the general willingness of the courts to give effect to the obvious intention of the parties. In *Carter Holt Harvey Ltd v Carroll Logging Ltd* the Court of Appeal suggested that the parties would not have included the words ‘fair dealing’ (which might be seen as analogous to good faith) in their contract unless the parties intended them to have some meaning.¹²⁷ Further, the comments of Tipping J do not appear to be consistent with the observations of the Privy Council in *Queensland Electricity Generating Board v New Hope Collieries Pty Ltd*.¹²⁸ In that case Sir Robin Cooke recognised that arguments involving the alleged uncertainty or inadequacy in the machinery available to the Court for making contractual rights enforceable and effective exert minimal attraction.¹²⁹

¹²⁴ [2002] 3 NZLR 486.

¹²⁵ *Ibid*, at 496 per Tipping J.

¹²⁶ Compare this finding to the observation of the Supreme Court of Canada that ‘the institution of bargaining in good faith is one that is worthy of legal protection in those circumstances where that protection accords with the expectations of the parties.’: *LAC Minerals Ltd v International Corona Resources Ltd* [1989] 2 SCR 574, at [189] per Sopinka J.

¹²⁷ (Court of Appeal, CA 204/03, 18 November 2003), at [19] per Heath J.

¹²⁸ [1989] 1 Lloyd’s Rep 205.

¹²⁹ *Ibid*, at 210.

Thus, the courts are quite willing to recognise an agreement to mediate.¹³⁰ The justification for deeming an agreement to mediate enforceable but an agreement to negotiate unenforceable is susceptible to scrutiny.¹³¹ Indeed, it is difficult to draw a pragmatic distinction between an agreement to mediate and an agreement to negotiate. Certainly, an agreement to mediate may impose some specific and definitive obligations such as the requirement to appoint a mediator and attend the meditation. But the courts have apparently been willing to recognise significantly less certain duties under an agreement to mediate. These obligations could equally apply to a contractual negotiation process. For example, in *Haines v Carter*¹³² the Privy Council accepted that the parties were under a duty to act in good faith during the course of a mediation involving the division of relationship property. Lord Rodger considered that the obligation meant that the parties could not conceal the existence of relationship property, exaggerate its worth or fail to reveal some factor affecting its value.¹³³ The good faith duty therefore influenced the tactics which the parties were permitted to employ during the mediation.

Further, in *Hooper Bailie Associated Ltd v Natcon Group Pty Ltd* Giles J suggested that an agreement to negotiate and an agreement to mediate were both distinct from an agreement to agree.¹³⁴ An agreement to mediate and an agreement to negotiate could require the parties to participate in the negotiation process in a manner that could be

¹³⁰ *Haines v Carter* [2003] 3 NZLR 605. See also Robert Angyal, 'The Enforceability of Agreements to Mediate' (1994) 12 *Australian Bar Review* 1. The courts have however demonstrated a reluctance to engage in a critique or analysis of what takes place at a mediation due to the public interest in the finality of the dispute resolution process. See *Hildred v Strong* [2008] 2 NZLR 629. Conceivably those policy considerations do not apply in the case of agreements to negotiate in the context of contractual bargaining.

¹³¹ See David McLauchlan, 'The Agreement to Negotiate in Good Faith: A Non-Justiciable Contract?' (2005) 11 *New Zealand Business Law Quarterly* 454, at 460.

¹³² [2003] 3 NZLR 605.

¹³³ *Ibid*, at 612.

¹³⁴ (1992) 28 NSWLR 194, at 209. As to the enforceability of a heads of agreement see *Fletcher Challenge Energy Ltd v Electricity Corporation of New Zealand Ltd* [2002] 2 NZLR 433.

defined with sufficient certainty to justify the legal recognition of the agreement.¹³⁵ This depended upon the express terms and any terms that might be implied into the agreement.

Having denounced the justiciability of an agreement to negotiate in good faith, the Court in *Wellington City Council* paradoxically went on to say that even if the agreement was enforceable there could be no lack of good faith. The Council was entitled to seek the highest possible price and was free to engage in negotiations with other potential purchasers. The Court did not appreciate that it completely undermined its earlier reasoning by advancing this alternative ground. The Court should not have been able to embark upon the question of whether the Council had negotiated in good faith, let alone make a definitive conclusion, if the issue truly was not justiciable.¹³⁶ Arguably the logical reasons which the Court advanced as to why good faith had not been breached may have been a better justification for the decision than the non-justiciability supposition.

Indeed, the restrictive approach adopted to date by the courts has received significant criticism. The reasoning in *Walford* apparently contradicts rather than protects the principle of freedom of contract. It seems irrational that negotiating parties are not free to bargain away their right to withdraw from negotiations if they so choose.¹³⁷ It is extremely difficult to comprehend how commercial parties do not intend to create a legal relationship where they have made a serious promise to negotiate and have provided good consideration.¹³⁸ Accordingly the Court should be hesitant to override the obvious intention of the parties.

¹³⁵ Ibid, at 209.

¹³⁶ See McLauchlan, above n 131, at 459.

¹³⁷ See Peter Liao, 'Good Faith: in Defence of *WCC*' [2008] *New Zealand Law Journal* 190; McLauchlan, above n 131, at 460. See also Jeff Cumberbatch, 'In Freedom's Cause: The Contract to Negotiate' (1992) 12 *Oxford Journal of Legal Studies* 586; Ian Brown, 'The Contract to Negotiate: A Thing Writ in Water?' [1992] *Journal of Business Law* 353; Alan Berg, 'Promises to Negotiate in Good Faith' (2003) 119 *Law Quarterly Review* 357.

¹³⁸ See generally Geoffrey Flint, '"Enforce Them All": A Battle Cry for the Beleaguered Agreement to Negotiate' (1995) 13 *Australian Bar Review* 262.

Despite the current views of the judiciary, agreements to negotiate and, more particularly, agreements to negotiate in good faith, are commonplace in commercial dealings within New Zealand.¹³⁹ Commercial parties and their advisors are demonstrating a reluctance to yield to the view of the courts. This result is to be expected in light of the commercial importance of contractual negotiations. A number of modern studies have indicated that the negotiation period cannot be dismissed as insignificant.¹⁴⁰ Negotiations may take place in stages over a considerable period of time in large-scale or complex commercial transactions. There is an increasing time and expense commitment as the parties move more towards a formal agreement. The economic investment in contractual negotiations arguably justifies a measure of protection and surety.

It therefore appears somewhat irrational and unfair that the courts often deny commercial parties the effect of an agreement to negotiate when plainly the commercial world values such agreements. The striking down of bargains solely to preserve legal niceties divorces the law from the realities of commerce and the ability of the law to move in parallel with the development of commercial life.¹⁴¹ In *Homburg Houtimport BV v Agrosin Private Ltd* Lord Steyn endorsed the extra-judicial comments of Lord Goff opining:

We are there to help businessmen, not to hinder them: we are there to give effect to their transactions, not to frustrate them: we are there to oil the wheels of commerce, not to put a spanner in the works, or even grit in the oil.¹⁴²

Accordingly, it is submitted that an increased preparedness by the judiciary to uphold agreements to negotiate is required. Relevant to this thesis, a doctrine of good faith may

¹³⁹ *Porter v Gullivers Travel Group Ltd* (Court of Appeal, CA 245/06, 14 August 2007), at [35] per Gendall J. See also Liao, above n 137.

¹⁴⁰ See generally Giliker, above n 84, at 969-970.

¹⁴¹ See Ross Buckley, 'Walford v Miles: False Certainty about Uncertainty' (1993) 7 *Journal of Contract Law* 58, at 63.

¹⁴² [2004] AC 715, at 749, citing Lord Goff, 'Commercial Contracts and the Commercial Court' [1984] *Lloyd's Maritime and Commercial Law Quarterly* 382, at 391.

assist in achieving this objective by contributing legally binding content to an agreement to negotiate.¹⁴³

A doctrine of good faith would be unable to act as consideration for an agreement to negotiate. It would be inconsistent with the doctrine of consideration to determine that a promise to negotiate in good faith amounts to consideration on the basis that the parties forgo certain rights in making the promise.¹⁴⁴ Further, the envisaged doctrine of good faith should only apply to promises which are capable of having the force of contracts. The subject doctrine of good faith is unlikely to save a promise to negotiate that is unsupported by good consideration. Provided however there is some recognisable consideration for the promise, good faith could potentially be read into an agreement to negotiate as a further term which alone makes it effective.¹⁴⁵ This result would seemingly be consistent with the primary duty of the Court to uphold the contract between the parties.¹⁴⁶ The courts should strive to reduce any uncertainty to an acceptable level provided contractual intention can be established.¹⁴⁷ Conceivably a general duty of good

¹⁴³ See Sir Anthony Mason, 'Contract, Good Faith and Equitable Standards in Fair Dealing' (2000) 116 *Law Quarterly Review* 66, at 81.

¹⁴⁴ See Carter and Furmston, above n 83, at 93. However, within the United States an obligation to act in good faith has been held to constitute consideration for a contract in some instances. For example, in *Gregg v US Indus*, 715 F2d 1522 (1983, US App) the defendant promised to supply working capital to the plaintiff's business, but the agreement did not specify the quantity. In order to avoid finding the contract void for indefiniteness and want of consideration, the Court held that the defendant had an implied duty to determine the quantity in good faith. For further discussion of the relationship between consideration and good faith in America see Joseph M Perillo and Helen Hadjiyannakis Bender, *Corbin on Contracts* (revised ed, 1993) vol 2, at 139.

¹⁴⁵ It has been recognised that an implied term may save an otherwise unenforceable contract. See Burrows, Finn and Todd, above n 2, at 156. Kirby P has accepted that a promise to negotiate supported by consideration might be enforceable where the promise is clear and part of an undoubted agreement between the parties. His Honour further considered that in some instances the 'court may be able to add flesh to a provision which is otherwise unacceptably vague or uncertain or apparently illusory.': *Coal Cliff Collieries Pty Ltd v Sijehama Pty Ltd* (1991) 24 NSWLR 1, at 27.

¹⁴⁶ *McCann v Switzerland Insurance Australia Ltd* (2000) 176 ALR 711, at 726 per Kirby J.

¹⁴⁷ *Fletcher Challenge Energy Ltd v Electricity Corporation of New Zealand Ltd* [2002] 2 NZLR 433; *Attorney-General v Barker Bros Ltd* [1976] 2 NZLR 495.

faith would permit the courts to enforce a bare agreement to negotiate because it would enable judges to more readily spell out the content of any contractual obligation.¹⁴⁸ Good faith would require that the parties renounce the purely adversarial position that they would otherwise be entitled to adopt if their negotiations were not the subject of an agreement.¹⁴⁹

In *Wellington City Council* one of the primary problems Tipping J perceived in respect of a good faith obligation giving content to an agreement to negotiate was that, in his Honour's view, the meaning of good faith was subjective honesty. Such a standard of conduct apparently could not be appraised and applied by the courts. In this respect, Tipping J suggested that an obligation to negotiate in good faith was distinct from an obligation to negotiate reasonably. Apparently the latter might embody a sufficiently objective and enforceable criterion.¹⁵⁰

The reasoning of Tipping J breaks down if it is accepted that good faith can assume an objective standard of conduct. Indeed, it will be contended in Chapter 3 that good faith may embody an objective definition and may conceivably include requirements of reasonable behaviour. Thus, there is no reason why the subject doctrine could not be used by the courts to give contractual meaning and enforceability to an agreement to negotiate to the extent that the meaning of good faith subsumes an objective standard of conduct.

There is no doubt that it would be difficult to develop an adequate characterisation of good faith conduct in contract negotiations in order to give content to a contract to negotiate.¹⁵¹ However, the difficulty in prescribing a standard of good faith conduct in negotiations is no different than formulating an appropriate measure of good faith

¹⁴⁸ See Sir Anthony Mason, above n 143, at 81.

¹⁴⁹ See generally Berg, above n 137, at 363. Berg suggests that good faith might embody an obligation to participate in negotiations, retain an open mind, refrain from taking advantage of the ignorance of the other party and only withdraw from negotiations for a genuine reason.

¹⁵⁰ [2002] 3 NZLR 486, at 492.

¹⁵¹ Hugh Beale, 'Commentary on "Good Faith and Fairness in Failed Contract Negotiations"' (1995) 8 *Journal of Contract Law* 121, at 124.

conduct under a substantive contract. Certain types of conduct may amount to a failure to negotiate in good faith depending on the circumstances of the case. Such conduct may include a bare refusal to negotiate¹⁵², or complete inflexibility (as distinct from legitimate hard bargaining)¹⁵³ and obstructing or delaying negotiations. In some cases the doctrine of good faith might preclude a party to a negotiation agreement from engaging in parallel or alternate negotiations. Logically the good faith doctrine could not require the parties to reach a concluded contract. However, conceivably there should be some reasonable justification for the termination of negotiations. Such genuine circumstances may include impasse, a change in market conditions or a more favourable offer by a third party.

On balance it is submitted that in appropriate cases the subject doctrine may be utilised to give legally enforceable content and contractual force to an agreement to negotiate which is supported by valid consideration. The doctrine may therefore result in an increased recognition of agreements to negotiate. This is a desirable development such that the law becomes better aligned with the expectations of the commercial community in New Zealand. It is appropriate however to reemphasise that the subject doctrine would have no application to negotiations which are not the subject of a purported agreement. The doctrine is contractual in origin.

2.4.3 Preliminary or Process Contracts and the Good Faith Doctrine:

In certain circumstances the common law has regulated contractual negotiations by adopting a two contract methodology. This approach is based on the theory that a secondary or procedural contract may arise governing the way in which the parties conduct their dealings in pursuit of the prospective primary contract.¹⁵⁴ Thus, in *Barry v Davies* it was held that there was a secondary contract between an auctioneer and the highest bidder in an auction without reserve. The contract was constituted by an offer by

¹⁵² *Teachers Insurance Annuity v Butler*, 626 F Supp 1229 (SDNY, 1986).

¹⁵³ Jeannie Paterson, 'The Contract to Negotiate in Good Faith: Recognition and Enforcement' (1996) 10 *Journal of Contract Law* 120, at 133.

¹⁵⁴ See Burrows, Finn and Todd, above n 2, at 43.

the auctioneer to sell to the highest bidder which was accepted when the bid was made.¹⁵⁵ The vendor breached the secondary contract by failing to sell to the highest bidder. The bidder was therefore entitled to recover the difference between the market value of the auctioned goods and the amount of the bid.

Similarly, in *Markholm Construction Co Ltd v Wellington City Council*¹⁵⁶ a process contract came into existence where the Council sought purchase bids for sections of land. The Council had promised to hold a ballot if more than one bid was received for a particular section. Jeffries J held that there was a contract between the conforming bidders, including the plaintiffs, and the Council. The contract required the Council to hold the ballot.¹⁵⁷ Accordingly, the Council had breached the process contract by declining to conduct the ballot. The plaintiffs were unable to establish that they would have won the substantive contract but for the breach. Damages were therefore confined to loss of a chance and inconvenience.

The two contract methodology is arguably evidence of the courts showing much ingenuity to promote good faith and fair dealing in the negotiation of primary contracts.¹⁵⁸ Moreover, the increasing judicial endorsement of the process contract rationale may conceivably provide greater scope for a doctrine of good faith to regulate negotiations for a substantive contract. The subject doctrine could be applicable to a preliminary process contract as a matter of construction.

Indeed, obligations of good faith under a process contract have already received some support in the context of public tendering. In *R v Ron Engineering & Construction (Eastern) Ltd* the Supreme Court of Canada propounded a contractual model based on the formation of preliminary and final contracts in the tender process.¹⁵⁹ A request for tenders

¹⁵⁵ [2000] 1 WLR 1962, at 1964 per Sir Murray Stuart-Smith.

¹⁵⁶ [1985] 2 NZLR 520.

¹⁵⁷ *Ibid*, at 527.

¹⁵⁸ Carter and Furmston, above n 83, at 107.

¹⁵⁹ [1981] 1 SCR 111.

is an offer by the invitor. The submission of a conforming bid amounts to an acceptance leading to a process contract on the terms specified in the call for tenders.¹⁶⁰

The principle is illustrated in the case of *Blackpool and Fylde Aero Club Ltd v Blackpool Borough Council*.¹⁶¹ The Council sent invitations to tender to the Aero Club and six other parties. The tender related to concessions to operate pleasure flights from an airport. The invitation stated that tenders submitted after a certain time would not be considered. The Aero Club submitted a tender within the prescribed time. However, the Council staff made an error and recorded the tender as being submitted late. In consequence, the tender was not considered and the concessions were awarded to another party. The Aero Club sued for breach of contract. Bingham LJ held that an invitee who conformed to the terms of the invitation was entitled to some protection. This protection extended past a mere expectation. The invitee enjoyed a contractual right to have his or her tender considered in conjunction with the other conforming tenders.¹⁶² The obligation incumbent on the Council did not preclude it from declining to award the tender. However, the decision had to be *bona fide* and honest.¹⁶³

Thus, the terms of the tender invitation are the foundation for the terms of the preliminary contract. The process contract governs the manner in which the invitor is to consider the submissions. It gives rise to an expectation that the substantive contract will be awarded by following the prescribed procedure. The courts have endeavoured to ensure that this expectation is realised by implying terms of good faith into the process contract.

For example, in *Pratt Contractors Ltd v Transit New Zealand* the Privy Council accepted that the invitor was subject to an implied obligation under the preliminary contract to deal

¹⁶⁰ Peter Devonshire, 'The Modern Law of Public Tendering: The Principles Defined' (2004) 10 *New Zealand Business Law Quarterly* 114, at 114-115.

¹⁶¹ [1990] 3 All ER 25.

¹⁶² *Ibid*, at 30.

¹⁶³ *Ibid*, at 32 per Stocker LJ.

with the tenderers in fairness and in good faith.¹⁶⁴ These duties meant that the invitor was obliged to treat each of the tenderers equally. However, there was no obligation on the part of the invitor to act judicially.¹⁶⁵

The majority of cases involving good faith obligations in the context of tendering have hitherto involved public bodies.¹⁶⁶ It remains to be substantively tested in New Zealand whether obligations of good faith would be implied into a preliminary contract in a wholly private tender process. In *Lab Tests Auckland Ltd v Auckland District Health Board* the Court of Appeal recognised that a public body engaged in a tender process must exercise its contracting power in accordance with its enabling statute.¹⁶⁷ Principles of natural justice therefore apply. Arguably this is one of the reasons justifying an implied duty of good faith. A private individual is not subject to such public law obligations. It is therefore debatable whether a private tender process will warrant an implied duty of good faith.

Nonetheless, obligations of good faith would apply to all process contracts regardless of whether public bodies or private individuals are involved if a universal doctrine of good faith were to be introduced. Accordingly, the two contract methodology in conjunction with a doctrine of contractual good faith is a means by which negotiations may be regulated and contractual liability imposed in cases of bad faith conduct.

¹⁶⁴ [2005] 2 NZLR 433, at 438 per Lord Hoffmann. The point was conceded by the parties. For further discussion see Andrew Phang, 'Tenders, Implied Terms and Fairness in the Law of Contract' (1998) 13 *Journal of Contract Law* 126; Judith Cheyne and Peter Taylor, 'Commercial Good Faith' [2001] *New Zealand Law Journal* 245.

¹⁶⁵ *Ibid*, at 446. See also *Gregory v Rangitikei Council* [1995] 2 NZLR 208; *Hughes Aircraft Systems International v Airservices Australia* (1997) 146 ALR 1. The extent of any implied obligation will depend on the wording of the tender documents. See *Prime Commercial Ltd v Wool Board Disestablishment Company Ltd* (High Court, Wellington, CIV 2001-485-994, 19 May 2005, Wild J), (2006) 7 NZCPR 697 (CA); *Onyx Group Ltd v Auckland City Council* (2003) 11 TCLR 40.

¹⁶⁶ For a discussion of public law considerations in the contractual arena and, in particular, tendering, see *Lab Tests Auckland Ltd v Auckland District Health Board* (Court of Appeal, CA 154/07, 25 September 2008).

¹⁶⁷ *Ibid*, at [56] per Arnold and Ellen France JJ.

2.5 Contracting Out of the Doctrine of Good Faith:

The extent to which contracting parties could limit or exclude a duty of good faith is fundamental to the jurisprudential foundation of the subject doctrine. The issue is complicated by the lack of consensus as to whether a doctrine of good faith should be incorporated into contract law as an implied term or as a principle of construction.

2.5.1 Contracting Out of an Implied Term:

Those who subscribe to the idea that the doctrine of good faith would be a term implied in law generally take the view that the parties should be free to exclude its application by express agreement. It was noted above that the ability to contractually exclude the implication of a term is a well-established rule. In *Lynch v Thorne* the English Court of Appeal declined to imply a term which would create an inconsistency with the express language of the agreement.¹⁶⁸ Implied terms are therefore of their nature incapable of rising above express terms.¹⁶⁹

Some good faith supporters seek to displace this rule. In *Commonwealth Bank of Australia Ltd v Spira* Gzell J suggested that public policy considerations should result in the law refusing to countenance any exclusion of a term implied as a matter of general policy in all contracts of a particular class.¹⁷⁰ His Honour did however acknowledge that higher authority bound him to hold to the contrary. Others have also contended that there would be no scope to exclude a duty of good faith created by an appellate court applying to all contracts and requiring each party to do that which is necessary for the performance of the contract.¹⁷¹

¹⁶⁸ [1956] 1 All ER 744, at 748 per Evershed MR. See also *Commissioner of Inland Revenue v Mitsubishi Motors Ltd* [1994] 2 NZLR 392.

¹⁶⁹ *LMI Australia Pty Ltd v Baulderstone Hornibrook Pty Ltd* [2001] NSWSC 886, at [75] per Barrett J.

¹⁷⁰ (2002) 174 FLR 274, at [147]. Public policy considerations are discussed below.

¹⁷¹ See Justice James Douglas, 'Exploring the Recent Uncertainty Surrounding the Implied Duty of Good Faith in Australian Contract Law: The Duty to Act Reasonably – Its Existence, Ambit and Operation' *Lexis Nexis Contract Law Master Class* (2006), at [35].

Minimal rationale is advanced to support these opinions. Apparently some exception to the rules relating to implied terms is justified on the basis of the sheer importance of a universally implied obligation of good faith. The essentiality of an implied term of good faith has been emphasised by arguing that such an obligation cannot be excluded without rendering an agreement a hollow shell, devoid of legally significant content.¹⁷² These contentions can be readily countenanced by observing that the majority of contracts within New Zealand currently function without the need for an implied term of good faith.

2.5.2 Contracting Out of a Rule of Construction:

The foregoing analysis within this chapter advocated the incorporation of a doctrine of good faith into contract law primarily as a rule of construction rather than as an implied term. Accordingly it is necessary to consider whether a principle of construction can be contractually limited or excluded.

A comparison was previously drawn between the doctrine of frustration and the envisaged doctrine of good faith. The doctrine of frustration is a principle of construction and can be modified by the express agreement of the parties. This can occur where the parties specifically provide for the frustrating event.¹⁷³ This analogy implies that contracting parties might also be free to expressly limit or negate an obligation of good faith. Because construction is dependent on the nature of the contract and the surrounding circumstances, contracting parties could avoid duties of good faith by making their contracts sufficiently clear.¹⁷⁴

However, some have argued that a principle of good faith incorporated as a rule of construction may not be so readily excluded. Baron has adopted this rationale. She

¹⁷² See Seddon and Ellinghaus, above n 42, at 459-460.

¹⁷³ See Burrows, Finn and Todd, above n 2, at 648.

¹⁷⁴ See Peden, above n 39, at 231.

further asserts that this may render the constructivist approach preferable to the implied term methodology:

[T]here seems to be little difference in the two competing approaches that have characterised much of the good faith debate in Australia: the constructivist and the implication approach...Despite the similarities in outcome, a technical advantage, perhaps, of the constructivist approach relates to the exclusion of good faith obligations. As Justice Finn acknowledged in *Marconi*, on the law as it currently stands [], parties can expressly exclude an obligation of good faith. However, on a constructivist approach, and keeping in mind the central ideas of the notion of contract as a mutual endeavour and contract as a process, it seems likely that core good faith obligations could not be excluded because to do so would render the contract illusory.¹⁷⁵

With respect, the argument is not convincing. It was noted above that the fundamental importance of good faith has also been advanced as a reason for precluding the right to contract out of an implied term of good faith. The distinction between construction and implication that Baron seeks to draw is not clear. In any event contracts can function without a good faith rule of construction under the existing law. It is not therefore a tenable argument to suggest that the contractual exclusion of a construction based on good faith would destroy the foundation of the contract.

Ultimately, rules of construction are the means by which the courts determine the mutual objective intention of contracting parties. Accordingly, it is logical that the parties could prevent a contract from being construed to require good faith by demonstrating an intention to the contrary. Prima facie, the doctrine of good faith could be limited or negated by contracting parties if it were to be introduced as a rule of construction.

2.5.3 How Would a Good Faith Doctrine be Limited or Negated?

It is necessary to consider the practical means by which the operation of a doctrine of good faith would be contractually limited or excluded. It has been reasoned that exclusion would be difficult to achieve. No doubt alarm bells are likely to ring if a term expressly

¹⁷⁵ Baron, above n 48, at 424.

mandating bad faith or dishonest conduct were sought to be included by a party to a contract.¹⁷⁶ In practical terms it is difficult to conceive an attractively drafted term which overtly seeks to exclude an obligation of good faith and fair dealing.¹⁷⁷

Nonetheless, exclusion may seemingly be achieved by more subtle means. For example, contractual clauses may be expressed to permit a party to exercise powers at 'its sole discretion' or 'for any reason whatsoever.' Such clauses may prevent the Court from scrutinising the motive and reasonableness of the exercise of a contractual power which it might have otherwise done if a breach of good faith were alleged.¹⁷⁸ To deem that contracting parties intended a sole discretion clause to be subject to good faith obligations may be a strained construction. An absolute discretion clause may at least serve to dilute the standard of conduct required to discharge a good faith obligation.

In *Vero Insurance New Zealand Ltd v Fleet Insurance & Risk Management Ltd* Asher J considered a contractual clause which permitted a joint venture party to withhold consent to a change in shareholding of the other joint venture party at its absolute discretion. His Honour held that the absolute discretion element did not necessarily exclude the application of the obligation of good faith which the parties were subject to pursuant to another term of the contract.¹⁷⁹ Likewise, in *Hungry Jack's* the New South Wales Court of Appeal examined a clause which gave a franchisor the sole discretion to grant consent to the recruitment of third party franchisees and concluded that:

If full force is given to [the sole discretion] concept, it would allow [the franchisor] to give or to withhold relevant approval "at its whim" including capriciously, or with the sole intent of engineering a default of the Development Agreement, giving rise to a right to terminate.¹⁸⁰

¹⁷⁶ See Finn, above n 40, at 385.

¹⁷⁷ See Douglas, above n 171, at [38].

¹⁷⁸ Obligations of good faith and reasonableness in respect of the exercise of contractual discretions are extensively discussed in Chapter 4.

¹⁷⁹ (High Court, Auckland, CIV 2007-404-1438, 21 May 2007), at [42].

¹⁸⁰ [2001] NSWCA 187, at [176] per Sheller, Beazley and Stein JJA.

Apparently the Court considered that the parties did not intend a sole discretion clause to mandate an arbitrary exercise of the discretion. Such observations may suggest that although it may be possible to specifically exclude an obligation of good faith, an attempt to impliedly do so by virtue of a sole discretion clause and other similarly wide contractual provisions is unlikely to find judicial favour.¹⁸¹

Certainly there is no consistency in judicial approach. In *Vero Asher J* suggested, in obiter dicta, that it would be most surprising if an unfettered right to cancel or terminate could be subject to the qualification that it must be exercised in good faith.¹⁸² A system of contract requiring an examination of the motives for the exercise of contractual rights could be subject to chaos and uncertainty. On this rationale a clause permitting termination at one's sole discretion is unlikely to be subject to good faith considerations. Seemingly an absolute discretion clause may therefore be sufficient to negate or limit the application of a good faith doctrine in certain circumstances.

Conceivably the doctrine of good faith might also be excluded by an 'entire agreement' clause. These clauses frequently appear in commercial agreements. The wording usually adopted is to the effect that the written agreement constitutes the entire agreement between the parties or that or that the document sets out all the express terms and conditions of the bargain. Often entire agreement clauses serve to exclude the operation of the common law. Accordingly such a clause could preclude the application of good faith as a principle of construction. There exists authority for the proposition that an entire agreement clause may effectively preclude the imposition and application of an implied term.¹⁸³ By analogy, that result could also apply to a rule of construction.

¹⁸¹ See Bill Dixon, 'Can the Common Law Obligation of Good Faith be Contractually Excluded?' (2007) 35 *Australian Business Law Review* 110, at 118.

¹⁸² (High Court, Auckland, CIV 2007-404-1438, 21 May 2007), at [43].

¹⁸³ *Hope v RCA Photophone of Australia Pty Ltd* (1937) 59 CLR 348; *Australian Guarantee Corp Ltd v Ross* [1983] 2 VR 319; *Johnson Matthey Ltd v AC Rochester Overseas Corp* (1990) 23 NSWLR 190; *Quantum Timber Products (NZ) Ltd (In Receivership and in Liquidation) v Koppers Arch Wood Protection (NZ) Ltd* (High Court, Auckland, CIV 2003-404-50, 8 September 2003, Master Lang), at [13]; *Exxonmobil Sales and Supply Corp v Taxaco Ltd* [2004] 1 All ER (Comm) 435, at [27] per Teare QC; *Filter Solutions*

However, others take a contrary view and argue that an entire agreement clause could not preclude the operation of an implied term of good faith. The rationale presented is that an entire agreement clause would not be sufficiently precise to constitute an express exclusion of a duty of good faith and fair dealing that would otherwise be implied in law.¹⁸⁴ A further justification is that every implication of a term which the law deems necessary is embodied in the contract as if it were expressly written into the agreement.¹⁸⁵ An entire agreement clause does not serve to exclude the operation of terms deemed to be within the contract.

However, this reasoning is dubious. An entire agreement clause may expressly exclude the common law rules of implication and construction.¹⁸⁶ It is submitted that such a clause should be effective in precluding any good faith obligations being incorporated into the contract either by construction or implication.

No doubt the courts may need to resort to the rule of *contra proferentum* to resolve whether a specific clause, including an entire agreement clause or a sole discretion

Ltd v Donaldson Australasia Pty Ltd (High Court, Auckland, CIV 2005-404-1095, 4 July 2006, Associate Judge Doogue), at [87]. Cf Elizabeth Peden and John Carter, 'Entire Agreement – and Similar – Clauses' (2006) 22 *Journal of Contract Law* 1.

¹⁸⁴ *GEC Marconi Systems Pty Ltd v BHP Information Technology Pty Ltd* (Federal Court of Australia, NG 733 of 1997, 12 February 2003), at [922] per Finn J.

¹⁸⁵ *Hart v MacDonald* (1910) 10 CLR 417, at 427 per O'Connor J.

¹⁸⁶ *Lewis v Bell* (1985) 1 NSWLR 731; *NT Power Generation Pty Ltd v Power and Water Authority* (2001) 184 ALR 481; *Vodafone Pacific Ltd v Mobile Innovations Ltd* [2004] NSWCA 15, at [200] per Giles JA. In *Stanley v Fuji Xerox New Zealand Ltd* (High Court, Auckland, CP 479/96, 5 November 1997) Elias J observed (at 24) that a 'term is not to be implied merely because it is sensible or reasonable unless in all the circumstances the term must have been intended by the parties at the time of entering into the contract...The contract itself purports by clause 11 to embody the entire understanding of the parties and exclude the implication of any other terms. While that provision is not conclusive it prompts caution. It indicates that the parties themselves intended to express their obligations in the written agreement with some precision.'

provision, is clearly worded enough to exclude the subject good faith doctrine.¹⁸⁷ Those legal issues are however somewhat distinct from the good faith debate. Prima facie, an appropriately drafted clause could exclude or limit the doctrine.

Traditionally the common law has prevented the contractual exclusion of certain obligations on the grounds of public policy. It is necessary to consider whether public policy considerations could be invoked to displace the above finding that the subject doctrine could be contractually limited or negated. These public policy issues are explored below.

2.5.4 Public Policy Considerations:

The fact that it may be possible to contract out of an obligation of good faith is an outcome which is not universally endorsed by proponents of the doctrine. The ability to contract out of good faith would tend to dilute the potency and frequency of application of the doctrine. This can be contrasted against the European codifications. These often preclude the exclusion or limitation of the duty of good faith and fair dealing.¹⁸⁸

It is highly conceivable that if contracting parties were permitted to contract out of the doctrine then this would frequently occur within New Zealand. The use of standard form contracts is increasing.¹⁸⁹ It is not difficult to envisage well-drafted exclusion and entire agreement clauses within standard consumer contracts preventing the application of a good faith doctrine. Accordingly, the utility of the good faith doctrine as a means of redressing inequality of bargaining power may be weakened. Similarly, commercial parties may seek to exclude a doctrine of good faith taking the view that it need not be relied upon provided both parties perform the contract as expected. Corporate parties operating at arms length may make a commercial election to avoid the uncertainties

¹⁸⁷ The onus is on the person seeking the protection of the exclusion clause to show that the contingency has in fact arisen. See *DHL International (NZ) Ltd v Richmond Ltd* [1993] 3 NZLR 10.

¹⁸⁸ See generally art 1:201 Principles of European Contract Law.

¹⁸⁹ See Burrows, Finn and Todd, above n 2, at 16.

associated with good faith. In particular, they may seek to avoid challenges to their motives for exercising contractual powers. It is therefore plausible that the doctrine would be unlikely to have any meaningful impact on commercial contracts if contracting parties were permitted to completely exclude it.¹⁹⁰ Moreover, it is even conceivable that if a good faith doctrine were introduced, thereby increasing the awareness of the need to achieve contractual exclusion, obligations of good faith in classes of contract under which such obligations are currently implied are more likely to be excluded either deliberately or inadvertently. Paradoxically, the introduction of a good faith doctrine may diminish the application of good faith obligations in New Zealand contractual relationships.

Consequently, public policy may prevent contractual exclusion of good faith. There are some standards and obligations which are not suitable for contractual variation despite the insistence on party autonomy in the field of contract law.¹⁹¹ Fraud is an obvious example. It has been recognised that ‘no subtlety of language, no craft or machinery in the form of contract, can estop a person who complains that he has been defrauded.’¹⁹² In *HIH Casualty and General Insurance Ltd v Chase Manhattan Bank*¹⁹³ the House of Lords identified the policy justifications for the rule. Lord Scott noted that a party to a contract should not be permitted to benefit from his or her own fraud.¹⁹⁴ Lord Hobhouse also observed that a contractual exclusion may be meaningless where a contract has been procured by material fraud because the party deceived has not given a true consent to be bound by the contract.¹⁹⁵

¹⁹⁰ See Paterson, above n 1, at 279.

¹⁹¹ See Justice Paul Finn, ‘Equity and Commercial Contracts: A Comment’ [2001] *Australian Mining and Petroleum Law Association Yearbook* 414, at 422.

¹⁹² *Pearson & Son Ltd v Dublin Corporation* [1907] AC 351, at 356 per the Earl of Halsbury.

¹⁹³ [2003] 2 Lloyd’s Rep 61. The House left open the issue of whether a principal can exclude liability for the fraud of his or her agent.

¹⁹⁴ *Ibid*, at 85.

¹⁹⁵ *Ibid*, at 81.

Conceivably the doctrine of good faith may also fall within this public policy exception category. Certainly a term expressly permitting bad faith conduct may approach the threshold to be unenforceable as against public policy.¹⁹⁶ It is notable that in *HHH* Lord Bingham opined that each party to a contract will assume the honesty and good faith of the other and the parties would not enter into a contract absent such an assumption.¹⁹⁷

Nonetheless, it is dubious whether a doctrine of good faith invokes correspondingly strong policy considerations to those justifying the necessity to provide a victim of fraud with some legal recourse. Whilst fraud would be an obvious example of a breach of good faith, conduct falling well short of common law fraud is also likely to contravene the good faith standard. Indeed, if the law permits exclusion of liability for negligence¹⁹⁸ there is no evident justification for preventing contracting parties from excluding liability for breach of good faith.

Accordingly, there does not appear to be any outstanding policy consideration or element of illegality which would preclude contracting parties from specifically limiting or excluding the doctrine of good faith. On the contrary, to suggest that good faith cannot be excluded on the basis of some abstract notion of community standards is likely to work against the interests of contracting parties and commercial parties in particular.¹⁹⁹ Arguments based on illegality and public policy are unlikely to hold sway in respect of an exclusion of good faith. The courts will be reluctant to read down freedom of contract. An appropriate exclusion clause should therefore embarrass the judiciary into submission.²⁰⁰

¹⁹⁶ Seddon and Ellinghaus, above n 42, at 460.

¹⁹⁷ [2003] 2 Lloyd's Rep 61, at 68.

¹⁹⁸ See generally *Shipbuilders Ltd v Benson* [1992] 3 NZLR 549; *Kanieri Gold Dredging Ltd v The Dunedin Engineering and Steel Co Ltd* (1985) 1 NZBLC 99,024; *Producer Meats Ltd v Thomas Borthwick & Sons Ltd* [1964] NZLR 700.

¹⁹⁹ See Dixon, above n 181, at 115.

²⁰⁰ W Grover, 'A Solicitor Looks at Good Faith in Commercial Transactions' in *Commercial Law: Recent Developments and Emerging Trends* (Special Lectures of the Law Society of Upper Canada, 1985), at 106-107.

Accordingly it is concluded that the common law would not be capable of preventing contracting parties from excluding or limiting the doctrine of good faith. Although the right to contract out of the doctrine would be subject to existing legal and equitable controls, such as the rule of *contra proferentum*, the doctrine could not be utilised to rewrite the agreed terms of a contract.²⁰¹ The courts should not be permitted to override a clear contractual intention to negate or avoid good faith obligations.

2.5.5 A Matter for the Legislature?

The foregoing conclusion that the courts would be unlikely to prevent contracting parties from excluding the doctrine may suggest to ardent good faith proponents that the doctrine should be introduced by the legislature rather than the judiciary.

For example, the United States, via the Uniform Commercial Code, has adopted an approach which appears to strike a balance between contractual autonomy and the desire for a mandatory rule of good faith. Section 1-102(3) provides:

The obligations of good faith, diligence, reasonableness and care prescribed by this Act may not be disclaimed by agreement but the parties may by agreement determine the standards by which performance of such obligations is to be measured if such standards are not manifestly unreasonable.

Thus, although the duty of good faith cannot be excluded, its application may be modified via an express contractual provision referring to the standard of care expected of the parties. It has been recognised that the interpretation of the section within the United States has been varied.²⁰²

²⁰¹ Finn, above n 40, at 384.

²⁰² Paterson, above n 1, at 279. The issue of exclusion of good faith obligations in the United States is further discussed in Chapter 6.

Clearly it is not within the power of the New Zealand judiciary to impose a rule of exclusion analogous to that within the Uniform Commercial Code. Thus, it may be necessary for the subject doctrine to be introduced through legislation which could contain a similar rule to that relating to exclusion in the Uniform Commercial Code. This could ensure that the good faith duty would have the potency and wide ranging effects envisaged by proponents. Parliament has displayed a willingness to restrict the freedom of contracting parties to contract out of certain statutory obligations where it deems those obligations to be fundamental. For example, it is not possible to contract out of the Consumer Guarantees Act 1993²⁰³, or the Credit Contracts and Consumer Finance Act 2003.²⁰⁴ Should a doctrine of good faith receive statutory codification then conceivably similar restrictions may be placed on the contracting parties.

It is outside the scope of this thesis to extensively consider a statutory obligation of contractual good faith. The subject doctrine appraised within this thesis is one which would be judicially introduced. Nonetheless, the prospective limits of a judicial doctrine of contractual good faith relative to a legislative rule are recognised.

2.6 Summary:

This chapter has sought to explain the general aspects of the doctrine of good faith being appraised within this thesis. In considering the two primary means by which good faith may be incorporated by the courts into New Zealand law, the constructivist methodology was preferred over the implied term methodology. On this rationale a contract could be construed to require good faith. This construction may suggest that contractual discretions, powers and rights must be exercised in good faith. Further, a free-standing obligation of good faith might be created in appropriate circumstances as an incidence of construction.

²⁰³ Section 43 Consumer Guarantees Act 1993.

²⁰⁴ Section 135 Credit Contracts and Consumer Finance Act 2003.

It has been shown that the subject doctrine may be of potential benefit in the context of agreements to negotiate. Conceivably, the doctrine could be invoked by the courts to give effect to agreements to negotiate which have hitherto been deemed unenforceable. The beneficial outcome would be to better align contract law with the expectations of commercial parties in New Zealand.

However, the analysis has also served to demonstrate that the subject doctrine would be considerably more limited in scope than proponents of good faith may desire. The doctrine would be grounded in the common law of contract. It would not assume equitable characteristics. Accordingly good faith would have little application to pre-contractual negotiations in the absence of a preliminary agreement. Certainly it would have no application where a binding contract does not come into force. Moreover, the application of the common law doctrine could be fettered or excluded by agreement. In the result, the frequency of application and the potency of the subject doctrine is likely to be restricted to some extent. Opponents of good faith are liable to suggest that these outcomes are a minimum requirement for the preservation of classical contract theory and contractual autonomy. On the other hand, ardent good faith proponents should logically favour the introduction of obligations of good faith by way of legislation to ensure its wide ranging and universal effect. Based on either viewpoint, these results militate against the judicial introduction of good faith in New Zealand law by means of the subject doctrine.

Chapter 3

Definition and Application of Good Faith

3.1 Chapter Introduction:

Good faith is a nebulous idea. When the context in which it is sought to be applied changes, it is capable of taking on expanded or altogether new meanings.¹ Often an attempt to explain the concept of good faith renders an explanation of the explanation necessary.²

One of the principal objections to the introduction of a universal doctrine of good faith is that the meaning of good faith is too uncertain. It cannot be appropriately defined or applied in practice with sufficient precision. Good faith is an amorphous principle with indeterminate parameters.³ For example, whilst it is agreed that a doctrine of good faith would impose some restriction on the pursuit of self-interest, the extent of that restriction is not apparent.⁴ Further, the meaning of good faith is liable to vary between different people, in different moods, at different times, and in different places.⁵ Accordingly, a doctrine of good faith would be the subject of too much judicial discretion if it were to become part of New Zealand contract law.

¹ See H K Lücke, 'Good Faith and Contractual Performance' in Paul Finn (ed), *Essays on Contract* (1987), at 160.

² *State v Robinson*, 23 SW 1066, at 1069 (1893).

³ Joseph Thompson, 'Good Faith in Contracting: A Sceptical View' in Angelo Forte (ed), *Good Faith in Contract and Property Law* (1999), at 75.

⁴ Roger Brownsword, 'Positive, Negative, Neutral: the Reception of Good Faith in English Contract Law' in Roger Brownsword, Norma Hird and Geraint Howells (eds), *Good Faith in Contract* (1999), at 16.

⁵ Michael Bridge, 'Does Anglo-Canadian Contract Law Need a Doctrine of Good Faith?' (1984) 9 *Canadian Business Law Journal* 385, at 407.

In light of this fundamental objection, the purpose of this chapter is to explore the meaning of contractual good faith. It will further evaluate whether the good faith concept could be applied with sufficient certainty to allow for the introduction of a universal contractual doctrine within New Zealand. Part 3.2 considers the purpose of a good faith doctrine, recognising that its envisaged function should play a role in informing the prospective conceptualisation of good faith. Part 3.3 evaluates whether a characterisation of good faith based on bad faith conduct is appropriate. Part 3.4 advances a definition of good faith based on cooperation, honesty and reasonableness. Part 3.5 highlights the various meanings and applications of good faith in specific classes of contracts under which such obligations currently apply in New Zealand. This analysis is used to determine whether those meanings might be of any utility in formulating a potential definition of good faith in the context of the subject doctrine. Part 3.6 provides an appraisal of whether the definition of good faith, and therefore the conduct required of the parties to discharge an obligation of good faith, can be sufficiently determined in order to permit the introduction of a universal doctrine within New Zealand. Part 3.7 draws conclusions as to the findings.

3.2 The Purpose of Good Faith:

The meaning of good faith should comprise both content and purpose.⁶ Thus, in evaluating an appropriate meaning of good faith in the context of a general doctrine, any proposed definition ought to be informed by the purpose of the doctrine. The adequacy of any legal conceptualisation is measured, in part, by whether it sufficiently serves the function of the legal obligation being formulated.⁷ Lord Steyn, speaking extra-judicially, has suggested:

⁶ See generally Rick Bigwood, 'Symposium Introduction: Confessions of a "Good Faith" Agnostic' (2005) 11 *New Zealand Business Law Quarterly* 371, at 373.

⁷ Robert S Summers, 'The General Duty of Good Faith – Its Recognition and Conceptualization' (1982) 67 *Cornell Law Review* 810, at 818.

[I]t is right that academic lawyers, practitioners and judges should constantly consider whether rules of law under consideration serve the purpose which led to their formation. Or, putting it more simply, we must never lose sight of Lord Reid's observation in *Cartledge v E Jopling & Sons Ltd* that "The common law ought never to produce a wholly unreasonable result..."⁸

Therefore, it is necessary to briefly identify the envisaged purposes of the subject doctrine before embarking on a discussion of the meaning and content of good faith.

The most fundamental goal of a doctrine of good faith is to render the law of contract in New Zealand more responsive to the needs of commerce and the reasonable expectations of contracting parties and the commercial community.⁹ Reference to 'reasonable expectations' derives from the observations of Steyn J who, in *First Energy (UK) Ltd v Hungarian International Bank Ltd*, opined:

A theme that runs through our law of contract is that the reasonable expectations of honest men must be protected. It is not a rule or principle of law. It is the objective which has been and still is the principal moulding force of our law of contract...[I]f the prima facie solution to a problem runs counter to the reasonable expectations of honest men, this criterion sometimes requires a rigorous examination of the problem to ascertain whether the law does indeed compel demonstrable unfairness.¹⁰

The idea of reasonable expectations in the field of contract law has attained much popularity. New Zealand contract law is based on an objective theory of contract. This involves the observance of an objective external standard. As a result it is possible that reasonable expectations may be contravened where a contracting party adheres to the letter of a contract but acts in a manner not within the reasonable contemplation of the parties. Accordingly, Lord Steyn recognises that in order to ensure that reasonable expectations are upheld, 'it occasionally requires that the law should treat contractual

⁸ Justice Johan Steyn, 'The Role of Good Faith and Fair Dealing in Contract Law: A Hair Shirt Philosophy?' in Lord Steyn, *Democracy Through the Law* (2004), at 223.

⁹ Justice Edward Thomas, 'Good Faith in Contract: A Non-Sceptical Commentary' (2005) 11 *New Zealand Business Law Quarterly* 391, at 393.

¹⁰ [1993] Lloyd's Rep 194, at 196.

obligations as defeasible or that a discretionary remedy should be denied.’¹¹ Conceivably contractual good faith is a means by which reasonable expectations can be protected and enforced. The introduction of a doctrine of good faith may allow the law to better give effect to the spirit of contracts in a way which appropriately prioritises the reasonable expectations of contracting parties.¹² Proponents envisage that a good faith requirement would thwart any misconception that the free market and traditional contract theory condones dishonest and unscrupulous behaviour.¹³

The concept of reasonable expectations must however be qualified to some extent. The law of contract cannot set its sights too high.¹⁴ The notion of reasonable expectations should not reflect the viewpoint of a moral philosopher.¹⁵ Instead the focus should be on the outlook of ordinary right thinking people. This rings true particularly in the context of commercial expectations where the interests of proper commerce should prevail over vague standards of morality. The function of good faith should be to satisfy the reasonable expectations of the parties rather than to punish moral wrongdoing.¹⁶ Reasonable expectations are liable to be contravened in a contractual setting where a party seeks to recapture the opportunities that he or she forwent upon entering the agreement.¹⁷ A proposed definition and application of good faith should prevent a contracting party from achieving this windfall. It follows that good faith should operate to restrict a contracting party from exercising a discretion in a way that falls outside the justified expectations of the parties at the time of contract formation.¹⁸ Further, good faith

¹¹ Lord Steyn, above n 8, at 213.

¹² See Brownsword, above n 4, at 27.

¹³ See Thomas, above n 9, at 393.

¹⁴ Lord Steyn, above n 8, at 222.

¹⁵ Ibid, at 223. Cf Duncan Kennedy, ‘Form and Substance in Private Law Adjudication’ (1976) 89 *Harvard Law Review* 1685, at 1721 (advocating an obligation to act altruistically).

¹⁶ See generally *Co-operative Insurance Society Ltd v Argyll Stores Ltd* [1997] 3 All ER 297, at 305 per Lord Hoffmann.

¹⁷ Steven Burton, ‘Breach of Contract and the Common Law Duty to Perform in Good Faith’ (1980) 94 *Harvard Law Review* 369, at 373. See Chapter 5 for further discussion of this rationale.

¹⁸ See Elizabeth Peden, ‘The Meaning of Contractual “Good Faith”’ (2002) 22 *Australian Bar Review* 235.

could require the parties to behave in an objectively reasonable manner in the event that an unforeseen contingency arises. The notion of reasonable expectations therefore has relevance to the apportionment of unanticipated contractual gains or losses.

A law of contract which gives effect to reasonable expectations is also likely to promote a culture of trust and cooperation as a corollary.¹⁹ This outcome may conceivably enhance economic efficiency.²⁰ The need for the law to promote cooperation has been recognised from a commercial standpoint.²¹ Business could not be carried on smoothly without contractual cooperation. A contracting party could not rely on realising the full benefit of his or her contract.²²

The protection of reasonable expectations and the promotion of contractual cooperation subsume a number of more specific objectives. Four such objectives are identified by Thompson.²³ Firstly, a doctrine of good faith may serve to prevent dishonesty. This may require negotiating parties to disclose material information. Similarly, good faith may imply that contractual rights and powers must be exercised for a proper purpose. A dishonest motive might not be tolerated. These applications are analysed further in Chapter 4. Secondly, good faith may ensure that a person keeps his or her word. Good faith may more readily require a promisor to be held to his or her word than existing contractual doctrine would allow. Good faith may therefore bear similarities to the notion of promissory estoppel. Again, this contention is discussed in Chapter 4. Thirdly, good faith may prevent a contracting party from, as a result of his or her behaviour, making the position of the other contracting party worse. For example, it was noted in Chapter 2 that a good faith doctrine may preclude a party to an agreement to negotiate from terminating negotiations for reasons which are capricious or arbitrary. Finally, good faith may relieve

¹⁹ See Brownsword, above n 4, at 32.

²⁰ Ibid. An economic analysis of good faith is undertaken in Chapter 5.

²¹ See generally Alessandro Arrighetti, Reinhard Bachmann and Simon Deakin, 'Contract Law, Social Norms and Inter-Firm Cooperation' (1997) 21 *Cambridge Journal of Economics* 171.

²² See generally John Burrows, 'Contractual Co-Operation and the Implied Term' (1968) 31 *Modern Law Review* 380.

²³ See generally Thompson, above n 3, at 66-70.

contracting parties from absurd consequences which flow from their agreement. Like the doctrine of frustration, good faith might be utilised by the courts to construe a contract in a manner which produces a reasonable and substantively fair result. Conceivably this objective might best be attained by incorporating good faith into contract law as a principle of construction.

The subject doctrine of good faith may also perform a basic pragmatic purpose in respect of the management of the law of contract in addition to the more idealistic aspirations identified above. Essentially good faith may act as a unifying principle. It could address bad faith conduct through a rational, direct and open method. This may be preferable to the existing piecemeal and back door approach currently prevailing within the common law in New Zealand and other Commonwealth countries.²⁴ Conceivably a more unified approach may result in greater efficiency in the administration of the law of contract. The judiciary would not be forced to covertly stretch and manipulate existing doctrine. There would be no necessity for *sub rosa* adjudication.²⁵ The judiciary would be armed with a flexible remedy to justify its decision making. The perceived benefits of a general principle of good faith as compared to the current approach in New Zealand are extensively explored in Chapter 4.

The purpose of good faith, as envisaged by proponents of the doctrine, can therefore be summarised by three fundamental goals namely, the protection of the reasonable expectations of contracting parties, the promotion of cooperation and trust, and the unification of existing legal and equitable principles into a more coherent and positive doctrine. The following discussion of the meaning and application of good faith is undertaken with these purposes in mind.

²⁴ See generally William Tetley, 'Good Faith in Contract: Particularly in the Contracts of Arbitration and Chartering' (2004) 35 *Journal of Maritime Law and Commerce* 561, at 584

²⁵ Brownsword, above n 4, at 32.

3.3 Defining Good Faith as the Absence of Bad Faith Conduct – Excluder Analysis:

Good faith has been famously defined by Summers as the absence of bad faith conduct.²⁶ This exclusionist definition has an attractive simplicity. Apparently actions taken in bad faith can be readily identified. Bad faith supposedly has an identifiable meaning.²⁷ Thus it is relatively straightforward to distinguish between good faith and bad faith conduct. Summers observes that if good faith had an unambiguous meaning of its own then there would be no need to derive a definition from its opposite but

...good faith is not that kind of doctrine. In contract law, taken as a whole, good faith is an “excluder.” It is a phrase without general meaning (or meanings of its own) and serves to exclude a wide range of heterogeneous forms of bad faith...Aristotle was one of the first to recognize that the function of some words and phrases is not to convey general, extractable meanings of their own, but rather to exclude one or more of a variety of things.²⁸

Summers therefore contends that it is only possible to formulate positive meanings for particular uses of good faith by ruling out forms of bad faith. It is unlikely that these meanings may be generalised into a single, positive and unifying definition of good faith.²⁹ Judges should not attempt to formulate restrictive definitions of good faith. Instead the judiciary should carefully characterise the particular forms of bad faith which justifies a legal remedy. Ultimately, ‘bad faith rather than good faith wears the pants in this dichotomy.’³⁰

It is submitted that a definition of good faith based on the conceptualisation advanced by Summers is not appropriate if a doctrine of contractual good faith were to be introduced

²⁶ Robert S Summers, “‘Good faith’ in General Contract Law and the Sales Provisions of the Uniform Commercial Code” (1968) 54 *Virginia Law Review* 195.

²⁷ See Michael Bridge, ‘Doubting Good Faith’ (2005) 11 *New Zealand Business Law Quarterly* 426, at 429.

²⁸ Summers, above n 26, at 201.

²⁹ Summers, above n 7, at 820.

³⁰ Summers, above n 26, at 207.

within New Zealand. The definition is incompatible with the envisaged purposes of the doctrine. The justification for this inference is explored below.

Arguably a definition of good faith based on bad faith could not positively contribute to the existing law of contract within New Zealand. The regulation of bad faith conduct in relation to contracts is already encapsulated, in whole or in part, within existing legal and equitable principles such as misrepresentation, duress, undue influence and unconscionability. Thus it is not clear what the benefit is of shifting from a conceptualisation of bad faith conduct to instead focus on a symmetrical and mutually dependent definition of good faith.³¹ Indeed, the subject doctrine would not produce any different legal outcomes within New Zealand if good faith is merely defined with reference to existing rules. There would be no enhancement of the protection of reasonable expectations or improved trust and cooperation within contractual relationships. At best, good faith might serve some limited benefit as a unifying principle. More likely, the doctrine would assume a reductionist character. It would add nothing to the existing tools of contract law in New Zealand.³² The application of contract principles under the guise of good faith would merely be a rebadging of what the courts already do.³³ The result is liable to be unnecessary confusion. Good faith would not have any positive pragmatic effect on the law within New Zealand.

This outcome is inconsistent with the views of good faith proponents who suggest that the doctrine would create new obligations to provide a remedy in situations where the existing rules of contract cannot reach or appear unable to reach.³⁴ Good faith could fill any space that may exist between the current doctrines.³⁵ *Ipsa facto*, the breadth of the

³¹ See Marietta Auer, “‘Good Faith’ and its German Sources: A Structural Framework for the ‘Good Faith’ Debate in General Contract Law and Under the Uniform Commercial Code” (2001), at 104 <<http://www.law.harvard.edu/academics/graduate/publications/papers/auer.pdf9>>, at 26 February 2008.

³² Bridge, above n 27, at 428.

³³ *Ibid.* This argument is further discussed in Chapter 4.

³⁴ See Thomas, above n 9, at 394. See also Hector MacQueen, ‘Good Faith in the Scot’s Law of Contract’ in Forte (ed), above n 3, at 37.

³⁵ Brownsword, above n 4, at 27.

law regulating bad faith conduct must be expanded if this result is to be achieved under Summers' definition. Conceivably this would be attained through the incremental development and broadening of existing legal and equitable doctrines. Arguably this was what Summers was effectively advocating by suggesting that the judiciary must focus on bad faith rather than good faith. However, there are two obvious problems with this approach.

Firstly, Summers' definition fails to articulate clearly what bad faith conduct is, if it is to be understood as distinct from, or wider than, conduct already attracting a remedy under the existing law. Accordingly, there is no guidance for the judiciary in cases involving novel allegations of bad faith which do not fit within existing doctrinal categories.³⁶ The excluder definition is no more certain than a positive definition of good faith.

Secondly, it was noted above that proponents of a good faith doctrine argue that whereas the existing law requires judges to deal with good faith in an unclear and roundabout fashion, an introduction of the subject doctrine would permit judges to directly and openly confront breaches of good faith. That argument loses impetus if the definition of good faith is to be founded on a more stringent regulation of bad faith conduct under the existing back door methods.

Additional criticisms can be leveled at the excluder definition. Good faith and bad faith are not necessarily symmetrical. Bad faith may set a minimal standard which contracting parties must meet whilst good faith may be more a standard of aspiration.³⁷ Good faith is likely to require positive action such as cooperation, support and assistance.³⁸ Bad faith conduct, as understood within the existing law, is focused on negative requirements such

³⁶ It has been recognised that Summers' approach 'provides absolutely no guidance to the disposition of future cases, except to the extent that they may be on all fours with a decided case.': Bridge, above n 5, at 398.

³⁷ Brownsword, above n 4, at 17, citing Lon L Fuller, *The Morality of Law* (revised ed, 1969).

³⁸ Ibid.

as non-victimisation, non-exploitation and non-opportunism.³⁹ There is a void between those positive and negative requirements which a definition based on bad faith cannot subsume. Thus, a definition focused on bad faith conduct might be unable to deal with instances where the defendant adopts a passive role.⁴⁰ To take a hypothetical example, a prospective purchaser of land may know that it is rich in oil and also that the vendor is ignorant of this fact. The purchaser may acquire the land at a deflated price by omitting to disclose the information to the vendor.⁴¹ In such a case the purchaser has not actively engaged in bad faith conduct. Arguably however his or her non-disclosure may amount to a breach of good faith.⁴² A good faith doctrine might compel the purchaser to warn the vendor. The excluder definition may be inadequate in this scenario.

Accordingly, the definition advanced by Summers would be inappropriate if a general doctrine of good faith were to be introduced within New Zealand law. Such a definition would not achieve the desired purposes of the good faith obligation. An affirmative definition is required to justify support for the subject doctrine. Thus, the excluder definition must be abandoned in favour of a positive conceptualisation of good faith.

3.4 Cooperation, Honesty and Reasonableness:

In light of the foregoing findings, a positive definition of good faith is required to allow for the introduction of a doctrine of good faith in New Zealand. In an oft-cited article, Sir Anthony Mason suggests that good faith embraces no less than three related notions:

³⁹ Ibid.

⁴⁰ See Bridge, above n 27, at 429.

⁴¹ For a further discussion of the hypothetical example see Bridge, above n 27, at 429-430.

⁴² It is debatable whether good faith would be contravened in this scenario. It has been noted that ‘people disagree whether it is dishonest consciously to remain silent where one’s intervention (say, by disclosure of information) would rescue another from the risk of making a harmful mistake.’: Jane Stapleton, ‘Good Faith in Private Law’ (1999) 52 *Current Legal Problems* 1, at 9. The example is further explored in Chapter 5.

(1) an obligation on the parties to co-operate in achieving the contractual objects (loyalty to the promise itself); (2) compliance with honest standards of conduct; and (3) compliance with standards of conduct which are reasonable having regard to the interests of the parties.⁴³

To summarise, good faith encapsulates cooperative, honest and reasonable conduct. This conceptualisation has received judicial and academic support.⁴⁴

An important implication of the definition advanced by Mason is that it does not absolutely preclude a party from acting in his or her self-interest.⁴⁵ Thus in *Topline International Ltd v Cellular Improvements Ltd* Venning J observed that an obligation of good faith does not require contracting parties to act only in their common interests.⁴⁶ Each party is entitled to both protect and advance his or her own commercial position. That outcome must be preserved to facilitate competition and efficiency. Accordingly, good faith is not synonymous with a fiduciary duty. It does not require a contracting party to subordinate his or her own interest to the interests of the other.⁴⁷ Nonetheless, a duty of good faith requires that a party must have regard to the reasonable expectations of the other party to the relationship. It exacts a degree of neighbourhood responsibility.⁴⁸ Good faith may curtail the use of power over another. In this respect, a contracting party may

⁴³ Sir Anthony Mason, 'Contract, Good Faith and Equitable Standards in Fair Dealing' (2000) 116 *Law Quarterly Review* 66, at 69.

⁴⁴ For judicial citation of Mason's definition see *Vero Insurance New Zealand Ltd v Fleet Insurance & Risk Management Ltd* (High Court, Auckland, CIV 2007-404-001438, 21 May 2007, Asher J); *Bobux Marketing Ltd v Raynor Marketing Ltd* [2002] 1 NZLR 506; *Burger King Corp v Hungry Jack's Pty Ltd* [2001] NSWCA 187; *Alcatel Australia Ltd v Scarcella* (1998) 44 NSWLR 349; *Hughes Aircraft Systems International v Airservices Australia* (1997) 146 ALR 1. For academic citation see Justice Paul Finn, 'Good Faith and Fair Dealing: Australia' (2005) 11 *New Zealand Business Law Quarterly* 378, at 381; Adam Wallwork, 'A Requirement of Good Faith in Construction Contracts?' (2004) 20 *Building and Construction Law* 257; Peden, above n 18.

⁴⁵ See Finn, above n 44, at 381.

⁴⁶ (High Court, Auckland, CP 144-SW02, 17 March 2003), at [103].

⁴⁷ *MacLean v Arklow Investments Ltd* [1998] 3 NZLR 680, at 723 per Thomas J.

⁴⁸ See Finn, above n 44, at 382.

be obliged to consider the legitimate interests of the other party when pursuing self-interested ends.⁴⁹

The elements of the definition proffered by Mason, namely cooperation, honesty and reasonableness will each be discussed in turn below.

3.4.1 Cooperation:

It was identified above that one of the purposes of good faith is to promote cooperation and trust amongst contracting parties. Obligations of cooperation already exist within the common law to some extent. In *Concrete Pty Ltd v Parramatta Design & Developments Pty Ltd* Callinan J noted that it is a well-settled rule of construction of contracts within Australia that each party owes the other a duty to cooperate.⁵⁰ This duty requires that contracting parties must carry out those acts which are necessary for the performance of the contract.

So, for example, in *Mackay v Dick*⁵¹ it was held that a contracting party must cooperate by not preventing the fulfillment of a condition by the other contracting party. The contract is taken to be satisfied where a party engages in such preventative and uncooperative conduct.

Broadly, a duty of cooperation has been taken to mean an obligation not to prevent the fulfilment of the contractual purpose of the other contracting party.⁵² This means that performance by the other party to the contract must not be hindered.⁵³ Perhaps a more

⁴⁹ See Brownsword, above n 4, at 15.

⁵⁰ (2006) 231 ALR 663, at 704 per Callinan J.

⁵¹ (1881) 6 App Cas 251.

⁵² *Shepherd v Felt and Textiles of Australia Ltd* (1931) 45 CLR 359, at 378 per Dixon J.

⁵³ *William Cory & Son LD v London Corporation* [1951] 2 KB 476, at 484 per Lord Asquith. Analogy can be drawn with the land law principle of non-derogation from the grant which embodies the maxim that ‘a man who sells or leases land [] may not act so as to frustrate the purpose for which in the contemplation of both parties the land was hired.’: *Lyttelton Times Co Ltd v Warners Ltd* [1907] AC 476, at 481 per Lord

stringent and positive application of a duty of cooperation is that each party owes an obligation to the other to do all that is reasonably necessary to secure the intended performance of the contract.⁵⁴ Overall, the essence of the duty is that contracting parties should facilitate the performance and fulfilment of the contract.

Unlike the approach taken in Australia, the New Zealand courts have not accepted that there is a general duty to cooperate which applies to every contract. Instead, a term requiring cooperation will be implied if the circumstances so warrant. In *Devonport Borough Council v Robbins* Cooke J recognised that the question is one of construction based on the particular contract.⁵⁵ The circumstances of the case will determine in what respects and the extent to which a contracting party is obliged to cooperate with the other. Duties of cooperation are often implied into joint venture arrangements within New Zealand. In *Prophecy Mining No Liability v Kiwi Gold No Liability* Thomas J held that parties to a joint venture agreement were obliged to cooperate and assist each other in order to implement their joint enterprise.⁵⁶ This is a logical outcome. Joint venture arrangements and other types of correspondingly relational contracts are predicated on collaborative conduct between the parties.

It is therefore evident that an obligation of cooperation in contracts is neither foreign to the common law nor manifestly uncertain. Moreover, obligations of cooperation like

Loreburn LC. Notably, the obligation not to derogate from the grant is a separate and independent obligation and applies even if the contractual agreement excludes the application of implied terms. See *Shadbolt v The King* (1909) 28 NZLR 1026. See also *Nordern v Blueport Enterprises Ltd* [1996] 3 NZLR 450.

⁵⁴ *Secured Income Real Estate (Australia) Ltd v St Martins Investments Pty Ltd* (1979) 144 CLR 596, at 607 per Mason J.

⁵⁵ [1979] 1 NZLR 1, at 29. For a discussion of an attempt to imply a term of cooperation relying on *Devonport Borough Council v Robbins* see *Pacifica Shipping (1985) Ltd v Centreport Ltd* (High Court, Wellington, CP 230100, 31 October 2000, Durie J), at [16].

⁵⁶ (High Court, Auckland, CP 2264/88, 8 August 1990), at 14; (Court of Appeal, CA 30/91, 18 July 1991). An obligation to cooperate has also been implied into a contract for the sale and implementation of software. See *Williams & Adams Ltd v Computer Systems Implementation Ltd* (High Court, Wellington, CP 215/92, 9 March 1995, Ellis J).

those found in relational contracts bears analogy to a duty of good faith.⁵⁷ Often cooperation is seen as equivalent to good faith.⁵⁸ Indeed, judicially imposed requirements of cooperation may be perceived as attempts to introduce obligations of good faith within the common law.

Accordingly it is submitted that an obligation of cooperation can be taken to be an element of the definition of good faith. Cooperative behaviour is a norm of conduct required for the observance of contractual good faith.

3.4.2 Honesty:

In the context of good faith under the subject doctrine, it is contentious whether the honesty element means only subjective honesty or whether it incorporates objective honesty. Some favour the former.⁵⁹ Subjective honesty implies honesty in the sense of a clear conscience or lack of a guilty mind.⁶⁰ In order for there to be a breach of good faith the plaintiff would, for example, have to establish that the defendant intended to deceive the plaintiff, or knowingly exercised a contractual discretion for an ulterior motive.

The judiciary will be faced with the difficult task of determining the actual intentions of the contracting parties if good faith is to be characterised by honesty in the subjective sense. In the dissenting opinion of Bingham LJ in *Walford v Miles* it was suggested that subjective intentions could be hard to decide, but no more difficult than certain other matters which regularly require judicial determination.⁶¹ For example, judges may often

⁵⁷ See John Burrows, Jeremy Finn and Stephen Todd, *Law of Contract in New Zealand* (3rd ed, 2007), at 19.

⁵⁸ See Elizabeth Peden, *Good Faith in the Performance of Contracts* (2003), at 170.

⁵⁹ For example, Peden suggests that subjective good faith means a lack of 'ill-will' and that the 'subjective sense of good faith would be appropriate in an imposed common law obligation of good faith in contracts.': Peden, above n 18, at 235.

⁶⁰ David McLauchlan, 'The Agreement to Negotiate in Good Faith: A Non-Justiciable Contract?' (2005) 11 *New Zealand Business Law Quarterly* 454, at 462.

⁶¹ (1991) 62 P & CR 410, at 420 (CA); [1992] 1 All ER 453 (HL).

be charged with making factual findings as to subjective intention in criminal proceedings.

However, the view of Bingham LJ was not endorsed by the House of Lords.⁶² In *Wellington City Council v Body Corporate 51702 (Wellington)* the New Zealand Court of Appeal went so far as to suggest that the determination of subjective good faith not only gives rise to an evidential difficulty but is so indeterminate as to not be capable of judicial consideration.⁶³

Arguably the Court of Appeal took the argument too far. Nonetheless, the perceived problems can be remedied by recognising that any reference to honesty when defining good faith should incorporate an objective element. In no part of commercial law is honesty determined by a purely subjective ‘Robin Hood’ standard.⁶⁴ Dishonesty in a civil liability sense is quite distinct from dishonesty in a criminal liability sense.⁶⁵ Thus, a person may be regarded as dishonest even if he or she does not contravene his or her own standard of honesty. In legal terms, good faith is not always to be measured by what a contracting party believes to be right or wrong.⁶⁶ Instead honest good faith conduct must be gauged by that standard which the law deems appropriate to be observed between all contracting parties in their dealings with one another.

Guidance may perhaps be drawn from equity in determining an appropriate measure of honesty for good faith contractual conduct. In *Twinsectra Ltd v Yardley*⁶⁷ the House of Lords considered the meaning of honesty in the context of liability for the assistance of a

⁶² *Walford v Miles* [1992] 1 All ER 453.

⁶³ [2002] 3 NZLR 486, at 495-496 per Tipping J.

⁶⁴ *Twinsectra Ltd v Yardley* [2002] 2 All ER 377, at 384 per Lord Hutton. See also McLauchlan, above n 60, at 462.

⁶⁵ See *Royal Brunei Airlines Sdn Bhd v Tan* [1995] 3 All ER 97, at 105 per Lord Nicholls. For a comprehensive discussion of dishonesty in the context of criminal liability see *R v Hayes* [2008] 2 NZLR 321.

⁶⁶ *First National Bank of Chicago v Trebein Company* (1898) 59 Ohio St 316, at 324-325 per Minshall J.

⁶⁷ [2002] 2 All ER 377.

breach of trust. Such liability often arises in the circumstance of commercial and professional relationships.⁶⁸ The majority advocated a mixed subjective and objective test for dishonesty. In order to be found dishonest, the defendant would have to have breached the ordinary standards of reasonable and honest people but also he or she would have to appreciate that by those standards the conduct was dishonest.⁶⁹ Lord Millett (dissenting) omitted the last requirement. A defendant would not have to appreciate that he or she was acting dishonestly; it would be sufficient that he or she was.⁷⁰ His Lordship cogently justified his conclusion on the basis that civil liability is predicated on the conduct of the defendant rather than his or her state of mind.⁷¹ Culpability results from unreasonable or negligent behaviour. Accordingly, neither an honest motive nor an innocent conscience can absolve a defendant who is objectively dishonest.

The test propounded by Lord Millett should be preferred in the context of honesty as a conceptualisation of good faith under the subject doctrine.⁷² The envisaged purpose of a

⁶⁸ See for example *Royal Brunei Airlines Sdn Bhd v Tan* [1995] 3 All ER 97; *Al-Sabah v Grupo* [2001] Lloyd's Rep Bank 36; *US International Marketing Ltd v National Bank of NZ Ltd* [2004] 1 NZLR 589; *Equiticorp Industries Group Ltd (In Statutory Management) v The Crown (Judgment no 47)* [1998] 2 NZLR 481.

⁶⁹ [2002] 2 All ER 377, at 384 per Lord Hutton. This test has also been utilised in criminal law in the context of obtaining property by deception. Thus it has been observed that it 'is no defence for a man to say, "I knew that what I was doing is generally regarded as dishonest; but I do not regard it as dishonest myself. Therefore I am not guilty." What he is, however, entitled to say is, "I did not know that anybody would regard what I was doing as dishonest."': *R v Ghosh* [1982] 2 All ER 689, at 696 per Lord Lane CJ.

⁷⁰ *Ibid*, at 408.

⁷¹ *Ibid*, at 407 and 409. It seems anomalous that a dishonest state of mind is not necessary for liability for inducing a breach of contract but such a state of mind is required for dishonest assistance, especially where equity is generally thought to impose more stringent requirements than the common law. See Rosy Thornton, 'Dishonest Assistance: Guilty Conduct or a Guilty Mind?' [2002] *Cambridge Law Journal* 524, at 526.

⁷² Notably, the New Zealand Court of Appeal has left open the issue of whether to adopt the majority test or Lord Millett's test for dishonest assistance. See *US International Marketing Ltd v National Bank of NZ Ltd* [2004] 1 NZLR 589. The Privy Council has since favoured a more objective test by recognising that the subjective component is only relevant to assessing what objective standard of honesty is required. In determining the standard the Court should consider the personal attributes of the defendant and his or her

good faith doctrine is to protect the reasonable expectations of contracting parties. It would be anomalous if those reasonable expectations were subject to, or qualified by, the subjective viewpoints of a contracting counterparty. In keeping with traditional notions of civil liability, contractual good faith should be defined predominantly with regard to the objective nature of the impugned conduct and its effect on the rights of others. A requirement for the transgressor to act with a guilty state of mind should not enter into the equation.

This outcome is pragmatic. It avoids the necessity to prove subjective intentions. Further, in many instances those defending allegations of a breach of contractual good faith will be corporations. It is far more logical to evaluate the conduct of a company from an objective perspective. Imputation of the guilty knowledge of corporate controllers to a fictitious legal entity can be an attenuated process, which is best avoided.⁷³

Despite having determined that good faith may be characterised by objective honesty, it is recognised that a conceptualisation of good faith cannot be limited solely to honesty. For instance, a contractual power may be exercised in a capricious manner with an improper motive but the transgressor may openly disclose that motive to the contacting counterparty. Although the defendant has not acted in an objectively dishonest manner per se, conceivably he or she has still acted in breach of good faith.

intelligence and experience. See *Barlow Clowes International Ltd (in liquidation) v Eurotrust International Ltd* [2006] 1 All ER 333. For a comprehensive discussion see Jessica Palmer, 'The Privy Council on Being (Dis)Honest About Dishonest Assistance' (2005) 24 *University of Queensland Law Journal* 539. It is conceded that divorcing the state of mind of the defendant from the inquiry may produce severe outcomes in some instances. Take, for example, 'a man who comes from a country where public transport is free. On his first day here he travels on a bus. He gets off without paying. He never had any intention of paying. His mind is clearly honest; but his conduct, judged objectively by what he has done, is dishonest.' *R v Ghosh* [1982] 2 All ER 689, at 696 per Lord Lane CJ. Nonetheless, whilst the more stringent test for dishonesty may not be warranted in the criminal law, it is submitted that it is appropriate for the determination of civil liability.

⁷³ It has been suggested that attributing the knowledge of corporate controllers to a corporation seriously distorts the principle of mens rea. See Rebecca Rose, 'Corporate Criminal Liability: A Paradox of Hope' (2006) 14 *Waikato Law Review* 52, at 61.

For example, in *The Atlantic Baron*⁷⁴ a firm of shipbuilders agreed to build a tanker for the plaintiff. Payment was to be made in five instalments. There was a currency decline after the first instalment was paid. In consequence, the shipbuilders demanded a 10 per cent increase in the price. They threatened not to perform if the additional payment was not forthcoming. Both parties were well aware that the reason for the threat was the exchange rate change. In fact, the plaintiff had made the shipbuilders aware that its business was also adversely affected by the currency devaluation.⁷⁵ Mocatta J held that the threat amounted to economic duress.⁷⁶ At no time did the shipbuilders act dishonestly. The reason for the undue pressure was made clear. Nonetheless, the conduct displayed by the shipbuilders arguably contravened standards of good faith. The shipbuilders were endeavouring to recover opportunities forgone upon contracting. They sought to recapture the opportunity to include provision for currency alterations which opportunity they had relinquished upon contracting by assuming the risks of currency fluctuations. The case clearly evidences that a definition of good faith based only on honesty is not sufficient. In some instances a different, and perhaps more stringent, measure of conduct may be required.

A definition of good faith which requires an element of reasonableness may overcome the limitations of the honesty element. Certainly, reasonableness may impose a more stringent standard than honesty. A person who acts reasonably must be acting honestly but it is possible that a person acting honestly may be acting unreasonably.⁷⁷ Some believe any concept of reasonableness within the meaning of good faith must be seen as limited to an element of honesty.⁷⁸ The scenario presented by *The Atlantic Baron* case

⁷⁴ [1978] 3 All ER 1170.

⁷⁵ Ibid, at 1174 per Mocatta J.

⁷⁶ However, relief was not granted because the plaintiff had affirmed the contract by its conduct. Ibid, at 1184.

⁷⁷ Thus it has been suggested that reasonableness and fair dealing subsumes the concept of honesty. See generally Finn, above n 44, at 380.

⁷⁸ See John Carter and Elizabeth Peden, 'Good Faith in Australian Contract Law' (2003) 19 *Journal of Contract Law* 155.

shows this should not necessarily be the case. It is therefore necessary to determine whether reasonableness is an appropriate element of the definition of good faith. This is explored below.

3.4.3 Reasonableness:

There is little consensus as to whether contractual good faith includes a duty of reasonableness.⁷⁹ Plainly there is a close association between good faith and reasonableness. This is evidenced by the overlap of content in many applications of the concepts of reasonableness and good faith.⁸⁰

Judicial opinion on the relationship between reasonableness and good faith is varied. In *Minster Trust Ltd v Traps Tractors Ltd* Devlin J suggested that conduct may be unreasonable notwithstanding that it may be conceived in good faith.⁸¹ Likewise, in *Vero Insurance New Zealand Ltd v Fleet Insurance & Risk Management Ltd* Asher J said that a requirement for good faith conduct is not commensurate with a requirement for reasonableness.⁸²

However, there is an evolving tendency to equate an obligation of good faith with a requirement to act reasonably. This is an incidence of the acceptance that good faith

⁷⁹ See Paula Baron, 'Resistance: A Consideration of the Opposition to a Duty of Good Faith in Australian Commercial Contracts' (2005) 11 *New Zealand Business Law Quarterly* 408, at 410-411.

⁸⁰ *Renard Constructions (ME) Pty Ltd v Minister for Public Works* (1992) 26 NSWLR 234.

⁸¹ [1954] 3 All ER 136, at 145. The observation was made in relation to a clause within the terms of sale of farming equipment which required the equipment to be reconditioned to the 'satisfaction' of a third party. It was suggested that if the purchaser was to assert that the equipment was not satisfactory then the dissatisfaction of the third party would have to be a reasonably held opinion, irrespective of whether it was *bona fide*. Devlin J did not however elaborate on the distinction between reasonableness and good faith in this context.

⁸² (High Court, Auckland, CIV 2007-404-001438, 21 May 2007), at [50].

incorporates an objective standard of conduct.⁸³ In *Telecom Corporation of New Zealand Ltd v Business Associates Ltd* Richardson J recognised that good faith incorporates some objective element of reasonableness:

The content of any duty of good faith turns on the circumstances of the relationship in question. It requires consideration of what a reasonable person in the shoes of the parties will consider ought to be done by one to protect the interests of the other in the particular circumstances.⁸⁴

In *Burger King Corp v Hungry Jack's Pty Ltd* the New South Wales Court of Appeal went so far as to suggest that there is no distinction of substance between an implied term of reasonableness and one of good faith.⁸⁵

Those who oppose a requirement of reasonableness within the good faith definition argue that reasonableness, the related concept of fair dealing, and good faith, do not assume homogenous meaning and content.⁸⁶ A definition of good faith which incorporated these distinct concepts would produce a broad and vague conceptualisation.⁸⁷ In consequence, the application of good faith would be subject to an unnecessarily wide and potentially dangerous judicial discretion.⁸⁸ Judges would be permitted to pursue a normative agenda under the semblance of good faith.⁸⁹ This would be further exacerbated because the imposition of a requirement for every contracting party to act reasonably would open up

⁸³ See generally *Francis v South Sydney District Rugby League Football Club Ltd* [2002] FCA 1306, at [203] per Lindgren J.

⁸⁴ (Court of Appeal, CA 7/93, 23 June 1993), at 20.

⁸⁵ [2001] NSWCA 187.

⁸⁶ See Tyrone Carlin, 'The Rise (and Fall) of Implied Duties of Good Faith in Contractual Performance in Australia' (2002) 25 *University of New South Wales Law Journal* 99, at 121.

⁸⁷ Elizabeth Peden, 'Contractual Good Faith: Can Australia Benefit from the American Experience?' (2003) 15 *Bond Law Review* 187, at 188.

⁸⁸ David Yates, 'Commentary on "Two Concepts of Good Faith"' (1995) 8 *Journal of Contract Law* 145.

⁸⁹ See Stapleton, above n 42, at 5.

virtually every aspect of contractual performance, enforcement and termination to challenge and judicial scrutiny.⁹⁰

No doubt it would be a significant step for the courts to impose a contractual obligation of reasonableness on commercial parties interacting at arms length.⁹¹ Stapleton suggests that such a duty is both too stringent and inconsistent with good faith:

A requirement to satisfy a standard of reasonable behaviour is more demanding than the requirement of good faith. Certainly, acting in good faith is necessary for reasonable conduct: to be dishonest, deliberately contradictory, or exploitative is always unreasonable. But acting in good faith is not sufficient to satisfy a reasonableness standard: as most inadvertent negligence cases show, a person may act in good faith but nevertheless have acted unreasonably as judged by an objective standard.⁹²

Support for the idea that good faith does not require reasonable conduct has been sourced from other areas of the law. In *First City Corporation Ltd v Downsvie Nominees Ltd* Gault J recognised that a receiver who acts in good faith and honestly may still be found to have acted negligently and therefore unreasonably.⁹³ Certain statutory provisions defining good faith also appear to require more than mere negligence and unreasonableness. For example, s (1)(2) Sale of Goods Act 1908 provides:

A thing is deemed to be done in good faith within the meaning of this Act when it is in fact done honestly, whether it is done negligently or not.⁹⁴

Despite these concerns it is submitted that some element of reasonable conduct must be imported into a potential definition of contractual good faith under the subject doctrine.

⁹⁰ See John Carter and Andrew Stewart, 'Interpretation, Good Faith and the 'True Meaning' of Contracts: the Royal Botanic Decision' (2002) 18 *Journal of Contract Law* 182, at 195.

⁹¹ See generally Peden, above n 18.

⁹² Stapleton, above n 42, at 8.

⁹³ [1989] 3 NZLR 710, at 742. It has been noted in the receivership context that 'the concept of good faith should [not] be diluted by treating it as capable of being breached by conduct that is not dishonest or otherwise tainted by bad faith.' *Medforth v Blake* [2000] Ch 86, at 103 per Sir Richard Scott VC.

⁹⁴ See also Bills of Exchange Act 1908.

In addition to the rationale provided above in respect of *The Atlantic Baron* example, various other reasons may be advanced to support this finding.

Firstly, the sources relied on to justify the exclusion of reasonableness from a good faith definition under a general contractual doctrine are often taken out of context. The concept of good faith is often utilised in a wide range of legal circumstances and can therefore assume vastly different content depending on the context.⁹⁵ This is particularly evident in the varying applications of good faith under statute. Thus the meaning of good faith under contract law may be very different in meaning from good faith when it is used in the context of a person claiming to be entitled to possession of a child⁹⁶, or making a complaint about a solicitor⁹⁷, or purchasing goods where the seller has a voidable title.⁹⁸

Indeed, some statutory applications of good faith do embody elements of reasonableness. For example, in *Sojourner v Robb* Fogarty J held that the obligation of good faith on directors under s 131 Companies Act 1993 comprises an amalgam of objective and subjective standards.⁹⁹ In terms of the reasonableness standard, a consideration of how people of business might be expected to act is required.¹⁰⁰ Further, a directorial decision could not be justified if it is based on an inappropriate understanding of the interests of the company.¹⁰¹

Because of the varying meanings and applications of good faith under statute, it is submitted that legislation dealing with good faith will be of marginal or no use in

⁹⁵ See generally Thomas, above n 9, at 394-395. See also Justice Johan Steyn, 'Contract Law: Fulfilling the Reasonable Expectations of Honest Men' in Lord Steyn, above n 8, at 230.

⁹⁶ Section 210A Crimes Act 1961.

⁹⁷ Section 138(1)(c) Lawyers and Conveyancers Act 2006.

⁹⁸ Section 25 Sale of Goods Act 1908.

⁹⁹ [2006] 3 NZLR 808, at 829; aff'd [2008] 1 NZLR 751 (CA).

¹⁰⁰ Ibid, at 829.

¹⁰¹ Ibid, at 830.

determining an appropriate meaning of good faith under a contractual doctrine.¹⁰² Certainly, the fact that some specific legislative applications of good faith do not require an element of reasonableness is not justification for excluding it from a potential definition of good faith in the context of contract.

A requirement for reasonableness would ensure not only honest conduct but also fair conduct. It is noteworthy that codifications in Continental Europe pertaining to contractual good faith require fair dealing.¹⁰³ The necessity for fair dealing in the conclusion and performance of the transaction may be regarded as a critical requirement of good faith.¹⁰⁴ Fair dealing denotes that a party should act reasonably when making a contractual decision. This implies that the position of the other party should be considered.¹⁰⁵

Ultimately the issue as to whether good faith should incorporate a reasonableness standard can be resolved by looking to the envisaged purposes of the subject doctrine. Protection of reasonable expectations is paramount. Whilst attempts have been made to downgrade the notion to an expectation of mere honesty and sincerity¹⁰⁶, the desirable means by which reasonable expectations are to be protected is by insisting on objectively reasonable and fair conduct. A definition of good faith which omits elements of reasonableness and the composite concept of fair dealing would simply be too divorced from the envisaged purposes of the subject doctrine.

¹⁰² See generally Elizabeth Peden, 'The Mistake of Looking for Legislative Influence in Contractual Good Faith' (2002) 16 *Commercial Law Quarterly* 20.

¹⁰³ See for example art 1375 Italian Civil Code; art 1:102 Principles of European Contract Law.

¹⁰⁴ See Steyn, above n 95, at 378. One commentator has argued that the common law would have been better off by focusing on fair dealing and avoiding the distraction of the language of good faith altogether. See Finn, above n 44, at 378.

¹⁰⁵ Justice James Douglas, 'Exploring the Recent Uncertainty Surrounding the Implied Duty of Good Faith in Australian Contract Law: The Duty to Act Reasonably – Its Existence, Ambit and Operation' *Lexis Nexis Contract Law Master Class* (2006), at [33].

¹⁰⁶ See generally Stapleton, above n 42, at 8-9.

Acceptance of reasonableness as a facet of good faith might also countenance concerns about the indeterminate application of the subject doctrine. Regardless of what may be written about reasonableness within the common law, the concept does not attract the same fears and criticisms about uncertainty which are directed towards good faith.¹⁰⁷ The common law endorses reasonableness as an appropriate and sufficiently clear test. The courts are frequently required to determine what conduct is reasonable in negligence cases. Because reasonableness is a familiar and universally accepted concept within the common law, its incorporation into a definition of good faith may appease concerns relating to the functioning of the subject doctrine to some extent.

Accordingly it is concluded that an obligation to act in an objectively reasonable and fair manner should be included as an aspect of a prospective definition of good faith. This requirement is necessary to give effect to the envisaged purpose of the subject doctrine.

It has been determined that good faith requires cooperation, honesty and reasonable conduct. The following discussion analyses the meaning of good faith as it currently applies to specific classes of contracts. It will be determined whether those specific applications are of any benefit in shaping and applying the core definition which has been proffered.

3.5 Specific Applications of Good Faith:

3.5.1 Employment Relationships:

The Employment Relations Act 2000 (“ER Act”) applies to every employment relationship within New Zealand. The ER Act expressly recognises a duty of good faith.

¹⁰⁷ See Justin Smith, ‘Good Faith’ in, *The Law of Obligations – “Contract in Context”* (New Zealand Law Society Intensive, 2007), at 34. Cf Geoffrey Kuehne, ‘Implied Obligations of Good Faith and Reasonableness in the Performance of Contracts: Old Wine in New Bottles?’ (2006) 33 *University of Western Australia Law Review* 63, at 102-106.

This obligation is the cornerstone of the legislative framework.¹⁰⁸ The requirement for good faith extends not only to a concluded individual or collective employment agreement, but also the bargaining process.¹⁰⁹

The ER Act does not provide an exhaustive definition of good faith. However, s 4 does contain some definitional elements:

- (1) The parties to an employment relationship specified in subsection (2)—
 - (a) must deal with each other in good faith; and
 - (b) without limiting paragraph (a), must not, whether directly or indirectly, do anything—
 - (i) to mislead or deceive each other; or
 - (ii) that is likely to mislead or deceive each other.
- (1A) The duty of good faith in subsection (1)—
 - (a) is wider in scope than the implied mutual obligations of trust and confidence; and
 - (b) requires the parties to an employment relationship to be active and constructive in establishing and maintaining a productive employment relationship in which the parties are, among other things, responsive and communicative; and
 - (c) without limiting paragraph (b), requires an employer who is proposing to make a decision that will, or is likely to, have an adverse effect on the continuation of employment of 1 or more of his or her employees to provide to the employees affected—
 - (i) access to information, relevant to the continuation of the employees' employment, about the decision; and
 - (ii) an opportunity to comment on the information to their employer before the decision is made.

¹⁰⁸ See Geoff Devenport and Judy Brown, *Good Faith in Collective Bargaining* (2002), at 1.

¹⁰⁹ See s 4(4) Employment Relations Act 2000. In respect of bargaining for an individual employment agreement, the Employment Relations Act 2000 applies only to employers and employees who have attained that status such that there will be no statutory cause of action for breach of good faith in the bargaining process if there has been no offer and acceptance. See generally Lexis Nexis, *Mazengarb's Employment Law*, (at 4 March 2008) Employment Relations Act 2000: Part 1/Key Provisions/Good Faith Employment Relations, at [4.16A].

The obligations under s 4(1A) requiring open dialogue and consultation engender a requirement of contractual cooperation.

The prohibition against misleading or deceiving the other party under s 4(1)(b) is founded on the policy that the contracting parties must be honest with each other.¹¹⁰ However, it seems that an obligation not to mislead or deceive can extend past subjective honesty and perhaps even objective honesty in some cases. The wording under the ER Act is based on the terminology within ss 9 and 12 of the Fair Trading Act 1986 (“FTA”).¹¹¹ It is not necessary for a person engaging in misleading or deceptive conduct to intend to mislead or deceive under the FTA.¹¹² There is no element of culpability.¹¹³ This would at least

¹¹⁰ In *National Distribution Union Inc v General Distributors Ltd* [2007] 1 ERNZ 120 the full Employment Court noted (at 140) that ‘[a]lthough not doing so exhaustively, the definitions of good faith dealings given in s 4 address what might be referred to as the honesty or transparency of dealings between parties so that deceiving and misleading, whether intentional or consequential, are prohibited...Those attributes of good faith dealing address how relationships are to be conducted rather than constraining the substance of them including, for example, the lawfulness of acting in one's self-interest. So, albeit simplistically, s 4 does not constrain an employer from engaging in otherwise lawful bargaining tactics with a union but does require the employer to do so transparently and truthfully and to open and maintain channels of communication with the union in so doing.’

¹¹¹ See *Mazengarb*, above n 109, at [4.6].

¹¹² *Bonz Group Pty Ltd v Cooke* (1996) 5 NZBLC 104,193.

¹¹³ *Comite Interprofessional du Vin de Champagne v Wineworths Group Ltd* [1992] 2 NZLR 327. Thus, in *Premium Real Estate Ltd v Stevens* (2008) 12 TCLR 133 Arnold J, delivering the judgment of the Court of Appeal, found (at [43]) that ‘whether deliberately or not, [the defendant] created a false impression in the minds of the [plaintiffs] by telling them only part of the story...In these circumstances we consider that the Judge was correct to conclude that [the defendant] was in breach of s 9 of the Fair Trading Act.’ The Court did however go on to recognise, in obiter dicta, that the state of mind of the defendant may have to be examined where an expression of an opinion is alleged to amount to misleading and deceptive conduct. Arnold J opined (at [54]) that it ‘is difficult to see why an honestly held, reasonably based opinion should be actionable under s 9 simply because it is not borne out by subsequent events. The person expressing the opinion may have done all that could sensibly be done to reach an informed view but would still be liable, even if the subsequent events or circumstances were unforeseeable.’ The comments certainly indicate that the impugned conduct should be examined with reference to the circumstances at the time it is carried out and not with the benefit of hindsight. On appeal to the Supreme Court, liability under the Fair Trading Act

suggest that the good faith obligations under the ER Act are not confined to subjective honesty.

In *Auckland City Council v New Zealand Public Service Assn Inc* the Court of Appeal suggested that the obligation of good faith under the ER Act does not mandate a wholly objective definition of good faith because:

That would be to exclude consideration of honesty or lack of it which can be an important element in the concept of good faith. To suggest that conduct, undertaken honestly, that has an adverse effect for reasons completely unforeseen, is to be held to have been undertaken other than in good faith would be a significant departure from the natural meaning of those words. To judge conduct solely by reference to effect in this way would be to invoke hindsight and to disregard the influence of the circumstances in which conduct is undertaken. We think a broader and more balanced approach is called for...¹¹⁴

Clearly the Court of Appeal is correct in noting that good faith cannot be defined solely by reference to the effect of the conduct. However, to use the example given by the Court, it is difficult to conceive of situations where a contracting party who engages in honest conduct, whose adverse consequences are reasonably unforeseeable, would be deemed to have acted inappropriately even on a strict objective standard. Further, too much concentration on subjective intention and motives could lead to a narrow focus on bad faith behaviour rather than the positive good faith behaviour the ER Act is designed to promote.¹¹⁵ Conceivably a more objective test for breach of good faith by an industrial participant might be appropriate where there is no evidence of subjective intent.¹¹⁶

1986 was upheld and Blanchard J reaffirmed that misleading and deceptive conduct for the purposes of s 9 'need not have been advertent' : (Supreme Court, SC 23/2008, 6 March 2009), at [92].

¹¹⁴ [2004] 2 NZLR 10, at 15 per Gault P.

¹¹⁵ See *Mazengarb*, above n 109, at [4.5D]. Canada has adopted an objective test. See *Royal Oak Mines Inc v Canada (Canadian Labour Relations Board)* (1996) 133 DLR (4th) 129. The United States is more reluctant to require objectively reasonable conduct in industrial bargaining. See generally *NLRB v American National Ins Co*, 343 US 395 (1952); *White v NLRB*, 255 F2d 564 (1958, US App); *Chevron Oil Co & Standard Oil Co of Texas Division v NLRB*, 442 F2d 1067 (1971, US App); *NLRB v United Clay Mines Corp*, 219 F2d 120 (1955, US App).

¹¹⁶ See generally Paul Roth, 'Employment Law' [2004] *New Zealand Law Review* 723, at 742.

In the context of employment contracts it has been noted that it ‘not possible to lay down rules or protocols defining what may or may not constitute dealing in good faith.’¹¹⁷ As a result of the lack of an exhaustive definition under s 4, the Court is obliged to assess good faith on a case by case basis.¹¹⁸ Such comments bear a close resemblance to observations often made in the debate concerning a universal contractual doctrine of good faith.

The circumstances in which the ER Act obligation of good faith may be breached are vast. An analysis of the recent case law reveals the wide ranging application of good faith. For example, an employer will breach the obligation when it fails to provide the grounds for dismissal of an employee¹¹⁹, or it pre-determines that it will effect redundancies and merely purports to consult with employees¹²⁰, or it communicates with unionised employees without reference to the union.¹²¹ An employee may be found to have breached good faith where he or she uses the confidential information of the employer to set up in competition against the employer.¹²² Likewise, a union might breach the obligation by failing to discuss alternative working arrangements with an employer during a proposed strike¹²³, or failing to comply with an undertaking to re-enter negotiations.¹²⁴

¹¹⁷ *Auckland City Council v New Zealand Public Service Assn Inc* [2004] 2 NZLR 10, at 16 per Gault P.

¹¹⁸ *Wellington City Council v Body Corporate 51702 (Wellington)* [2002] 3 NZLR 486, at 497 per Tipping J.

¹¹⁹ *X v Auckland Hospital Board* (Employment Court, Auckland, AC 10/07, 23 February 2007, Chief Judge Colgan).

¹²⁰ *Funnell v Bruce A Short Ltd* (Employment Court, Auckland, AC 12/06, 14 March 2006, Chief Judge Colgan).

¹²¹ *Christchurch City Council v Southern Local Government Officers Union Inc* (2007) 4 NZELR 63; *New Zealand Amalgamated Engineering Printing and Manufacturing Union Inc v Energex Ltd* (Employment Court, Auckland, AC 48/06, 28 August 2006, Judge Shaw).

¹²² *BDM Grange Ltd v Parker* [2006] 1 NZLR 353.

¹²³ *Service and Food Workers Union Nga Ringa Tota Inc v Spotless Services (NZ) Ltd* (Employment Court, Auckland, AC 43/07, 11 July 2007, Chief Judge Colgan).

¹²⁴ *Professor Graeme Fogelberg, Vice Chancellor of the University of Otago v Association of University Staff* (Employment Court, Christchurch, CC 23/02, 16 February 2002, Judge Palmer).

It is evident that the diverse application of the statutory duty of good faith is heavily dependent on the particular nature of the employer and employee or employer and union relationship. Accordingly, the utility of drawing on the various applications of good faith within the context of employment contracts for the purposes of defining a general contractual doctrine must be doubted. In *Wellington City Council* the Court of Appeal said it would be a mistake to equate the good faith reasoning in the employment relations arena with ordinary contract cases.¹²⁵ Tipping J contended that:

The employment relationship itself immediately provides a degree of contextual objectivity...The problematic element of subjectivity attaching to good faith negotiations in the law of contract is therefore significantly reduced in the case of the good faith obligations referred to in s 4 of the Employment Relations Act.¹²⁶

An additional hindrance to comparing good faith under employment law with a conceptualisation under the subject doctrine is that, within industrial contracts, good faith is broader than the obligation of trust and confidence. Section 4(1A)(a) of the ER Act expressly recognises this to be the case.¹²⁷ Every employment agreement is subject to an implied duty of trust and confidence under common law¹²⁸ and the statutory provisions clearly impose wider obligations. It would be an illogical step to determine that every contracting party in any arms length transaction is entitled to repose trust and confidence in the other contracting party. The duty of good faith under the ER Act is likely to impose

¹²⁵ [2002] 3 NZLR 486, at 497 per Tipping J.

¹²⁶ Ibid.

¹²⁷ Section 4(1A)(a) was inserted as an amendment to the original Employment Relations Act 2000 to counter the majority Court of Appeal decision in *Coutts Cars Ltd v Baguley* [2002] 2 NZLR 533, which held to the effect that the duty of good faith did not differ significantly from the implied common law term of trust and confidence.

¹²⁸ *Walden v Barrance* [1996] 2 ERNZ 598; *Woods v WM Car Services (Peterborough) Ltd* [1981] ICR 666. The meaning of trust and confidence at common law is also vague and has often been linked with duties of good faith. Lord Nicholls has said that the ‘trust and confidence implied term means, in short, that an employer must treat his employees fairly. In his conduct of his business, and in his treatment of his employees, an employer must act responsibly and in good faith.’: *Eastwood v Magnox Electric plc* [2004] 3 All ER 991, at 997.

standards of conduct which are far more stringent than those that would be expected in a non-relational contract. Accordingly, the understanding of good faith in employment contracts, which extends even further than a duty of trust and confidence, is likely to be an inappropriate comparator for a definition of good faith under a general contractual doctrine.

3.5.2 Partnership Agreements:

The law imposes on a partner a duty of complete good faith towards his or her co-partners in respect of all partnership dealings and transactions.¹²⁹ Obligations of good faith applicable to partners within New Zealand derive from the common law, equity and the Partnership Act 1908. In the context of a partnership, good faith means that a partner must, inter alia, act honestly¹³⁰, disclose relevant information¹³¹, and he or she must not personally generate profits at the expense of the firm without accounting for those profits¹³², or use partnership property for an improper purpose¹³³, or compete with the partnership.¹³⁴

The duty of good faith owed by partners extends to intending partners. Accordingly there is an obligation on existing partners to disclose material information to persons negotiating their entry into a partnership.¹³⁵ Although obligations of good faith may exist

¹²⁹ See R C I Banks, *Lindley and Banks on Partnership* (18th ed, 2002), at 469. See generally *Loughnan v Dalgety & Co* (1897) 16 NZLR 299; *Wilkie v Wilkie (No 2)* (1900) 18 NZLR 734; *Gibson v Tyree* (1900) 20 NZLR 278; *Gibson v Tyree (No 2)* (1901) 20 NZLR 562; *Lankshear v ANZ Banking Group (New Zealand) Ltd* [1993] 1 NZLR 481.

¹³⁰ *Carmichael v Evans* [1904] 1 Ch 486.

¹³¹ *Imperia Mercantile Credit Association v Coleman* (1871) LR 6 HL 189.

¹³² Section 32 Partnership Act 1908.

¹³³ Section 23 Partnership Act 1908.

¹³⁴ Section 33 Partnership Act 1908. See also *Gibson v Tyree (No 2)* (1901) 20 NZLR 278.

¹³⁵ *Conlon v Simms* [2006] 2 All ER 1024; [2007] 3 All ER 802 (CA).

prior to contracting, good faith obligations do not subsist after the dissolution of a partnership.¹³⁶

A partnership arrangement is characterised as being fiduciary in nature. The distinguishing obligation of any fiduciary is the duty of loyalty.¹³⁷ Partners act as agents for each other. A partner must subject his or her interests to that of the partnership. The fiduciary relationship between partners is derived from the existence of obligations of a fiduciary nature, not the other way around.¹³⁸ In *Thompson's Trustee in Bankruptcy v Heaton Pennycuick VC* therefore recognised that the fiduciary relationship arises from the duties of good faith which are owed by partners, rather than any trust of property.¹³⁹

It is submitted that the application of good faith in partnership agreements is unlikely to be of any utility to informing a universal doctrine of contractual good faith. It is evident that there is no prescribed definition of good faith within partnership law. Instead the duty of good faith is a general label used to group together the specific obligations and duties owed by partners. It is unlikely that those obligations, which are particular to a partnership context, can have application to a general contractual doctrine. The contractual relationship between partners is unique. It is at the upper extremity of the relational contract scale. The majority of the specific obligations of good faith owed by partners have limited relevance to transactional and arms length contracts.

Further, the understanding of good faith within the partnership arena is coloured by the existence of a fiduciary relationship. It was noted above that it is almost universally accepted that good faith in the context of contract law should not be equated with a requirement for the observance of fiduciary duties.¹⁴⁰ Many of the duties owed by

¹³⁶ *Nilsen v Murcott* (High Court, Invercargill, CIV 2007-425-348, 27 November 2007, John Hansen J).

¹³⁷ *Bristol and West Building Society v Mothew* [1998] Ch 1, at 18 per Millett LJ.

¹³⁸ See Banks, above n 129, at 470. See also *Bristol and West Building Society v Mothew* [1998] Ch 1, at 18 per Millett LJ.

¹³⁹ [1974] 1 WLR 605, at 613.

¹⁴⁰ See generally Peden, above n 58, at 199.

partners coined as being good faith obligations are manifestations of fiduciary duties. These duties may derive from equity and can exist outside of the wording of a partnership contract. The obligations are not consonant with contractual duties.

As a result it is concluded that partnership law is exceptional and should not be confused with the development and conceptualisation of contractual good faith.¹⁴¹ The meaning and application of good faith within partnership law cannot be adequately divorced from the fiduciary nature of the relationship to be of any benefit in the context of a universal contractual doctrine.

3.5.3 Joint Venture Arrangements:

There have been a number of recent cases considering an obligation of good faith in the context of joint venture arrangements.¹⁴² Unlike a partnership, a joint venture may not necessarily give rise to a fiduciary relationship. Notwithstanding, parties to a joint venture may still be subject to an obligation of good faith by virtue of a term implied in law.¹⁴³ Thus, in *Paper Reclaim Ltd v Aotearoa International Ltd* Chambers J suggested that there is no need for equitable intervention in the form of a fiduciary relationship where the joint venture contract itself contains an implied term to act reasonably and in good faith.¹⁴⁴ Even where parties have expressly excluded a fiduciary relationship under

¹⁴¹ Ibid, at 198.

¹⁴² See *Ross River Ltd v Cambridge City Football Club Ltd* [2008] 1 All ER 1004; *Chirnside v Fay* [2007] 1 NZLR 433; *Archibald Barr Motor Company Ltd v ATECO Automotive New Zealand Ltd* (High Court, Auckland, CIV 2007-404-5797, 26 October 2007, Allan J); *Vero Insurance New Zealand Ltd v Fleet Insurance & Risk Management Ltd* (High Court, Auckland, CIV 2007-404-1438, 21 May 2007, Asher J); *Todd Petroleum Mining Company Ltd v Shell (Petroleum Mining) Company Ltd* (High Court, Wellington, CIV 2005-485-819, 19 June 2006, Wild J); *McLachlan v Mercury Geotherm Ltd (in rec)* (High Court, Auckland, M 129-IM00, 14 June 2002, Potter J) (Court of Appeal, CA 142/02, 28 August 2003) (2006) 7 NZCPR 135 (PC); *Petroleum Resources Ltd v Greymouth Petroleum Acquisition Co Ltd* (High Court, Auckland, CIV 2003-404-6962, 22 December 2003, Heath J).

¹⁴³ A joint venture agreement is considered to be a class of contract in which a term of good faith may be implied in law. See generally Burrows, Finn and Todd, above n 57, at 177.

¹⁴⁴ [2006] 3 NZLR 188, at 210.

the contract, it is possible that the parties must still act towards each other in good faith in carrying out the obligations which they have assumed under the joint venture agreement.¹⁴⁵ An obligation of good faith will be implied provided the specific contract can be characterised as requiring mutual trust and confidence.¹⁴⁶

In *Petroleum Resources Ltd v Greymouth Petroleum Acquisition Co Ltd* Heath J suggested that obligations of good faith found within joint venture agreements can be utilised to interpret the express terms of the contract.¹⁴⁷ It is envisaged that the subject doctrine would assume a similar function under all contracts.

Obligations of good faith within New Zealand have been held to require a joint venture party to appropriately account to the joint venture for profits made¹⁴⁸ and to make an informed and open-minded decision when exercising a voting power under a joint venture agreement.¹⁴⁹ In this respect a duty of good faith may impose positive obligations. However, there are limits on the concept of good faith. The duty will not be breached where one party to a joint venture arrangement makes a commercial decision to further its interests, provided it does not destroy the fruits of the contract for the other party.¹⁵⁰ Similarly, a joint venture party is entitled to utilise the services of a competitor of the other joint venture party where the joint venture contract does not provide any relevant restriction.¹⁵¹ As is intended under a general doctrine, joint venture parties are not totally precluded from acting in a self-interested manner.

¹⁴⁵ *Todd Petroleum Mining Company Ltd v Shell (Petroleum Mining) Company Ltd* (High Court, Wellington, CIV 2005-485-819, 19 June 2006, Wild J).

¹⁴⁶ See generally *Archibald Barr Motor Company Ltd v ATECO Automotive New Zealand Ltd* (High Court, Auckland, CIV 2007-404-5797, 26 October 2007, Allan J).

¹⁴⁷ (High Court, Auckland, CIV 2003-404-6962, 22 December 2003, Heath J), at [34].

¹⁴⁸ *Chirnside v Fay* [2007] 1 NZLR 433.

¹⁴⁹ *Petroleum Resources Ltd v Greymouth Petroleum Acquisition Co Ltd* (High Court, Auckland, CIV 2003-404-6962, 22 December 2003, Heath J).

¹⁵⁰ *McLachlan v Mercury Geotherm Ltd (in rec)* (High Court, Auckland, M 129-IM00, 14 June 2002, Potter J), at [86]; (Court of Appeal, CA 142/02, 28 August 2003); (2006) 7 NZCPR 135 (PC).

¹⁵¹ *Paper Reclaim Ltd v Aotearoa International Ltd* [2006] 3 NZLR 188.

The leading case in respect of obligations owed by joint venture parties is the decision of the Supreme Court in *Chirnside v Fay*. Perhaps contrary to prior understanding, it was asserted that the majority of joint venture arrangements will give rise to a fiduciary relationship.¹⁵² The Court sought to justify its conclusion on the analogy between a joint venture relationship and a partnership.¹⁵³ Both types of arrangement not only give rise to duties of good faith but also an obligation of loyalty.¹⁵⁴ These duties required that neither of the joint venture parties is permitted to put himself or herself in a position of conflict with the joint venture and each party is obliged to account for any unauthorised profits obtained by an opportunity arising through the venture.¹⁵⁵

Based on the *Chirnside* decision, it is evident that the majority of joint venture parties will owe each other equitable fiduciary obligations unless such obligations have been expressly excluded within the contract. Conceivably any definition or application of good faith which may emanate from a joint venture arrangement will give rise to similar problems to that which is encountered in the partnership arena when attempting to apply the definition to a general contractual doctrine. Whilst joint ventures may provide some guidance as to contractual cooperation, the fact that obligations of good faith on joint venture parties are generally equitable in nature suggests that the type and standard of conduct required is liable to be too stringent to have any meaningful application to the subject contract doctrine.

¹⁵² The strong preference for fiduciary duties in a joint venture arrangement and the analogy with partnership has been criticised as not representing the commercial realities of risk and return and the principle of freedom of contract. See generally Bram van Melle, 'Fiduciary Duties and Joint Ventures' [2007] *New Zealand Law Journal* 32. For a comprehensive discussion of the *Chirnside* decision and equitable intervention in commercial relationships see Jessica Palmer, 'Fiduciaries and Remedies' [2007] *New Zealand Law Journal* 36.

¹⁵³ [2007] 1 NZLR 433, at 458 per Tipping J.

¹⁵⁴ *Ibid*, at 459.

¹⁵⁵ *Ibid*, at 443 per Elias CJ.

3.5.4 Insurance Contracts:

Insurance contracts are distinct from most other contracts in that they are said to be contracts of good faith. This good faith characteristic unique to insurance contracts has been recognised for more than 200 years.¹⁵⁶ The obligation of good faith exists outside of the contract. It is not an implied term arising from the particular terms of the insurance contract. Instead, it is a general principle imposed *ab extra* by the law.¹⁵⁷

Mere good faith usually is not sufficient in the insurance arena. Utmost good faith is required. This is reflected in the Latin term *uberrima fides*. Either party may avoid the contract if utmost good faith is not observed.¹⁵⁸

The application of good faith within insurance law is predominantly focused on the disclosure of information. The utmost good faith obligation represents a significant departure from the principle of caveat emptor. The duty of disclosure exists prior to entering into the contract and during the currency of the coverage. The good faith principle is expressed to apply to both insurer and insured. However, in practice the rule

¹⁵⁶ See Neil Campbell, 'Good Faith: Lessons from Insurance Law' (2005) 11 *New Zealand Business Law Quarterly* 479.

¹⁵⁷ *Insurance General Manager v McHale* [1992] 2 NZLR 399; *Merchants' and Manufacturers, Insurance Co Ltd v Hunt* [1941] 1 All ER 123, at 128-129 per Scott LJ. See also Burrows, Finn and Todd, above n 57, at 177. Cf *Moens v Heyworth* (1842) 10 M & W 147; *Merchants' and Manufacturers Insurance Co Ltd v Hunt* [1941] KB 295; *Kolokythas v Federation Insurance Ltd* (1980) 1 ANZ Insurance Cas 60-412. See also Robert Davis, 'The Origin of the Duty of Disclosure Under Insurance Law' (1991) 4 *Insurance Law Journal* 71. Obligations of good faith may derive from the common law or, in qualifying contracts, from the Marine Insurance Act 1908.

¹⁵⁸ *Brownlie v Campbell* (1880) 5 App Cas 925; *Watt v Southern Cross Assurance Co Ltd* [1927] NZLR 106; *Lee v British Law Insurance Co Ltd* [1972] 2 Lloyd's Rep 49; *Sampson v Gold Star Insurance Co Ltd* [1980] 2 NZLR 742; *Banque Financiere de la Cite SA v Westgate Insurance Co Ltd* [1990] 2 All ER 947; *State Insurance General Manager v McHale* [1992] 2 NZLR 399; *Switzerland Insurance Australia Ltd v Gooch* [1996] 3 NZLR 525.

is first and foremost relevant to the insured.¹⁵⁹ Ordinarily the insurer will have no relevant information to disclose. Accordingly, the good faith obligation is often only applicable to the insured in many cases.¹⁶⁰

The insured must disclose all material facts within his or her actual or presumed knowledge prior to entering into the contract.¹⁶¹ Facts are deemed to be material if the mind of a prudent insurer would be affected by knowledge of a particular fact, either in deciding whether to take the risk at all or in fixing the premium.¹⁶² The actual or presumed knowledge of the insured includes facts which he or she ought to have known.¹⁶³ This suggests an objective standard. Accordingly, an obligation of reasonable conduct may be perceived as an element of the duty of utmost good faith. The insurer may avoid the contract *ab initio*¹⁶⁴ in the event of non-disclosure provided that the non-disclosure induced the insurer to enter into the contract.¹⁶⁵

Certain duties of good faith exist post-formation of the insurance contract. Full disclosure must be made in the same manner as is required under the pre-formation duty where the

¹⁵⁹ *Carter v Boehm* (1766) 3 Burr 1905. See also Daniel Friedman, 'The Transformation of Good Faith in Insurance Law' in Brownsword, Hird and Howells (eds), above n 4, at 314; Anthony Tarr and Julie-Anne Kennedy, *Insurance Law in New Zealand* (2nd ed, 1992), at 58.

¹⁶⁰ For example, there is no duty on the insurer to ask questions unless the insurer is put on notice. See *Jaggar v Lyttelton Marina Holdings Ltd (In Receivership)* [2006] 2 NZLR 87; [2007] 2 NZLR 336 (CA).

¹⁶¹ However, facts which are material need not be disclosed to the insurer if: (i) they diminish the risk or; (ii) they are facts which the insurer knows or is presumed to know or are matters of common knowledge or; (iii) they are facts of which the insurer waives disclosure. See John Birds, *Birds' Modern Insurance Law* (7th ed, 2007), at 118.

¹⁶² *Wilson & Horton Ltd v Attorney-General* [1997] 2 NZLR 513; *State Insurance General Manager v McHale* [1992] 2 NZLR 399; *Quinby Enterprises Ltd (In Liquidation) v General Accident Fire and Life Assurance Corporation Public Ltd Co* [1995] 1 NZLR 736. Cf *Harding v Victoria Insurance Co Ltd* [1924] NZLR 267.

¹⁶³ *State Insurance General Manager v McHale* [1992] 2 NZLR 399, at 403 per Cooke P. See also s 18(1) Marine Insurance Act 1908.

¹⁶⁴ Birds, above n 161, at 113.

¹⁶⁵ *Pan Atlantic Insurance Co Ltd v Pine Top Insurance Co Ltd* [1994] 3 All ER 581.

insured seeks an extension of coverage under a held-coverage clause¹⁶⁶ or a variation of the insurance contract.¹⁶⁷ Obligations of good faith may also be placed on the insurer in controlling the defence of the insured.¹⁶⁸ However, in *Gan Insurance Co Ltd v Tai Ping Insurance Co Ltd* it was suggested by Mance LJ that such a good faith requirement imposed on the insurer does not necessarily arise from any principles or considerations unique to the law of insurance.¹⁶⁹ Instead it arises from the nature and purpose of the contractual provisions.

A further good faith duty of disclosure exists where an insured makes a claim under a policy. In *Manifest Shipping Co Ltd v Uni-Polaris Insurance Co Ltd* the House of Lords recognised that this requirement is simply a continuation of the pre-contract formation good faith principle.¹⁷⁰ However, the obligation of good faith will only be broken if the insured dishonestly conceals information from the insurer.¹⁷¹ Thus, the objective element of the good faith obligation becomes diluted to some extent. The obligation to disclose when making a claim extends only to information that the insured actually knows. Error or carelessness on the part of the insured is not enough.¹⁷² Accordingly, within the field of insurance law, the nature of the duty of good faith and the standard of conduct required under it fluctuates depending on the stage of the contractual process.¹⁷³

It is debatable whether the conceptualisation of good faith within the context of contracts *uberrimae fide* can be of any utility in formulating the prospective definition of good faith under a general doctrine applicable to all contracts. However, the analogy raises the important issue of whether good faith conduct under a universal doctrine should incorporate an obligation to disclose information.

¹⁶⁶ *Liberian Insurance Agency Inc v Mosse* [1977] 2 Lloyd's Rep 560.

¹⁶⁷ *Lishman v Northern Maritime Insurance Co* (1875) LR 10 CP 179, at 182 per Blackburn J.

¹⁶⁸ *Groom v Crocker* [1939] 1 KB 194.

¹⁶⁹ [2001] CLC 1103, at 1134.

¹⁷⁰ [2003] 1 AC 469, at 493 per Lord Hobhouse.

¹⁷¹ *NZ Insurance Co Ltd v Forbes* (1988) 5 ANZ Insurance Cas 75,449.

¹⁷² *Foster v Standard Insurance Co of New Zealand Ltd* [1924] NZLR 1093.

¹⁷³ See Birds, above n 161, at 137.

An obligation of disclosure applicable to all contracts has found support with some by making comparison with insurance law. Forte contends:

There is no good reason to believe [] that good faith should only apply to contracts of insurance and caution, that its role is exclusively interstitial rather than pervasively fundamental. Indeed, once the role of good faith is acknowledged in the particular, there is a logical imperative that its relevance to contracts generally should be accepted...[I]n certain circumstances, a positive duty of disclosure (as an aspect of the observance of good faith) is incumbent on parties to all contracts.¹⁷⁴

Others would extend an obligation to disclose information to apply to pre-contractual negotiations. Eggers and Foss, prominent insurance commentators, observe:

[A] party negotiating a contract is obliged only not to deceive, as opposed positively to make plain all the vices, and possibly virtues, of his own position. However, that does not mean that the common law could not reform itself in cases of positive injustice arising where good faith has been ignored or abused.¹⁷⁵

Such an obligation is liable to be opposed by classical contract theorists. A requirement for disclosure represents a significant challenge to the principle of caveat emptor. In the majority of negotiations parties are free to keep their cards near to their chests.¹⁷⁶ In *Banque Financière de la Cité SA v Westgate Insurance Co Ltd* Slade LJ recognised that it frequently appears with hindsight that one contracting party had knowledge of facts which, if communicated to the other contracting party, would have protected him or her from loss.¹⁷⁷ In such instances the law refuses to reopen the transaction to reapportion loss between the contracting parties. To require otherwise would be policing fairness by reference to moral principles.

¹⁷⁴ Angelo Forte, 'Good Faith and Utmost Good Faith' in Forte (ed), above n 3, at 96.

¹⁷⁵ Peter Eggers and Patrick Foss, *Good Faith and Insurance Contracts* (1998), at 4. See also *Lacey's Footwear (Wholesale) Ltd v Bowler International Freight Ltd* [1997] 2 Lloyd's Rep 369, at 384-385 per Brooke LJ.

¹⁷⁶ See Campbell, above n 156, at 480.

¹⁷⁷ [1989] 2 All ER 952, at 1013.

More will be said on obligations of disclosure within Chapters 4 and 5. For present purposes it is recognised that the law of insurance is unlikely to provide any meaningful assistance even if some disclosure is required under a general doctrine of contractual good faith. The obligation of utmost good faith in insurance contracts, and particularly the obligation on the proposer, is concerned with absolute disclosure. The purpose of the obligation is sound. An intending insured is in possession of all of the relevant information for the bargain. Full disclosure is required to allow for an efficient market due to the extreme informational imbalance. Without disclosure, it would be necessary for the underwriter to make enquiries in relation to every risk presented to him or her.¹⁷⁸ Whilst in every general contractual negotiation there is bound to be inequality of knowledge, the informational imbalance will rarely be as extreme as in cases of insurance. Accordingly, it would be an illogical step for the definition of good faith under a universal doctrine to include an obligation to disclose all material information. The obligation of good faith in insurance law is therefore unlikely to provide any pragmatic guidance on the extent to which disclosure could be required in all contracts. Moreover, any comparison that might be drawn could dangerously distort the argument. In consequence, the meaning of good faith in insurance law must remain divorced from any attempt to formulate a general concept of contractual good faith.

There is an additional problem associated with propounding an analogy between good faith in insurance law and good faith under the subject doctrine. As noted above, the duty of disclosure arises entirely outside the terms of the contract *uberrimae fidei*.¹⁷⁹ The remedy for a breach of good faith in insurance law is not the same as those contemplated under the general doctrine. The juristic basis of the respective duties is completely distinct. Thus, caution must be exercised when comparing good faith in contracts *uberrimae fidei* with a universal obligation of good faith in contractual performance.

¹⁷⁸ See Eggers and Foss, above n 175, at 43.

¹⁷⁹ See also *Banque Financière de la Cité SA v Westgate Insurance Co Ltd* [1989] 2 All ER 952, at 996 per Slade LJ.

Perhaps one experience that can be drawn from the field of insurance law is that good faith may operate on an objective standard. Clearly it requires the insured to act reasonably. However, this analogy may also be dangerous. To label the duty of absolute disclosure as one of good faith may be inaccurate.¹⁸⁰ In *Manifest Shipping* Lord Scott noted:

It is very possible for the duty that pre-contract is owed by an assured to be broken by an act or omission which would not in ordinary language be described as a breach of good faith at all...[A]n honest failure to disclose something of which the assured was in fact unaware may constitute a breach of duty...The addition of the adjective "utmost" does not affect the point.¹⁸¹

Thus, it has been recognised that the disclosure obligations within insurance law are based on a notion of strict liability.¹⁸² These observations reveal the fact that there is just as much debate within the field of insurance law as there is in the field of a general doctrine as to what the concept of good faith actually means and what standards of conduct it requires.

It is therefore concluded that obligations of good faith within relationships which are *uberrimae fide* will not be of any pragmatic utility in terms of informing a conceptualisation of good faith under a general and universal common law doctrine.

3.6 Operating Good Faith in Practice:

3.6.1 What Certainty is Required?

The foregoing analysis within this chapter has served to demonstrate that there is no universally accepted definition of good faith. Further, good faith tends to take on different meanings in different circumstances.

¹⁸⁰ See Campbell, above n 156, at 480.

¹⁸¹ [2003] 1 AC 469, at 511.

¹⁸² See Campbell, above n 156, at 480.

Nonetheless, the fact that good faith may be difficult to define is not in itself sufficient reason to reject the introduction of the subject doctrine within New Zealand. Many principles in the law such as unconscionability are vague but workable.¹⁸³ Often broad principles serve a beneficial organisational role.¹⁸⁴ Accordingly, indeterminacy may require care in application of the doctrine rather than dismissal.

Further, the struggle to achieve a precise definition of good faith cannot justify abandoning whatever precision may be possible.¹⁸⁵ This is particularly relevant if a good faith doctrine were to be accepted by the judiciary. Good faith would no longer be sporadically utilised to give weight or moral persuasiveness to a conclusion reached. Instead it would be a principle assuming a fundamental determinative role. Good faith could be the central or sole determinant in resolving particular contractual disputes.¹⁸⁶

It has been contended within this chapter that good faith fundamentally encapsulates obligations of cooperation, honesty and reasonableness, having regard to the reasonable expectations of the parties.

Some argue that attempts to give meaning to the broad concept of good faith by reformulating it in synonyms and different language is often of limited utility. In particular, the use of the concept of reasonableness to describe one aspect of the good faith obligation is suggested to be equally broad and equally vague.¹⁸⁷ Supposedly, it will also produce an unduly broad discretion and idiosyncratic judicial process.

With respect, these observations are not supported. It has been recognised throughout this chapter that concepts of cooperation, honesty and reasonableness are familiar to the

¹⁸³ See Rick Bigwood, 'Conscience and the Liberal Conception of Contract: Observing Basic Distinctions' (2000) 6 *New Zealand Business Law Quarterly* 3, at 9

¹⁸⁴ See Bigwood, above n 6, at 373.

¹⁸⁵ John E Coons, 'Compromise as Precise Justice' (1980) 68 *California Law Review* 250, at 261.

¹⁸⁶ Joachin Dietrich, 'Giving Content to General Concepts' (2005) 29 *Melbourne University Law Review* 218, at 221.

¹⁸⁷ *Ibid*, at 229. See also Kuehne, above n 107, at 102-106.

common law within New Zealand and are frequently applied in practice. To suggest that the judiciary is not competent to determine whether conduct is cooperative, honest and reasonable simply does not reflect the realities of modern judicial decision making. Indeed, save for established exceptions, when it comes to determining civil liability the law must refer to the standards of the reasonable person.¹⁸⁸ It follows that the Court must equate itself with a fair, honest and reasonable individual in order to reach a decision.¹⁸⁹

Those who criticise definitions of good faith tend to focus too much on how good faith might apply in practice rather than the essential concept. Good faith can only be defined at its core. It is impossible to capture all of the possible applications of good faith ‘in a short snappy sentence.’¹⁹⁰ Once this fact is accepted it becomes clear that a definition of good faith can only serve to describe the broad elements which comprise the good faith standard. It has been argued within this chapter that those elements fundamentally comprise cooperation, honesty and reasonableness. That is the extent of any definitional certainty that might be achieved.

A definition of good faith cannot prescribe the necessary conduct required in each particular case to satisfy the good faith standard. This is the uncertainty inherent in the application of contractual good faith. The difficulty bears analogy to tort law where the degree of care required to satisfy the standard of care is infinitely variable.¹⁹¹ Accordingly, an analysis is necessary of how the requisite conduct required to satisfy the good faith standard might be determined.

¹⁸⁸ *Donoghue v Stevenson* [1932] AC 562, at 619 per Lord Macmillan.

¹⁸⁹ For comments to that effect in the context of tort law see *Davis Contractors Ltd v Fareham Urban District Council* [1956] 2 All ER 145, at 160 per Lord Radcliffe.

¹⁹⁰ See Vanessa Sims, ‘Good Faith in English Contract Law: Of Triggers and Concentric Circles’ (2004) 1 *Ankara Law Review* 213, at 216.

¹⁹¹ Stephen Todd (ed), *The Law of Torts in New Zealand* (4th ed, 2005), at 313. Compare the comments of Warren CJ who suggests that the standard of good faith is itself nebulous: *Esso Australia Resources Pty Ltd v Southern Pacific Petroleum NL* [2005] VSCA 228, at [3].

3.6.2 Determining the Necessary Conduct Required to Satisfy Good Faith Obligations:

It is fundamental that the conduct required of the parties necessary to satisfy the good faith obligation will depend on the circumstances of the case.¹⁹² Even the most ardent of good faith proponents concede that good faith is incapable of being applied in the abstract.¹⁹³ The relevant facts must be known. As such the application of good faith will never be a pure question of law.¹⁹⁴ This led Einstein J to conclude in *Aiton Australia Pty Ltd v Transfield Pty Ltd* that because good faith is fact intensive, it is best assessed on a case by case basis.¹⁹⁵ Such an individualised inquiry may not necessarily be amorphous or unmanageable.¹⁹⁶

However, it is desirable that the judiciary have some guiding principles under which the required conduct of the parties may be determined. In *O'Neill v Phillips* the House of Lords cautioned against the Court doing whatever an individual judge happens to believe is fair in the circumstances.¹⁹⁷ The concept of good faith should be applied judicially and based on rational principles. The Court does not sit under a palm tree.¹⁹⁸ Additionally, contracting parties are entitled to some indication as to the nature of the conduct expected of them. Without sufficient guidance, there will be no way of determining a pragmatic benchmark against which contracting parties and their advisers can judge their conduct.¹⁹⁹ The commercial community will be detrimentally affected. Whilst one of the aims of contract law may well be to meet the reasonable expectations of contracting

¹⁹² See generally Thomas, above n 9, at 394. It has been noted that the meaning of good faith will differ at different stages of the contracting process. See Baron, above n 79, at 417.

¹⁹³ For a similar observation see Baron, above n 79, at 415.

¹⁹⁴ Ibid.

¹⁹⁵ (1999) 153 PLR 236, at 263.

¹⁹⁶ See Finn, above n 44, at 383.

¹⁹⁷ [1999] 2 All ER 961, at 966 per Lord Hoffmann.

¹⁹⁸ *Re J E Cade & Son Ltd* [1992] BCLC 213, at 227 per Warner J.

¹⁹⁹ See generally Andrew Stewart and Leanne McClurg, 'Playing Your Cards Right: Obligations of Disclosure in Commercial Negotiations' [2007] *Australian Mining and Petroleum Law Association Yearbook* 36.

parties, arguably its most urgent duty is to make it possible for lawyers to give clear advice to contracting parties such that they can go about their contractual business within the bounds of the law. Accordingly, certain prospective guiding principles are explored below.

The starting point for determining the requisite conduct to discharge good faith obligations must be the words of the contract itself. The more complete the contract and the more explicitly the contract sets out the manner in which the parties must behave, conceivably the less likely it is the parties intend rigorous good faith obligations to intrude. Good faith duties should therefore be commensurate with the express contractual obligations. It is essential that the intended purpose and tone of a particular contractual transaction is not to be eviscerated or usurped by an inappropriate formulation of good faith conduct.²⁰⁰

Secondly, the Court should look to the classification of the contract. A contract requiring an ongoing relationship or which incorporates elements of trust may require more rigorous obligations to discharge the good faith standard. For example, a franchise agreement is liable to be characterised by more stringent duties of cooperation under the good faith doctrine than obligations of cooperation expected in a contract involving a straightforward one-off transaction.²⁰¹ In this regard, the conduct expected of the parties under a good faith duty has been visualised as a spectrum or even a series of concentric circles.²⁰² The further the particular contract is along the spectrum or the further away the contract lies from the centre circle, the more demanding the conduct required. For example, contracts between commercial parties may require less intense good faith

²⁰⁰ See Brownsword, above n 4, at 37.

²⁰¹ A franchise agreement has been described as giving rise to a highly interdependent relationship: Jeannie Paterson, 'Good Faith in Commercial Contracts? A Franchising Case Study' (2001) 29 *Australian Business Law Review* 270, at 281. See also Gillian Hadfield, 'Problematic Relations: Franchising and the Law of Incomplete Contracts' (1990) 42 *Stanford Law Review* 927, at 928-929; Veronica Taylor, 'Contracts with the Lot: Franchises, Good Faith and Contract Regulation' [1997] *New Zealand Law Review* 459.

²⁰² See Sims, above n 190, at 229.

obligations than those demanded in consumer contracts.²⁰³ Moreover, it has been shown in the above discussion that the application of a duty of good faith in employment, partnership, joint venture and insurance is highly dependent on the general characteristics of contracts falling within those classifications.

Thirdly, the Court should look past the express words and strict classification of the bargain itself. The entire background circumstances should be evaluated. This reflects the ever developing judicial desire to avoid divorcing a contract from the circumstances in which it was set and is being performed.²⁰⁴ The behaviour expected of the parties may therefore be dictated by matters such as the vulnerability of the contracting parties, the degree of trust entitled to be reposed in one another, any inequality of bargaining power and any informational imbalance.²⁰⁵ For example, commercial parties of equal resources interacting at arms length may be subject to considerably less stringent duties than a bank seeking to obtain or enforce a guarantee from an elderly widow.

Ultimately it is only possible to speculate on what matters a court should consider in determining whether good faith obligations have been discharged. Further, these matters could only ever serve as a guide. It is unlikely that definitive criteria could, or would, be laid down. To introduce fixed rules would deprive the law of an important degree of flexibility which may be necessary for the successful application of a good faith doctrine.²⁰⁶ Accordingly, the Court is likely to be engaged in a balancing exercise when determining the appropriate behaviour required to satisfy the good faith principle in different circumstances.²⁰⁷

²⁰³ Ibid. See also Donal Nolan, 'The Classical Legacy and Modern English Contract Law' (1996) 59 *Modern Law Review* 603, at 614.

²⁰⁴ As to consideration of the background circumstances for interpreting a contract see generally Burrows, Finn and Todd, above n 57, at 159-168. See also *Prenn v Simmonds* [1971] 1 WLR 1381, at 1384 per Lord Wilberforce; *Boat Park Ltd v Hutchinson* [1999] 2 NZLR 74; *Gibbons Holdings Ltd v Wholesale Distributors Ltd* [2008] 1 NZLR 277.

²⁰⁵ See generally Sims, above n 190, at 230-231.

²⁰⁶ Ibid, at 230.

²⁰⁷ See Stapleton, above n 42, at 33.

Having explained what factors the courts may look to in applying good faith in practice, it is necessary to consider what difficulties could be encountered if a good faith doctrine were put into action. The impact of those difficulties on the desirability of the subject doctrine within New Zealand also requires examination. Those potential problems are explored below.

3.6.3 Practical Difficulties in Applying a Doctrine of Good Faith:

Developed case law will be the only source of guidance for lawyers and contracting parties affected by the subject doctrine of good faith. A Supreme Court decision introducing the doctrine could no doubt provide some general principles to assist the lower courts. Nonetheless, there is no escaping the fact that the character of good faith conduct will be shaped entirely by judicial decisions on individual fact scenarios. Accordingly, it is unlikely that there will be any pragmatic certainty as to the application of the doctrine until such time as a sufficient body of case law has developed from which factual and legal analogy may be drawn. Even ardent proponents of good faith must concede that the application of good faith within New Zealand is likely to be unpredictable in the absence of a developed background of good faith jurisprudence.²⁰⁸

Moreover, the development of the law of contractual good faith will not follow a similar process of evolution adopted by the courts in other areas of the law. For example, the creation of a novel duty of care in tort may be justified by analogy with established case authority. A judicial judgment is made but it is predicated on the coherent incremental development of the law.²⁰⁹ Judges would not have the initial benefit of decided authority from which to employ deductive and incremental reasoning if a good faith doctrine were to be introduced. Certainly it has been demonstrated in the above discussion that the

²⁰⁸ For similar observations in the English setting see Brownsword, above n 4, at 36.

²⁰⁹ See generally *South Pacific Mfg Co Ltd v NZ Security Consultants Ltd* [1992] 2 NZLR 282, at 294 per Cooke P.

existing instances in which New Zealand law recognises an obligation of good faith is unlikely to be of much pragmatic guidance.

This outcome is a significant deterrent to the introduction of a good faith doctrine. The practical effect of an introduction of a doctrine of good faith in New Zealand law cannot be underestimated. Conceivably there will be an explosion of litigation as the bounds of good faith duties are necessarily developed through case law. Indeed, this has been the experience in other common law jurisdictions incorporating good faith.²¹⁰ Such litigation may be beneficial to ensure that a coherent body of case law does quickly develop to act as a guide for contracting parties, lawyers and judges. However, it may also have a negative economic impact. Many good faith allegations are liable to proceed to trial solely because of the initial lack of clarity. Further, and more worryingly, the uncertainty may encourage unmeritorious litigation. This may be a very real problem. The increasing incidence of vexatious litigation within New Zealand has been recognised.²¹¹ The product is uneconomic litigation and strain on the court system.

Whilst these concerns about uncertainty may often be dismissed when it comes to more minor changes to the law, the same cannot be said about the subject doctrine which undoubtedly has the potential to fundamentally change the law of contract within New

²¹⁰ From 1980 to 1992 there were more than 600 cases interpreting the obligation to perform in good faith in the United States. See Steven Burton and Eric Andersen, *Contractual Good Faith: Formation, Performance, Breach, Enforcement* (1995), at 22. The concept of contractual good faith within the United States is further discussed in Chapter 6. It has also been recognised that the ‘experience of Israeli law indeed demonstrates that a toll must be paid for the desire to enhance the standard of moral behaviour in the contractual arena, at least in the formative years when the duty of good faith is being shaped.’: Nili Cohen, ‘The Effect of the Duty of Good Faith on a Previously Common Law System’ in Brownsword, Hird and Howells (eds), above n 4, at 211-212.

²¹¹ *Lai v Chamberlains* [2005] 3 NZLR 291, at 306 per Anderson P. By the end of the 20th century, the number of civil claims in the High Court and the Court of Appeal had dramatically increased relative to population growth. See John Smillie, ‘Certainty and Civil Obligation’ (2000) 9 *Otago Law Review* 633, at 635. See also Justice John Hansen, ‘Case Management in New Zealand Courts’ (1998) 9 *Otago Law Review* 319.

Zealand. No doubt a doctrine of good faith would vastly expand the role of the courts in the supervision and regulation of contractual performance.

Conceivably the uncertainty may also result in more caution on the part of contracting parties. Contractual negotiations and, consequently, contractual documents will become more detailed as the parties seek to avoid the problems associated with good faith. This may result in more expense and economic inefficiency. This issue is extensively explored in Chapter 5. Further, the doctrine is more likely to be contractually excluded if the commercial world and its legal advisors lack confidence in the meaning and application of good faith.

The uncertainty is also liable to be exacerbated if the New Zealand courts were to implement a universal doctrine of contractual good faith but the appellate courts of comparable common law countries such as England, Australia and Canada elect not to. There is a need for New Zealand to maintain comity with its larger Commonwealth counterparts to some extent. There is an increasing recognition of the requirement to preserve the harmonisation of commercial law between legal jurisdictions. A decision which compromises this harmony may attract criticism from the business community.²¹² These issues are further explored in Chapter 6.

Thus, it may be prudent for the New Zealand judiciary to decline the introduction of a doctrine of contractual good faith unless the appellate courts of the larger common law jurisdictions were to endorse the doctrine. This would allow for the Supreme Court of New Zealand to make an informed decision as to whether a good faith doctrine is desirable and what characteristics it should assume. Further, consequent on the introduction of the doctrine in the larger common law countries, there would inevitably be even more good faith litigation than that which would arise in New Zealand. Judges in New Zealand would therefore have the benefit of being able to call on more extensive overseas precedent to comprehensively define a good faith standard and apply the doctrine. A pre-existing corpus of case law from comparable jurisdictions could also

²¹² See Bernard Robertson, 'Over the Brink' [2003] *New Zealand Law Journal* 353, at 354.

provide some pragmatic guidance for legal practitioners advising clients on contractual matters. Accordingly, it is arguable that a good faith doctrine should not be introduced in New Zealand unless, and until, comparable common law countries were to accept the doctrine.

Because of the inherent uncertainty associated with the necessary conduct required under the good faith doctrine, it is arguable that the development of existing common law contract principles would be a less hazardous and more judicious alternative. Conceivably the current piecemeal solutions could be extended gradually, step by step, and by analogy with established authority with a view to better responding to the reasonable expectations of contracting parties.²¹³ Although this alternative would not achieve the unification and more direct approach that good faith proponents desire, it could minimise the identified risks relating to the uncertainty of good faith. It is therefore questionable whether the more drastic and potentially dangerous step of introducing a good faith doctrine is necessary when a more predictable and less controversial solution may suffice. Seemingly the good faith doctrine may be the paradigm case of ‘burning down the house to roast the pig.’²¹⁴ This observation will be further explored in Chapter 4.

In the round, these arguments present a serious challenge to the desirability of the introduction of a general good faith doctrine within New Zealand at least for the time being. Serious consideration must be given to the risks identified above when it comes to balancing the arguments for and against a general duty.

²¹³ For a discussion of similar methods of incremental development in the context of tort law see Stephen Todd (ed), *The Law of Torts in New Zealand* (3rd ed, 2001), at 149. See also Todd (ed), above n 191, at 122-123.

²¹⁴ *Arthur J S Hall & Co (A Firm) v Simons* [2000] 3 All ER 673, at 703 per Lord Hoffmann.

3.7 Summary:

This chapter has considered the difficulties associated with defining and applying the concept of good faith and how that impacts on the desirability of a universal doctrine within New Zealand. Clearly no utility can be derived by simply defining good faith with reference to bad faith. Good faith is best seen as synonymous with cooperation, honesty and reasonableness having regard to the reasonable expectations of the contract parties.

The significant uncertainty associated with the good faith doctrine is determining the requisite degree of conduct required to meet the proffered definition on a case by case basis. An analysis of specific classes of contracts in which good faith obligations currently apply reveals both that the type and degree of conduct required to satisfy the good faith obligation varies significantly. Further, those applications are so highly dependent on the unique nature of the particular contractual relationship that they are unlikely to be of any significant benefit in terms of applying the subject doctrine.

In reality, the specific conduct required of contracting parties in particular circumstances can only be defined with reference to general guiding principles, judicial impression and, over time, a development of case law. This outcome results in significant uncertainties for reasons identified. Conceivably an alternative to the introduction of a doctrine of good faith might be to develop the existing rules and doctrines. To some extent, this may achieve the desired purposes of the doctrine whilst avoiding the obvious risks. Such a course of action is considered in the next chapter, which examines the relationship between good faith and the existing law.

Chapter 4

The Relationship Between Good Faith and the Existing Law

4.1 Chapter Introduction:

There can be no doubt that the introduction of a judicial doctrine of contractual good faith within New Zealand would impact on existing legal, equitable and statutory principles. The function of this chapter is to explore the relationship between the existing law and a prospective doctrine of good faith.

Part 4.2 evaluates what has been described as the neutral view.¹ This school of thought is premised on the notion that good faith would generally produce the same legal outcomes as those under the existing law. It will be reasoned that this ideology tends towards a negative view in terms of the introduction of a universal good faith doctrine. Part 4.3 considers the positive view, which advocates that a doctrine of good faith could assist a deserving plaintiff in circumstances where the existing law is unable to. Various cases will be examined which have been cited in support of this positive theory. Having then evaluated these general ideologies, Parts 4.4 to 4.9 will undertake a comparative analysis of selected existing legal, equitable and statutory rules relative to a doctrine of good faith. This comparative study will be utilised to determine whether a duty of good faith is likely to provide any additional benefits to the existing law. Further, it will demonstrate the likely effect that the introduction of the doctrine may have on the relevant legal, equitable and statutory rules currently prevailing in the field of contract law. Drawing on the foregoing discussion, Part 4.10 will provide a summary and make some observations as to the desirability of a universal doctrine of contractual good faith within New Zealand.

¹ See generally Roger Brownsword, 'Positive, Negative, Neutral: the Reception of Good Faith in English Contract Law' in Roger Brownsword, Norma Hird and Geraint Howells (eds), *Good Faith in Contract* (1999).

4.2 The Neutral View:

4.2.1 What is the Neutral View?

The neutral view of a good faith doctrine is based on the thesis that the existing legal and equitable doctrines within Anglo-Antipodean contract law achieve the same results that would be realised by a doctrine of good faith. The law has developed adequate piecemeal solutions to remedy unfairness² as an alternative to a general obligation of good faith. Brownsword has described the view as follows:

The paradigm of neutrality holds: (i) that there is a strict equivalence between a general doctrine of good faith and the piecemeal provisions of English law that regulate fair dealing (we can call this ‘the equivalence thesis’); and (ii) that it makes no difference whether English law operates with a general doctrine or with piecemeal provisions (we can call this ‘the indifference thesis’).³

The neutralist approach is founded on the idea that the law within New Zealand and England effectively embodies a requirement of good faith albeit in substance rather than in name. This ideology is no doubt a widely held opinion.⁴ Even proponents of good faith make neutralist observations. For example, McKendrick, a good faith supporter, has conceded:

Many, if not most rules of English contract law, conform with the requirements of good faith and cases which are dealt with in other systems under the rubric of good faith and fair dealing are analysed and resolved in a different way by the English courts, but the outcome is very often the same.⁵

² *Interfoto Picture Library Ltd v Stiletto Visual Programmes Ltd* [1988] 1 All ER 348, at 353 per Bingham LJ.

³ Brownsword, above n 1, at 22.

⁴ *Ibid*, at 21.

⁵ Ewan McKendrick, ‘Good Faith: A Matter of Principle?’ in Angelo Forte (ed), *Good Faith in Contract and Property Law* (1999), at 41.

In practice most neutralists would accept an approximate rather than a perfect equivalence between good faith and the existing law.⁶ However, it is difficult for a neutralist to assert that it makes no difference whether the status quo is preserved or a good faith doctrine is introduced. The incorporation of a good faith doctrine into New Zealand contract law is likely to have significant practical implications on the administration of the law. Indeed, it is submitted that a doctrine of good faith should not be introduced if a satisfactory equivalence between good faith and the existing law can be established. Referring to the terminology of Brownsword, ‘the indifference thesis’ does not realistically hold where ‘the equivalence thesis’ is realised. A number of reasons exist to support this observation. These are explored below.

4.2.2 Neutrality – Tending Towards Negativity?

If good faith is simply introducing a new cause of action which will produce no different outcome to that under those causes of action currently available, there is no benefit in incurring the transactions costs associated with introducing the subject doctrine. *Ex hypothesi*, the neutral view must take the negative view on this practical issue.⁷

Likewise, it is unclear what the relationship would be between a doctrine of good faith and the existing piecemeal rules if the doctrine was implemented under equivalence

⁶ A comparative study has been conducted by Zimmermann and Whittaker to test the veracity of the equivalence thesis. 30 different fact patterns were applied to the prevailing contract law of 14 European countries, some of which expressly adopt good faith and others, such as England and Scotland, which do not. It was found that ‘twenty of the thirty cases led either to the same result in all the systems or the same result in all the systems bar one or two.’ The authors concluded that ‘in some of our cases some of the legal systems under consideration do not need to resort to a general corrective principle such as good faith because they possess instead particular legal doctrines which do the job, whether or not they are considered related to any wider principle...The existence of various other legal doctrines which “do the job” of good faith lends support to the view that, at least to an extent and in certain respects, its use in a particular legal system is contingent on the presence of such other, more particular doctrines.’: Reinhard Zimmermann and Simon Whittaker, ‘Coming to Terms with Good Faith’ in Reinhard Zimmermann and Simon Whittaker (eds), *Good Faith in European Contract Law* (2000), at 653, 683 and 684.

⁷ Brownsword, above n 1, at 22.

conditions. If good faith were to be introduced as a perceived supplement to the existing law, the result would be wasteful duplication. Good faith would be of no additional benefit to a wronged party seeking to bring a claim. Moreover, it is likely that the existing doctrines would become clouded by a general background standard of good faith.⁸ Conceivably, litigants might concurrently plead a breach of the applicable existing doctrine and good faith. The latter may be erroneously perceived as a ‘safety net.’ In theory, reliance on good faith should not increase the chances of a plaintiff succeeding.

Alternatively, under equivalence conditions the obligation of good faith may perfectly subsume the existing piecemeal doctrines rather than supplementing them. Existing contractual principles would be phased out as obsolete.

It is contentious whether a general principle is more desirable than a body of discrete principles. It is extremely difficult to assess the organisational impact of the introduction of a unifying principle.⁹

It has been suggested that the unification of the existing law under a general principle of good faith may enhance the efficient administration of contract law. A plaintiff could rely on one generalised cause of action rather than requiring him or her to fit within a rigid set of rules unique to a specific doctrine necessarily selected from a group of many. Some further contend that there is a tendency for contract law within the common law jurisdictions to break down into disjointed formalism. Often the underlying rationale of the distinct rules and their interconnection cannot be comprehended by practitioners and judges.¹⁰ Good faith proponents therefore believe that the subject doctrine would promote coherence in New Zealand contract law.

⁸ Ibid.

⁹ McKendrick, above n 5, at 44.

¹⁰ Scott C Styles, ‘Good Faith: A Principled Matter’ in Forte (ed), above n 5, at 177-178. See also P S Atiyah, *Essays on Contract* (1986), at 337.

Nonetheless, it is doubted that a general principle of good faith would improve the administration of the law of contract in New Zealand. A universal doctrine of good faith is more likely to have a negative administrative impact rather than a positive effect. The prevailing approach to confine judicial discretion within narrow parameters generally allows the law to be applied in a consistent, predictable and therefore efficient manner.¹¹ The substitution of firm rules for a vague discretionary general standard increases the likelihood of litigation which is more complex, protracted and expensive.¹² The incentive to appeal an adverse decision also strengthens. Moreover, it may be inappropriate to translate rules and concepts appearing under categories known to New Zealand lawyers and jurists into legal terminology with which they are largely unfamiliar.¹³ A general discretionary doctrine might lead to ‘well-meaning sloppiness of thought.’¹⁴

It is evident that many New Zealand lawyers, and contract lawyers in particular, have an innate distrust of general principles.¹⁵ The prevailing mentality in Europe is quite distinct from that in New Zealand and England. On the Continent the system is perceived as being complete and free from gaps. In New Zealand lawyers must feel their way gradually from case to case.¹⁶ European civil law practitioners prefer generalisations whilst New Zealand lawyers favour the systematics.

¹¹ See James Davies, ‘Why a Common Law Duty of Contractual Good Faith is not Required’ (2002) 8 *Canterbury Law Review* 529, at 537. It has further been suggested that orderly legal development will be imperiled by the dismantling of old principles without the substitution of a new coherent body of doctrine. See Sir Gerard Brennan, ‘Commercial Law and Morality’ (1989) 17 *Melbourne University Law Review* 100, at 101-102.

¹² See John Smillie, ‘Certainty and Civil Obligation’ (2000) 9 *Otago Law Review* 633, at 635.

¹³ See Daniel Friedman, ‘Good Faith and Remedies for Breach of Contract’ in Jack Beatson and Daniel Friedman (eds), *Good Faith in Contract Law* (1995), at 399.

¹⁴ *Baylis v Bishop of London* [1913] 1 Ch 127, at 140 per Scrutton LJ.

¹⁵ Similar observations are made in respect of English contract lawyers. See McKendrick, above n 5, at 46.

¹⁶ This is contended to be the prevailing perception of Continental lawyers towards the common law jurisdictions. See Konrad Zweigert and Hein Kötz, *An Introduction to Comparative Law* (3rd ed, 1998), at 69.

Attempts to formulate general principles in other areas of English contract law have been met with judicial disapproval. For example, the efforts of Lord Denning MR in *Lloyd's Bank Ltd v Bundy*¹⁷ to introduce a general doctrine of inequality of bargaining power was firmly rejected by the House of Lords in *National Westminster Bank plc v Morgan*.¹⁸ Lord Scarman suggested that it was the responsibility of the legislature to introduce such a doctrine.¹⁹ Parliament was the most appropriate body for imposing restrictions on the freedom of contract. Preference was also shown for judicial decision making based primarily on the particular facts of the case rather than applying some broadly defined general principle in the abstract.²⁰ Accordingly, the adverse reception shown by common law judges to general contractual principles suggests that it is likely that the existing approach will be preferred over a universal doctrine of good faith if the equivalence thesis holds.

Further, the presence of a general principle of good faith may allow judges to more readily engage in an unwarranted extension or manipulation of the remedies available under the existing law.²¹ The equivalence thesis and the neutral view are compromised if this occurs. Accordingly, a neutralist is likely to prefer the retention of the existing individual doctrines to an open-ended good faith principle. The latter may be open to judicial licence and abuse.

Accordingly, there is a clear tendency for the neutral view to lean towards a negative view of a good faith doctrine. If equivalence between the existing law and good faith can be established, the introduction of a general doctrine of good faith within New Zealand is unlikely to be supportable. A universal doctrine of good faith should only be put in place if it will result in different and supportable pragmatic legal outcomes. This positive ideology is explored below.

¹⁷ [1974] 3 All ER 757.

¹⁸ [1985] 1 All ER 821.

¹⁹ Ibid, at 830.

²⁰ Ibid, at 831.

²¹ See generally McKendrick, above n 5, at 44; Styles, above n 10, at 178.

4.3 The Positive View:

4.3.1 What is the Positive View?

In the context of a doctrine of contractual good faith, the positive school of thought is founded on the contention that good faith would provide an appropriate remedy for a deserving plaintiff where the current law simply fails to, or is able to only by judges ‘fictionalising’²² existing legal concepts and rules. This is the argument adopted by the majority of proponents of a universal doctrine of contractual good faith.

In the modern debate, Raphael Powell was probably the first to espouse the positive stance. He famously argued that there ‘is still an area in which a man’s conduct, though lacking in good faith, does not involve legal consequences in English law.’²³ Apparently there are abundant examples of instances in which the law has proved inadequate in serving the reasonable expectations of the commercial community.²⁴ The treatment by the courts of heads of agreements, agreements to negotiate, and the general distaste for positive obligations such as disclosure of the whole truth have been proffered as examples.²⁵

It has been asserted by some who endorse the positive approach that a legal remedy has been unjustifiably denied in some instances as a result of a lack of good faith. However, in other scenarios the existing law has been distorted to accommodate a remedy. For want of a good faith doctrine, judges have resorted to contortions or subterfuges to give effect to their sense of justice in a particular case.²⁶

²² Robert S Summers, “‘Good faith’ in General Contract Law and the Sales Provisions of the Uniform Commercial Code” (1968) 54 *Virginia Law Review* 195, at 198.

²³ Raphael Powell, ‘Good Faith in Contracts’ (1956) 9 *Current Legal Problems* 16, at 28.

²⁴ See generally Justice Edward Thomas, ‘Good Faith in Contract: A Non-Sceptical Commentary’ (2005) 11 *New Zealand Business Law Quarterly* 391, at 393.

²⁵ *Ibid.* Preliminary agreements were examined in Chapter 2. Non-Disclosure is discussed below and in Chapter 5.

²⁶ Powell, above n 23, at 26.

It would not be particularly surprising that this manipulation does occur in practice if the existing law is indeed perceived as inadequate. It is only natural for the judiciary to desire to achieve a fair result. A judge will think long and hard before reaching a conclusion which is not consistent with notions of good faith and fair dealing.²⁷ Indeed, the necessity for common law judges to distort the existing law has been the subject of criticism by civil lawyers. One Continental lawyer has suggested that the mistrust of Anglo-Antipodean jurists for the general concept of good faith is matched only by the imagination which they utilise to twist and extend particular concepts to achieve the same results.²⁸

There is obvious detriment in manipulating the existing law to give effect to good faith. The result is likely to be inequity, unclarity or unpredictability.²⁹ A doctrine of good faith is arguably more supportable if it would allow for more transparent decision making and prevent the unwarranted manipulation of existing legal and equitable rules. Finn endorses this argument:

[W]ith good faith, as in other areas of the law, quite elementary and intuitive notions of fairness are at work...If at the end of the day we must rely upon the good sense, experience, and instinct for justice of those who ordain or apply a given standard, what we ought to expect is a methodology that reveals rather than conceals the basis for judgment.³⁰

Were good faith to be implemented as a transparent and express legal device as Finn suggests, it would have to be considered how good faith would interact with the current law. Conceivably good faith may subsume and exceed the reach of existing rules of law. Thus it is possible that existing doctrines may be rendered altogether nugatory. However, the alternative is that a doctrine of good faith would sit alongside the existing law. This is

²⁷ McKendrick, above n 5, at 46.

²⁸ See Jacques-Henri Michel in the foreword to Jacques-Henri Michel et al, *La Bonne Foi* (1998), at x.

²⁹ See Summers, above n 22, at 198.

³⁰ Justice Paul Finn, 'Good Faith and Fair Dealing: Australia' (2005) 11 *New Zealand Business Law Quarterly* 378, at 382.

the more orthodox view. Good faith would fall into the hotchpotch of legal, equitable and statutory rules regulating contractual dealings. For example, good faith could be implanted without disturbing the classical grounds of invalidity such as force, fraud, mistake and undue influence.³¹ It has further been suggested that good faith may be called upon to extend existing principles. Brownsword opines:

[I]f we imagine good faith as an umbrella principle, covering, unifying, and filling the gaps between a range of specific doctrines designed to secure fair dealing, then in hard cases (of the kind that supposedly make bad law) judges could appeal to the umbrella principle to justify a one-off decision, or to adumbrate some new principle of fairness, or to extend the range of an already recognised principle (for example extending the range of equitable estoppel into pre-contractual dealings, or extending the principle of duress to some forms of economic pressure, and so on).³²

Moreover, good faith may conceivably override some existing legal principles. Supposedly certain extant contract doctrine might impede rather than assist the amicable resolution of contractual disputes.³³ The subject doctrine would therefore exert pressure upon rules which are incompatible with the principle of good faith.³⁴ As a result, proponents believe that certain arbitrary and harsh requirements, particularly relating to implication, construction and variation, could be ameliorated or eliminated by a developed good faith rule.³⁵

³¹ See Thomas, above n 24, at 494.

³² Brownsword, above n 1, at 26-27.

³³ See generally Finn, above n 30, at 387.

³⁴ See Friedman, above n 13, at 399-400.

³⁵ See generally Finn, above n 30, at 387. However, contrast the observations of Bigwood who observes that ‘it is not clear to me, however, that the law’s “covert tools” — the rules of interpretation and construction, unconscionability, the implied terms, offer and acceptance principles, and the like — are insufficiently malleable to achieve justice in “hard” cases. Perhaps we should be looking to exhaust the possibilities available in extant legal and equitable doctrine before looking for new solutions outside of it.’: Rick Bigwood, ‘Symposium Introduction: Confessions of a “Good Faith” Agnostic’ (2005) 11 *New Zealand Business Law Quarterly* 371, at 375.

In order to justify support for this positive view, it is necessary to consider whether the existing law is actually manifestly inadequate. The following section provides a critique of some of the noticeably varied case examples which have been cited as evidence of deficiencies in the existing law, which a doctrine of good faith may supposedly have rectified. Such an analysis can never be all-encompassing and it does not purport to be. However, the study may provide some insight into whether the positive stance can be endorsed.

4.3.2 Case Examples – Is the Existing Law Deficient?

In his pioneering article, Raphael Powell advanced the case of *L'Estrange v F Graucob Ltd*³⁶ to support his thesis that the law of contract is deficient without good faith. Miss L'Estrange purchased a cigarette slot machine for use in her café. The machine did not work satisfactorily and she claimed damages on the basis of an implied warranty. However, at the time of purchase Miss L'Estrange had signed a form which stipulated that implied warranties were excluded. The clause was in small print which she did not read. The English Court of Appeal held that the vendor had not engaged in any misrepresentation and thus Miss L'Estrange was bound by the terms of the agreement despite not having read those terms.³⁷ During the course of the judgment Maugham LJ stated:

I regret the decision to which I have come, but I am bound by legal rules and cannot decide the case on other considerations.³⁸

Seemingly the law did not permit Maugham LJ to give effect to his Honour's sense of justice and fairness in the case. Powell argued that a doctrine of good faith might have provided Miss L'Estrange with a remedy. Good faith could have compelled a party who

³⁶ [1934] 2 KB 394.

³⁷ Ibid, at 404 per Scrutton LJ.

³⁸ Ibid, at 405.

produces a printed form to call the attention of an intending signatory to the relevant clauses before signing the document.³⁹

However, it is debatable whether it would now be necessary to resort to a term of good faith to potentially achieve a different result. *L'Estrange* was decided some 75 years ago. The law has developed considerably since then. In *Crocker v Sundance Northwest Resorts Ltd* the Supreme Court of Canada held that a party to a written contract was not bound by a waiver because the clause was not drawn to his attention at the time of signing.⁴⁰ He had not read the document and he was unaware of the existence of the term. Accordingly the law has, at least in Canada, endeavoured to achieve the outcome desired by Powell without any need to resort to a principle of good faith.

Whilst the rule in *L'Estrange* has not necessarily been overridden in Australasia, it may be qualified in cases of particularly onerous clauses.⁴¹ In *Toll (FGCT) Pty Ltd v Alphapharm Pty Ltd* the High Court of Australia, although approving *L'Estrange*, recognised that in certain circumstances a contracting counterparty could not reasonably understand the signature of the other party to be evidence of assent by the signatory to the terms.⁴²

Moreover, within New Zealand other causes of action may be relied upon to negate the effect of an exclusion clause. For example, the Fair Trading Act 1986 ("FTA") may

³⁹ Powell, above n 23, at 27.

⁴⁰ (1989) 51 DLR (4th) 321, at 333 per Wilson J. See also *Tilden Rent-a-Car v Clendenning* (1978) 83 DLR (3d) 400.

⁴¹ See John Burrows, Jeremy Finn and Stephen Todd, *Law of Contract in New Zealand* (3rd ed, 2007), at 198.

⁴² (2005) 211 ALR 342, at 358 per Gleeson CJ, Gummow, Hayne, Callinan and Heydon JJ. It has been suggested that the approach in *Toll* is not inconsistent with good faith. Accordingly, notions of good faith do not give rise to an obligation to provide reasonable notice of the terms of the contract beyond the presentation of a document which the other party is free to read before signing it. See generally Elizabeth Peden and John Carter, 'Incorporation of Terms by Signature: L'Estrange Rules!' (2006) 21 *Journal of Contract Law* 96.

provide a remedy where an exclusion clause has been signed as a consequence of misleading or deceptive behaviour by the other party. Likewise, undue influence and unconscionability may provide relief in cases of victimisation.⁴³ Also, the Consumer Guarantees Act 1993 would prohibit a seller from relying on a clause like that in *L'Estrange* purporting to exclude liability for the quality of the goods purchased by a consumer.⁴⁴

It is therefore evident that the law within New Zealand has developed, to some extent, to address the unfairness perceived by Powell. In any event it is questionable whether the result in *L'Estrange* should have been otherwise. To abandon the presumptive rule that a signature to a contract is evidence of assent to be bound by the terms therein would be liable to create confusion and uncertainty.⁴⁵ If the law were to promote a different result under a doctrine of good faith, contracting parties would have an undesirable incentive to avoid reading contractual terms. The signatory would place unnecessary reliance upon the other party and a rule of good faith to protect his or her interests. This outcome is not to be welcomed, particularly in cases like *L'Estrange* where the purchaser was engaged in business and should have been expected to take steps to protect her own position.

This view was apparently endorsed by Ronald Young J in *Pure New Zealand Foods Ltd v Carter Holt Harvey Limited*.⁴⁶ An issue arose as to whether the plaintiff was bound by the terms of sale which included a clause limiting the liability of the defendant. His Honour held that that the plaintiff was so bound because it was aware that the signed acceptance of a quote also constituted acceptance of the standard terms of sale of the defendant. Whether the plaintiff 'chose to read the [t]erms of [s]ale was entirely a matter for [it] but any failure to do so [was] not relevant to whether they were a term of the contract.'⁴⁷

⁴³ See Burrows, Finn and Todd, above n 41, at 198.

⁴⁴ Section 43 Consumer Guarantees Act 1993.

⁴⁵ For a general discussion of the rule see Phillip Sharp, 'Revisiting the Rule in *L'Estrange v F Graucob Ltd*' (2005) 17 *Bond Law Review* 204.

⁴⁶ (High Court, Wellington, CIV 2004-485-2747, 11 November 2008). Cf *Nalder & Biddle (Nelson) Ltd v C & F Fishing Ltd* (Court of Appeal, CA 145/05, 31 July 2006).

⁴⁷ *Ibid*, at [59].

There was no evidence to suggest that the exclusion clause was particularly harsh in a commercial contract. Accordingly, the defendant was not obliged to draw it to the specific attention of the plaintiff.⁴⁸ Based on this logical rationale founded on contractual certainty, it is submitted that the judiciary would be unlikely to allow a good faith obligation to completely displace the rule in *L'Estrange*.

Accordingly, the example proffered by Powell provides little support for the positive theory. The law has developed to the requisite extent to achieve what a good faith obligation should otherwise.

The second case for consideration is the decision of the House of Lords in *Union Eagle Ltd v Golden Achievement Ltd*.⁴⁹ Michael Bridge has recognised that the case might be perceived as supporting the argument for good faith.⁵⁰ The appellant entered into a contract to purchase a flat in Hong Kong from the respondent. A 10 per cent deposit was paid. Time for settlement was of the essence. The appellant was 10 minutes late in tendering payment. The respondent purported to cancel the contract. The appellant sought specific performance of the agreement or relief against forfeiture of the deposit in the alternative. The Law Lords granted neither.

Although the outcome may be perceived to be somewhat unfair, it must be questioned whether a doctrine of good faith could have, and should have, produced a different result. The respondent had simply relied upon the terms of the contract. The appellant was well aware of its obligations and it failed to comply with the agreement. To hold that an obligation of good faith would preclude the respondent from relying on its strict contractual rights would be a paradigm example of the subject doctrine being utilised to override and rewrite the terms of an agreement. Further, to depend on good faith to grant

⁴⁸ Ibid, at [68]-[69].

⁴⁹ [1997] 2 All ER 215.

⁵⁰ See Michael Bridge, 'Doubting Good Faith' (2005) 11 *New Zealand Business Law Quarterly* 426, at 442. For further academic comment regarding good faith and the *Union Eagle* decision see McKendrick, above n 5, at 56-58; Brownsword, above n 1, at 18-20.

relief would produce too much uncertainty. There would be no clarity as to how late the tender of settlement would have to be before the vendor could validly cancel. Thus, it is unlikely that a good faith doctrine would have compelled the House to reach a different conclusion.

The outcome in *Union Eagle* was supported by the majority decision of the Supreme Court in *Rick Dees Ltd v Larsen*.⁵¹ Rick Dees contracted to purchase real estate from Larsen. By virtue of a settlement notice, the monies were to be transferred and confirmation of the same was to occur before 5pm on 5 March 2004. The funds were deposited direct into the trust account of Larsen's solicitors no later than 4:54pm. However, confirmation was not made until 5:07pm because the fax machine of Larsen's solicitors was engaged and the solicitor dealing with the transaction was unable to come to the telephone. In the meantime, Larsen's solicitors sent a fax to Rick Dees' solicitors at 5:03pm purporting to cancel for failure to comply with the settlement notice. Rick Dees sued for specific performance.

The majority⁵² held that the agreement had been validly cancelled. Rick Dees was obliged to provide Larsen with confirmation of payment before 5:00pm. No flexibility would be allowed because it would introduce a most undesirable element of uncertainty.⁵³

Again, it is questionable whether a good faith doctrine may have fettered the rights of Larsen and precluded him from cancelling. Elias CJ dissented. Her Honour found the argument relating to uncertainty to be 'unpersuasive.'⁵⁴ Larsen could readily have requested the bank into which the funds were paid, which acted as his agent, to provide confirmation that the funds were received in due time. Conceivably, Larsen would have made such an inquiry if he was acting in good faith.

⁵¹ [2007] 3 NZLR 577.

⁵² Blanchard, McGrath, Gault and Tipping JJ.

⁵³ [2007] 3 NZLR 577, at 588 per Blanchard J

⁵⁴ *Ibid*, at 582.

To deny relief on the grounds that it would detract from a certain rule is likely to provoke objection from ardent good faith proponents.⁵⁵ Nonetheless, it is submitted that the decision was correct and a doctrine of good faith should not have displaced the result. It has been contended that:

[N]otice at 5.01 pm is deemed to be received the following day. Time lines are strict, and while many solicitors would have allowed the purchaser in this case some minutes leeway on the basis that what goes around often comes around, it is probably fair to say that many would have thought the finding for the vendor [] unfortunate for the purchaser rather than unfair.⁵⁶

Ultimately, there are sound reasons why the existing law declines to provide a remedy in circumstances similar to those in *Union Eagle* and *Rick Dees*. Accordingly, it is unlikely that good faith would be interpreted to produce a different result.

The *L'Estrange* and *Union Eagle* cases are both examples where good faith proponents suggest that the outcome was incorrect. It is necessary to now consider some perceived examples where the result is contended to be correct but, for lack of a good faith doctrine, judges have had to manipulate the existing law.

The first case to be considered supposedly falling within this category has been propounded by Wightman.⁵⁷ It is the decision of the House of Lords in *Scally v Southern Health and Social Services Board*.⁵⁸ It was held that the Board was obliged to inform the doctors which it employed of changes in rules about pension contributions. These changes required the doctors to exercise their rights within a certain timeframe or otherwise face less favourable terms. The obligation to notify was said to be founded on a

⁵⁵ See generally McKendrick, above n 5, at 57.

⁵⁶ Thomas Gibbons, 'Rick Dees Ltd v Larsen' (2006) 12 *Butterworths Conveyancing Bulletin* 58.

⁵⁷ John Wightman, 'Good Faith and Pluralism in the Law of Contract' in Brownsword, Hird and Howells (eds), above n 1, at 64.

⁵⁸ [1991] 4 All ER 563.

term implied in law.⁵⁹ Lord Bridge devised intricate criteria to define the narrow class of contract for which the term would be implied. The class was described as follows:

(1) the terms of the contract of employment have not been negotiated with the individual employee but result from negotiation with a representative body or are otherwise incorporated by reference; (2) a particular term of the contract makes available to the employee a valuable right contingent upon action being taken by him to avail himself of its benefit; (3) the employee cannot, in all the circumstances, reasonably be expected to be aware of the term unless it is drawn to his attention.⁶⁰

The judgment has been regarded by some as contrary to the clear trend to treat terms implied in law as attaching to broad categories of contract such as contracts of employment as a whole.⁶¹ Good faith proponents suggest that had a doctrine of good faith been in place, conceivably it may not have been necessary to manipulate the traditional tests for implied terms.

However, these concerns can be readily appeased by recognising that within New Zealand there would have been no need to resort to the common law of implied terms to provide a remedy for the employee doctors in the *Sally* case. In accordance with the good faith obligations under the Employment Relations Act 2000 (“ER Act”), the Board would likely have been under a duty to advise its employees of the timeframe for exercising the contractual rights. This is consistent with the non-exhaustive definition of good faith under s 4(1A)(b) which requires communication between an employer and its employees. Thus there would have been no necessity to distort the existing law in New Zealand to arrive at the desired outcome in *Sally*.

To further support his argument, Wightman put forward the case of *Spring v Guardian Assurance plc*.⁶² There the House of Lords again derived a narrow test for defining the

⁵⁹ Ibid, at 571 per Lord Bridge.

⁶⁰ Ibid, at 571-572.

⁶¹ See Wightman, above n 57, at 64.

⁶² [1994] 3 All ER 129.

class of contract under which there would be a legally implied term. The term in question required an employer to take reasonable care in writing a reference for an employee.⁶³ It has been suggested that this is another clear example of the necessity to distort the existing law of implied terms for want of a good faith rule.

Again however, the ER Act would apply in this scenario, at least during the currency of the employment contract. Moreover, in *Spring* the employer was found to be under a duty of care in tort. The implied term added nothing to the tortious duty of care.⁶⁴ Thus, there was no real need to engage in the alleged manipulation of the law of implied terms to achieve the result desired.

It is therefore submitted that whilst the courts might occasionally make mistakes with the tools they possess, that ‘is no reason to change the toolbox.’⁶⁵ The perceived manipulation of the law in *Scally* and *Spring* could have been avoided in New Zealand whilst still reaching the same outcome. Accordingly, the cases proffered by Wightman provide little support for the positive theory.

The case of *Rice (t/a Garden Guardian) v Great Yarmouth Borough Council*⁶⁶ has also been propounded as an example of the courts giving effect to good faith by contorting existing law.⁶⁷ Rice entered into two contracts to provide leisure and ground management services to the Council for a period of four years. The Council purported to cancel the contracts seven months after their commencement. It had served numerous default

⁶³ Ibid, at 179. The class of contracts was defined by Lord Woolf as follows: ‘(i) the existence of the contract of employment or services; (ii) the fact that the contract relates to an engagement of a class where it is the normal practice to require a reference from a previous employer before employment is offered; (iii) the fact that the employee cannot be expected to enter into that class of employment except on the basis that his employer will, on the request of another prospective employer made not later than a reasonable time after the termination of a former employment, provide a full and frank reference as to the employee.’

⁶⁴ Ibid, at 147 per Lord Goff.

⁶⁵ Bridge, above n 50, at 436.

⁶⁶ [2003] TCLR 1.

⁶⁷ See Bridge, above n 50, at 441.

notices prior to the cancellation. These notices related to the quality and timeliness of the work required of Rice under the contracts. The Council relied upon a specific clause under the contracts to cancel. This stated that if Rice committed ‘a breach of any of [his] obligations under the [c]ontract’ then ‘the Council [could] terminate [Rice’s] employment under the [c]ontract by notice in writing having immediate effect.’ The English Court of Appeal upheld the finding of the trial judge that the cumulative breaches by Rice were not sufficiently serious to amount to a repudiatory breach.⁶⁸ Therefore, the critical issue related to the proper interpretation of the termination clause. The Court held that it could not be applied literally so as to give the Council the right to terminate the contracts ‘at any time for any breach of any term.’⁶⁹ Hale LJ opined that such an interpretation ‘flies in the face of commercial common sense.’⁷⁰ Because the terms of the contracts could be broken in so many different ways with such varying consequences, it was deemed that the parties could not have intended that any breach would entitle the innocent party to cancel the contracts.⁷¹ Accordingly, the Council was found to have improperly cancelled the contracts because the breaches were not sufficiently serious.

The decision is susceptible to scrutiny by both proponents and opponents of good faith. The former may argue that the Court was forced to invoke the guise of interpretation in order to override the ‘draconian’⁷² effect of a literal reading of the clause and to defend the desired outcome. It was bound to give effect to good faith *sub modo*.⁷³ On the contrary, opponents are liable to suggest that the Court had no justification to depart from the plain and ordinary meaning of the words such that the Council should have been entitled to cancel the contracts. The autonomy and clear intention of the parties was impermissibly undermined.

⁶⁸ [2003] TCLR 1, at [35]-[39] per Hale LJ.

⁶⁹ Ibid, at [24].

⁷⁰ Ibid.

⁷¹ Ibid, at [26].

⁷² See Bridge, above n 50, at 440.

⁷³ Ibid, at 441.

There is an outward attractiveness in arming the judiciary with a good faith doctrine to deal with cases like *Rice*. Adopting good faith as a rule of construction would conceivably allow the courts to construe such clauses with reference to notions of good faith. Thus, the good faith device could be used to avoid the construction of a contractual clause which may give rise to an unjust result. An express doctrine of good faith might therefore provide a more robust and defensible justification to rationalise an outcome which is ostensibly contrary to the plain wording of the contract.

Nonetheless, it is debatable whether the reasoning adopted in *Rice* did constitute a departure away from developed legal principles of contractual interpretation. In *Pyne Gould Guinness Ltd v Montgomery Watson NZ Ltd* the Court of Appeal recognised the ‘necessity for a construction which accords with business common sense.’⁷⁴ Undoubtedly, ‘a clause does not lack commercial sense just because a judge does not like the look of it.’⁷⁵ However, a literal reading of the termination clause in *Rice* must have offended commercial logic. To allow the Council to cancel for an insignificant breach of any term would all but permit it to terminate the contracts at will. Undoubtedly this would be an unacceptable position for *Rice* who had borrowed substantial sums of money, invested in equipment and considerably increased his workforce relying upon the continuance of the agreements.⁷⁶ Critically, even the Council acknowledged these commercial considerations by conceding that the cancellation clause would not allow it to terminate for ‘trivial’⁷⁷ breaches.

Further, in *Pyne Gould Guinness* it was also recognised that there is a need for ‘abundantly clear intention in event of [an] unreasonable result.’⁷⁸ The intention in *Rice* was not as clear as the wording of the cancellation clause suggested. For example, the

⁷⁴ [2001] NZAR 789, at [23] per McGechan J. See also *The Antaios* [1984] 3 All ER 229, at 323 per Lord Diplock.

⁷⁵ See Bridge, above n 50, at 441.

⁷⁶ [2003] TCLR 1, at [6] per Hale LJ.

⁷⁷ *Ibid*, at [17].

⁷⁸ [2001] NZAR 789, at [23] per McGechan J.

contracts provided for the issuing of default notices. This apparently revealed an intention that the Council might give Rice the right to rectify certain breaches as an alternative to exercising the right of cancellation. Accordingly, there was some apparent justification to depart from a literal interpretation of the termination clause.

It is therefore submitted that the decision in *Rice* was neither incorrect nor out of step with the law relating to contractual interpretation. The case is evidence of the move from a literal approach to a more purposive and commonsense construction of contracts.⁷⁹ Undoubtedly, the ‘best start to understanding a document is to read the words used, and to ascertain their natural and ordinary meaning in the context of the document as a whole.’⁸⁰ However, recourse to evidence of surrounding circumstances is helpful to ‘cross-check whether some or other modified meaning [is] intended.’⁸¹ Indeed, in *Mount Joy Farms Ltd v Kiwi South Island Co-operative Dairies Ltd* Hammond J recognised that the ‘day has long since passed in our Courts where words are to be given a purely literal meaning.’⁸² This modern approach to contractual interpretation is arguably evidence of the courts seeking to give better effect to the reasonable expectations of the contracting parties. The *Rice* decision therefore indicates that the Anglo-Antipodean common law has evolved in order to give effect to notions of good faith.

Notably, if the facts in *Rice* were to arise in New Zealand the issue would fall to be decided under s 7(4)(a) of the Contractual Remedies Act 1979 (“CRA”). It would have to be determined whether the parties had expressly or impliedly agreed that the term which was breached was essential to the Council so as to justify cancellation. This would raise a question as to whether s 7(4)(a) could be satisfied by way of a stand-alone clause providing that every clause in the contract is essential. Conceivably such a clause would have to be so clearly worded so as to put the matter beyond doubt. Seemingly the clause in *Rice* was not sufficiently clear. Hale LJ recognised that the cancellation clause did not

⁷⁹ Burrows, Finn and Todd, above n 41, at 161.

⁸⁰ *Pyne Gould Guinness Ltd v Montgomery Watson NZ Ltd* [2001] NZAR 789, at [29] per McGechan J.

⁸¹ *Ibid.*

⁸² (Court of Appeal, CA 297/00, 6 December 2001), at [38].

expressly characterise the importance of any particular term nor expressly ‘indicate which terms are to be considered so important that any breach will justify termination.’⁸³ Accordingly, it is unlikely that the provisions of the CRA would have altered the result in *Rice* or the interpretation of the termination clause. Rights of cancellation for breach and the relationship between good faith and the CRA are considered in more detail later in this chapter.

According to Thomas, the New Zealand judiciary has also engaged in subterfuge. Thomas suggests that, for lack of a good faith doctrine, the fiduciary principle has been stretched to cover factual scenarios that do not properly justify its application.⁸⁴ The Court of Appeal decision in *Liggett v Kensington*⁸⁵ (better known as the *Goldcorp* case) is put forward as an example. The decision requires analysis.

The facts can be briefly stated. Various customers of Goldcorp Exchange Ltd contracted to purchase bullion for future delivery. No bullion was set aside or appropriated to the contract at the time of payment. Goldcorp did however represent to its customers that it had an adequate stock of bullion to meet its contractual commitments to its customers. This was untrue. Goldcorp only held enough stock to meet likely delivery demands. It was intended that more bullion would be acquired over time by virtue of deferred purchase contracts. No funds were set aside for this purpose. The purchase monies advanced by the customers were intermingled within the general company funds. Goldcorp was subsequently placed into liquidation. A floating charge held by the Bank of New Zealand crystallised. There were insufficient funds in the creditors’ pool to satisfy the unsecured creditors. The customers claimed to be entitled to a proprietary interest either in the available bullion or the monies paid.

⁸³ [2003] TCLR 1, at [22].

⁸⁴ See Thomas, above n 24, at 405. In respect of applying fiduciary principles to remedy the perceived deficiencies of contract law, it is contended that it is ‘misguided to distort without good reason one reasonably intelligible and coherent body of law to remedy what is wanting in another.’: Paul Finn, ‘Contract and the Fiduciary Principle’ (1989) 12 *University of New South Wales Law Journal* 76, at 97.

⁸⁵ [1993] 1 NZLR 257.

The majority⁸⁶ of the Court of Appeal held that Goldcorp was under a fiduciary duty to the non-allocated purchasers. This required that Goldcorp would hold sufficient bullion on behalf of the customers as represented. The purchase money was held on trust, the purpose of which was setting aside sufficient bullion to meet the customer's claims. In consequence, the customers were entitled to a proprietary right in the bullion held by Goldcorp.

The Privy Council unanimously rejected this reasoning. It was possible for contractual obligations to give rise to fiduciary relations but in the case at hand there could be no obligations beyond those which Goldcorp had assumed under the contracts of sale.⁸⁷ The Court of Appeal had impermissibly stretched equitable fiduciary principles in an attempt to create a proprietary interest.

Thomas suggests that, had a general doctrine of good faith been available, then the Court of Appeal would not necessarily have had to grasp at a fiduciary duty. His reasoning is as follows:

If the law incorporated a developed doctrine of good faith, Goldcorp could have been held to have been in breach of the obligation to perform its contractual obligations with due regard to the legitimate interests of its customers. Of course, such a breach would not avail the customers unless the courts could also award a proprietary as well as a personal remedy for its breach. But that is another story.⁸⁸

With respect, the rationale adopted by Thomas is flawed and inadequate. The *Goldcorp* case cannot possibly substantiate an argument for contractual good faith. There was absolutely no doubt that Goldcorp was in breach of contract with its customers. It had failed to deliver the gold or title to the gold to the customers. Accordingly, each customer had a valid legal claim to recover the purchase monies and any associated loss for the failure to perform the contract. In this regard an obligation of contractual good faith

⁸⁶ Cooke P and Gault J (McKay J dissenting).

⁸⁷ [1994] 3 NZLR 385, at 399 per Lord Mustill.

⁸⁸ Thomas, above n 24, at 406.

would not have provided any additional benefit in terms of a claim for breach of contract. In reality, the case turned on the competing interests of creditors. The breach of contract claim, which existed with or without good faith, was not sufficient to create a proprietary remedy. That is the reason why the Court of Appeal resorted to fiduciary duties and the principle of a constructive trust. Only the breach of an equitable duty was sufficient to create a proprietary remedy. Thus, whilst Thomas is clearly correct in noting that the Court of Appeal had impermissibly stretched the fiduciary principle, it is obvious that a claim for breach of good faith would not have been of any benefit to the Court. A good faith doctrine could not have produced the desired outcome.

If the facts of Goldcorp were to arise today, the issue of the priority of the competing claims would in all likelihood have been determined under the Personal Property Securities Act 1999. Unless title to the bullion passed to the customers, the security interest held by the bank would prevail provided that security interest was registered.⁸⁹ In some limited circumstances equity might intervene in similar factual situations on the finding of a Quistclose trust. This may have entitled the customers to recover the money on the basis that it was held on trust for the sole purpose of being applied to acquire the gold and transfer title to the customers. However, there was no evidence of such a trust in *Goldcorp*. The customers' money was not held separately but was instead used in the business of the company. Despite the fact that the customers may have been ignorant that they were taking a risk by advancing the funds, they had failed to take appropriate steps to protect their own position. An obligation of good faith on Goldcorp would not have altered the outcome. More importantly, a contractual obligation of good faith could not have been utilised to determine the rights as between two innocent parties, namely the customers and the bank.

⁸⁹ Under s 53 Personal Properties Securities Act 1999 the customers would only take the gold free of the registered security interest held by the bank if the sale was actually completed and title transferred.

4.3.3 Précis:

The positive view espouses that a good faith doctrine would rectify the deficiencies in the existing law of contract in New Zealand by providing a remedy where the current law is unable to or is only able to by distorting the prevailing law of contract.

However, the analysis of the above cases has demonstrated that the existing law within New Zealand is not necessarily deficient as a result of a lack of good faith doctrine. The cases reveal that good faith either should not, or would not, produce a different result. Further, in cases where the reasoning adopted to reach a particular decision is dubious, there is no evidence to substantiate assertions that good faith would have been a better or more appropriate alternative legal device. The case examples examined therefore do not support the positive theory.

The remainder of this chapter will engage in a comparative analysis of a doctrine of good faith relative to selected existing legal, equitable and statutory principles which appear to be of the most relevance to the subject doctrine. The study will serve a variety of functions. It will be utilised to further evaluate whether the equivalence theory or the positive theory prevails. Moreover, it is necessary to consider how a doctrine of good faith and the existing legal and equitable doctrines would be affected by the other and how they might interact if a good faith doctrine were to be incorporated into New Zealand law.

4.4 Good Faith, Misrepresentation, Pre-Contractual Non-Disclosure and the Fair Trading Act 1986:

4.4.1 Misrepresentation:

The common law of misrepresentation is concerned with the effect of pre-contractual statements.⁹⁰ The remedies for misrepresentation are now principally dealt with by two statutes, namely the CRA and the FTA.

In essence, a misrepresentation is an incorrect statement of fact during the course of negotiations by one party to a contract which induces the other to enter into the contract. The obligation on a negotiating party to avoid making incorrect statements bears some analogy to a prospective duty of good faith in the sense that both obligations require the negotiating party to observe standards of honesty and reasonableness. The law of misrepresentation may therefore be understood to incorporate various elements reflecting an unacknowledged, but implicit regard for good faith.⁹¹

In the context of common law misrepresentation, the courts are concerned principally with the effect of the misstatement on the representee. Under ss 6 and 7 of the CRA, the state of mind of the representor is largely irrelevant. The misrepresentation may be either innocent or fraudulent. Thus, if good faith is to be perceived as a substitute for the law of misrepresentation, obligations of good faith would have to be based on an objective test. Good faith would have to be appraised independent of the subjective intentions of the defendant.

Whilst similarities may be inferred between misrepresentation and a contractual doctrine of good faith, one area of potential divergence relates to non-disclosure of information during contractual negotiations. It is this issue which will principally be explored below.

⁹⁰ See Burrows, Finn and Todd, above n 41, at 302.

⁹¹ See William Tetley, 'Good Faith in Contract: Particularly in the Contracts of Arbitration and Chartering' (2004) 35 *Journal of Maritime Law and Commerce* 561, at 572.

4.4.2 Misrepresentation, Pre-Contractual Non-Disclosure and the Contractual Remedies Act 1979:

As a general rule, mere silence during the course of pre-contractual negotiations does not constitute a misrepresentation.⁹² This rule holds even if it is obvious that the person is labouring under a wrong impression that would be remedied by disclosure.⁹³ Tacit acquiescence in the self deception of another is not actionable. The rule exemplifies the principle of caveat emptor.

However, it is possible that silence may amount to a misrepresentation in certain instances. The first exception is where what is said amounts to a half-truth. A remedy will lie where an incomplete statement is made which creates a misleading impression because of what is left unsaid.⁹⁴ Secondly, there may be an obligation of disclosure where a true representation has been made but has subsequently been rendered false by changed circumstances.⁹⁵ Thirdly, the silence of one party may be taken to be confirming a misrepresentation formed in the mind of the other party. This will occur in circumstances

⁹² *Fox v Mackreth* (1788) 2 Cox Eq Case 320, at 320 and 321 per Lord Thurlow.

⁹³ *Smith v Hughes* (1871) LR 6 QB 597.

⁹⁴ See Burrows, Finn and Todd, above n 41, at 309. For case examples see *Wakelin v R H and E A Jackson Ltd* (1984) 2 NZCPR 195; *Thompson v Vincent* [2001] 3 NZLR 355; *Nottingham Patent Brick and Tile Co v Butler* (1886) 16 QBD 778; *Dimmock v Hallett* (1866) 2 Ch App 21.

⁹⁵ *Walsh v Kerr* [1987] 2 NZLR 166. This principle is justified on the basis that the time for assessing the truth of the representation is the time when the representee relies on the statement. This is the time when the contract is entered into rather than the time at which the representation is made. Thus, in *With v O'Flanagan* [1936] Ch 575 Romer LJ said (at 586) that if 'A with a view to inducing B to enter into a contract makes a representation as to a material fact, then if at a later date before the contract is actually entered into, owing to a change of circumstances, the representation then made would to the knowledge of A be untrue and B subsequently enters into the contract in ignorance of that change of circumstances and relying upon that representation, A cannot hold B to the bargain.' There is some issue as to whether the representor must know of the changed circumstances in order to be liable. For a discussion see Rick Bigwood, 'Pre-Contractual Misrepresentation and the Limits of the Principle in *With v O'Flanagan*' (2005) 64 *Cambridge Law Journal* 94.

where there is a failure to correct an incorrect statement made by the representee.⁹⁶ Fourthly, active concealment of facts and other fraudulent conduct will give rise to a legal remedy.

Arguably these exceptions are evidence of the courts giving effect to notions of good faith and fair dealing. However, the exceptions are relatively well-established. There is no apparent necessity for their unification under a general doctrine of good faith. Moreover, the individual exceptions serve to define the boundaries of the common law of misrepresentation.

However, the above exceptions generally indicate that a bare non-disclosure, that is, non-disclosure unconnected with some positive statement, will not amount to a misrepresentation. Conceivably an obligation of good faith may provide a plaintiff with a remedy for a bare non-disclosure. In this respect, the existing law of misrepresentation may be perceived to be inadequate. This may lend support to the positive theory.

Various and controversial opinions have been expressed as to the extent of disclosure that might be required under a doctrine of good faith. These views include disclosure of all material facts⁹⁷, disclosure of facts affecting the contract price⁹⁸, disclosure of facts which a man of ordinary moral sensibilities would reveal⁹⁹ and disclosure of facts casually acquired.¹⁰⁰ The alternative and restrictive approach is that the dictates of good faith permit negotiating parties to remain silent, particularly in an arms length transaction, except for the circumstances where the current law of misrepresentation requires

⁹⁶ *Dell v Beasley* [1959] NZLR 89.

⁹⁷ See generally Robert Joseph Pothier, *Traité Du Contrat De Vente* (1772).

⁹⁸ See Julian C Verplanck, *An Essay on the Doctrine of Contracts: Being an Inquiry How Contracts are Affected in Law and Morals by Concealment, Error, or Inadequate Price* (1825).

⁹⁹ See W Page Keeton, 'Fraud – Concealment and Non-Disclosure' (1937) 15 *Texas Law Review* 1.

¹⁰⁰ See Anthony T Kronman, 'Mistake, Disclosure, Information, and the Law of Contracts' (1978) 7 *Journal of Legal Studies* 1.

disclosure.¹⁰¹ Under this view good faith does not represent an abandonment of caveat emptor.

The extent to which good faith obligations should require disclosure of information will be discussed further in Chapter 5, which approaches the issue from a law and economics perspective. Suffice to say however, there are serious jurisprudential impediments in associating a contractual doctrine of good faith with a positive requirement of disclosure in pre-contractual negotiations. These difficulties are explored below.

In other areas of the law where bare non-disclosure gives rise to legal or equitable remedies, the omission is not perceived as a misrepresentation.¹⁰² For example, non-disclosure in breach of the duty of utmost good faith in insurance contracts is *sui generis*, and unrelated to misrepresentation. Similarly, non-disclosure by a fiduciary is properly a breach of an equitable duty.¹⁰³ It is distinct from a misrepresentation at common law.

One of the reasons why non-disclosure should not be considered to be a misrepresentation is that it does not appropriately apply to s 6 of the CRA, the relevant part of which provides:

- (1) If a party to a contract has been induced to enter into it by a misrepresentation, whether innocent or fraudulent, made to him by or on behalf of another party to that contract—
 - (a) He shall be entitled to damages from that other party in the same manner and to the same extent as if the representation were a term of the contract that has been broken;

Clearly a non-disclosure may induce entry into a contract. However, it does not appear logical that a non-disclosure can be treated as if it were a term of the contract that has been broken. For example, suppose a vendor of goods omits to warn the purchaser of a

¹⁰¹ See E Allan Farnsworth, 'Precontractual Liability and Preliminary Agreements: Fair Dealing and Failed Negotiations' (1987) 87 *Columbia Law Review* 217.

¹⁰² See Burrows, Finn and Todd, above n 41, at 339.

¹⁰³ *Day v Mead* [1987] 2 NZLR 443.

defect in the goods. In order to render the non-disclosure actionable as a misrepresentation under the wording of the CRA, the Court would have to concoct a term to the effect that the vendor represented that the goods were free from defects.¹⁰⁴ Only then could the purchaser obtain damages for the difference between the value of the goods if they had not been defective and the actual value of the defective goods. This requires an untenable conversion of a non-disclosure into a positive statement. Indeed, Cartwright has aptly contended that non-disclosure cannot be transposed to an implied term (and therefore a term of the contract capable of being breached) even where a duty of disclosure may be owed:

Given the general position [] that there is no general duty of disclosure between negotiating parties, it follows that there is no general implied contractual promise by each party to the other that material matters have been disclosed. Even where the contract [] has associated duties of disclosure in the formation of the contract, there is not thereby any implied contractual warranty that disclosure has been made.¹⁰⁵

Consistently, the English courts have taken the view that non-disclosure cannot constitute a misrepresentation under s 2(1) of the Misrepresentation Act 1967, which provides:

Where a person has entered into a contract after a misrepresentation has been made to him by another party thereto and as a result thereof he has suffered loss, then, if the person making the misrepresentation would be liable to damages in respect thereof had the misrepresentation been made fraudulently, that person shall be so liable notwithstanding that the misrepresentation was not made fraudulently, unless he proves that he had reasonable ground to believe and did believe up to the time the contract was made the facts represented were true.

¹⁰⁴ It is well-established that there is no general duty to disclose defects of quality in the case of a contract for the sale of goods or land. See *Walters v Morgan* (1861) 3 De GF & J 718 at 723-724 per Lord Campbell; Burrows, Finn and Todd, above n 41, at 308. Whilst the courts may not be able to treat a failure to disclose defects in goods as a breach of contract, a purchaser might nevertheless be able to bring an action for breach of an implied warranty as to quality. Sections 14-17 of the Sale of Goods Act 1908 codifies the various common law implied conditions and warranties as to title and quality.

¹⁰⁵ John Cartwright, *Misrepresentation, Mistake and Non-Disclosure* (2007), at 570.

In *Banque Keyser Ullmann SA v Skandia (UK) Insurance Co Ltd*¹⁰⁶ Slade LJ said that s 2(1) requires that the misrepresentation be ‘made.’ Non-disclosure would not amount to the ‘making’ of a misrepresentation. If the legislature had intended that this form of silence could be treated as a misrepresentation then it would have expressly said so.¹⁰⁷ Thus, there could be no statutory liability for misrepresentation even if the defendant was under a duty of disclosure and breached that obligation.¹⁰⁸

However, the New Zealand position is not as clear as in England. In *Scales Trading Ltd v Far Eastern Shipping Co Public Ltd*¹⁰⁹ the Court of Appeal considered the obligation on a bank to disclose to an intending guarantor any unusual aspects of the underlying relationship between the bank and the debtor. Although not making a final determination on the issue, the Court suggested that a failure to discharge the duty of disclosure could amount to a misrepresentation for the purposes of the CRA. McGechan J justified this conclusion on the assumption that the juridical foundation for vitiation on account of non-disclosure is on the basis of an ‘implied representation’ that nothing unusual exists in the relationship between the bank and the debtor.¹¹⁰

¹⁰⁶ [1990] 1 QB 665.

¹⁰⁷ *Ibid.*, at 790.

¹⁰⁸ *Ibid.* See also Cartwright, above n 105, at 572; Edwin Peel, *The Law of Contract* (12th ed, 2007), at 438. Thus, it has been suggested that ‘the Act does not impose liability for non-disclosure where none existed before; nor does the Act vary or affect any existing liability or defence based on non-disclosure.’: P S Atiyah and Sir Guenter Treitel, ‘Misrepresentation Act 1967’ (1967) 30 *Modern Law Review* 369, at 369-370.

¹⁰⁹ [1999] 3 NZLR 26.

¹¹⁰ *Ibid.*, at 38. The matter was left open on appeal to the Privy Council: [2001] 1 NZLR 513. It has been recognised that the ‘jurisprudential basis for the duty of disclosure is somewhat unclear’: Geraldine Andrews and Richard Millett, *Law of Guarantees* (5th ed, 2008), at 176. See also, James O’Donovan and John Phillips, *Modern Contract of Guarantee* (4th ed, 2004), at [4.210]. In some cases the duty has been said to arise from the presumed basis of the guarantee rather than any implied representation that the undisclosed facts do not exist. See generally *Westpac Securities Ltd v Dickie* [1991] 1 NZLR 657, at 662-663 per Hardie Boys J. In *Behan v Obelon Pty Ltd* [1984] 2 NSWLR 637 Samuels JA said (at 639) that ‘the implied representation that “the thing does not exist” follows upon failure to perform the duty to disclose that it does; not the other way about. The reason for the existence of the duty must be found in

The reasoning in *Scales* is difficult to reconcile with that in *Banque Keyser*. Notably, ss 6 and 7 of the CRA, like the English equivalent, require the misrepresentation to be ‘made.’ This may necessitate actual representations thereby excluding implied representations. Further, whilst a contract of guarantee is not a contract *uberrimae fidei* and does not give rise to fiduciary obligations¹¹¹, the duty of disclosure is generally thought to be *sui generis*. Accordingly, in *Behan v Obelon Pty Ltd* Samuels JA doubted whether ‘the duty to disclose was derived from some doctrine that silence may constitute misrepresentation.’¹¹²

An additional problem with treating non-disclosure under a guarantee contract as a misrepresentation under the CRA is that the traditional remedies for non-disclosure are more confined than those offered under the CRA. Non-disclosure by the creditor only gives rise to an equitable right to a rescission of the contract and, perhaps, a restitutionary remedy in some instances.¹¹³ This is also the case in contracts *uberrimae fidei*. Non-disclosure in contracts of insurance does not give rise to a right to damages.¹¹⁴ The omission does not amount to a breach of contract. It has therefore been contended that the proposition that a non-disclosure could amount to a misrepresentation under s 6 of the CRA so as to justify an award of damages ‘seems unlikely.’¹¹⁵ Indeed, it would be an anomalous result if a non-disclosure could be treated as a misrepresentation for the

considerations such as those which are said to explain the principle of good faith in the law of insurance, and principally that which exemplifies the great advantage in point of knowledge of the circumstances which the assured enjoys over the underwriter.’

¹¹¹ See generally *Royal Bank of Scotland v Etridge (No 2)* [2001] 4 All ER 449, at 486 per Lord Hobhouse; Cartwright, above n 105, at 556.

¹¹² [1984] 2 NSWLR 637, at 639. These statements are in direct conflict with the comments of Hardie Boys J in *Westpac Securities Ltd v Dickie* [1991] 1 NZLR 657 where his Honour noted (at 662) that a ‘creditor’s failure to disclose to a guarantor a material fact known to him will vitiate the guarantee if the non-disclosure amounts to a misrepresentation.’

¹¹³ *Levett v Barclays Bank Plc* [1995] 1 WLR 1260. See also Cartwright, above n 105, at 559-560.

¹¹⁴ Burrows, Finn and Todd, above n 41, at 334.

¹¹⁵ *Ibid*, at 339.

purposes of s 7 of the CRA so as to warrant a cancellation of the contract but not a misrepresentation for the purposes of recovering damages under s 6. It is therefore submitted that the preferable approach is to altogether avoid treating a failure to discharge a duty of disclosure owed in particular classes of contractual relationship¹¹⁶ as a misrepresentation for the purposes of the CRA.¹¹⁷

This conclusion has fundamental implications for a doctrine of contractual good faith. If a bare non-disclosure cannot qualify as a misrepresentation under the CRA, a failure to disclose in contravention of good faith cannot be treated as a *de facto* breach of contract. Remedies such as expectation damages under s 6 would not be available. However, as was recognised in Chapter 2, the subject doctrine is grounded in the common law of contract. Unlike obligations of disclosure visited in particular contractual relationships, the subject doctrine would not function as some equitable or *ab extra* cause of action independent of the express or implied terms of the agreement. Accordingly any action for breach of good faith should logically be pleaded on the basis of a breach of the concluded contract itself. The CRA is the mechanism through which such a claim must be made. The statutory instrument defines the extent to which pre-contractual misconduct can be

¹¹⁶ Those classes have traditionally included: arrangements giving rise to fiduciary duties such as partnerships, a retainer between solicitor and client and contracts for the provision of financial advice; contracts *uberrimae fidei* including contracts of insurance, contracts to take shares in a company and family arrangements; guarantee contracts and; contracts for the sale of land. Ibid, at 333-338.

¹¹⁷ This appears to be the view of certain leading contract commentators in New Zealand who note that there 'remain some categories of case where law and equity have traditionally required disclosure, and when non-disclosure has involved the consequence that the agreement cannot be enforced. Whether such non-disclosure can ever be categorised as a misrepresentation for the purposes of the Contractual Remedies Act 1979 is doubtful...': Ibid, at 312. See also Francis Dawson and David McLauchlan, *The Contractual Remedies Act 1979* (1981), at 21. For a general discussion see David Kelly and Michael Ball, *Principles of Insurance Law in Australia and New Zealand* (1991), at 135-136. Notably s 7(1) of the Contractual Remedies Act recognises that the provisions of the Act replace the rules of common law and equity governing the circumstances in which a party may rescind for misrepresentation, repudiation or breach. Seemingly the remedies available for non-disclosure in contracts *uberrimae fidei* and in fiduciary relationships remain unaffected because failure to discharge such duties neither amounts to a misrepresentation, repudiation or breach of contract.

treated as a breach of contract. In this regard the subject doctrine could not provide any additional relief for non-disclosure than that offered under the existing law of misrepresentation, as codified under the CRA.

Accordingly, it is doubtful whether a good faith doctrine would be of any additional benefit to a plaintiff seeking to bring an action based on non-disclosure than those remedies available under the existing law. Conceivably the CRA would have to be amended to accommodate for both a misrepresentation and a bare non-disclosure. This would clearly permit the courts to treat a bad faith non-disclosure in the same manner as a contractual breach and thereby award contractual remedies, including damages. However, if the legislature were to put in place a specific remedy for non-disclosure under the CRA, there would apparently be little need for a plaintiff to resort to a general common law doctrine of good faith in the field of pre-contractual disclosure.¹¹⁸

4.4.3 Pre-Contractual Non-Disclosure and the Fair Trading Act 1986:

In some circumstances non-disclosure during pre-contractual negotiations may be actionable under the FTA. In this respect commonly held notions of good faith may equate more with the obligations under the FTA than those obligations under the common law of misrepresentation as codified under the CRA.

The FTA has been in force now for approximately 20 years. Its application has spread like oil on the waters.¹¹⁹ It has become a staple of civil proceedings.¹²⁰ The FTA creates

¹¹⁸ In respect of the prospect of development of a generalised duty of disclosure, one commentator has opined that ‘the fundamental difference between misrepresentation, on the one hand, and duties of disclosure, on the other, taken in the context of the general approach to the relationship between the parties during negotiations for a contract, is likely to lead the English courts to be very cautious in any such development.’: Cartwright, above n 105, at 540-541. Consequently, the view has been expressed that legislative duties are likely to inform any development in the law relating to pre-contractual disclosure. See generally Jack Beatson, *Anson’s Law of Contract* (28th ed, 2002), at 274-275.

¹¹⁹ See John Burrows in the foreword to Lindsay Trotman and Debra Wilson, *Fair Trading: Misleading or Deceptive Conduct* (2006), at v.

liabilities for various categories of misleading conduct. Section 9 is by far the most commonly invoked section due to its generality. It provides:

No person shall, in trade, engage in conduct that is misleading or deceptive or is likely to mislead or deceive.

An obvious caveat to s 9 is that the defendant must be engaged in trade. Unlike a general doctrine of contractual good faith, which would be applicable to all contracts, the FTA is limited to a specific class of dealings.¹²¹ However, the class is wide. For example, the FTA may apply to a vendor intending to develop residential land¹²², or the one-off sale of a capital asset¹²³ or the disposition of property by trustees of a charitable organisation.¹²⁴ Section 9 was undoubtedly intended to cast its net widely.¹²⁵

A misrepresentation can clearly constitute misleading and deceptive conduct under s 9. Plaintiffs may prefer the directness and simplicity of the CRA over the FTA in cases of misrepresentation.¹²⁶ However, a cursory examination of the number of recent cases in which both causes of action are concurrently pleaded or relied upon suggests that the FTA is becoming a popular alternative to the CRA.¹²⁷ In cases involving half-truths and

¹²⁰ See Christine French, 'Misrepresentation, Negligence and the Fair Trading Act 1986 in a Contractual Setting' in, *The Law of Obligations – "Contract in Context"* (New Zealand Law Society Intensive, 2007), at 46.

¹²¹ Trade is defined under s 2(1). It is the conduct complained of which must be 'in trade.' The focus is not on the general trading status of the defendant. See *Specialised Livestock Imports Ltd v Borrie* (Court of Appeal, 72/00, 28 March 2002).

¹²² *Nelson v Bellamy* [2000] NSWSC 182.

¹²³ *Bevanere Pty Ltd v Lubidineuse* (1985) 7 FCR 325; *Sunnylea Farms v Grey* (2004) 5 NZCPR 664.

¹²⁴ *Ramage v Sharp* (1993) ATPR ¶41-242.

¹²⁵ Trotman and Wilson, above n 119, at 49.

¹²⁶ See Burrows, Finn and Todd, above n 41, at 322.

¹²⁷ See for example *TFAC Ltd v David* (High Court, Auckland, CIV 2006-404-3984, 11 December 2007, Baragwanath J); *NJ Hoogeveen (Chartered Accountant) Ltd v WJ Lynch (Chartered Accountant) Ltd* (High Court, Hamilton, 2007-419-749, 13 November 2007, Associate Judge Faire); *Best of Luck Ltd v Diamond Bay Investments Ltd (No 2)* (High Court, Auckland, CIV 2007-404-2043, 11 October 2007, Heath J); *Simpson v BB's New Zealand Ltd* (High Court, Auckland, CIV 2005-404-6877, 5 June 2007, Andrews J);

non-disclosure, the FTA may well be preferred by plaintiffs. Critically, non-disclosure may more readily be actionable under the FTA than the CRA. Non-disclosure in itself may amount to misleading or deceptive conduct. The definition of 'conduct' under s 2 includes an omission to act. Thus, a failure by a defendant to communicate certain factual matters will constitute part of his or her conduct. Any reticence will be a relevant circumstance of the case.¹²⁸

Despite the FTA having been in force for approximately 20 years, the majority of cases under s 9 involving silence relate to half-truths.¹²⁹ The extent to which pure silence is capable of ever amounting to misleading and deceptive conduct under s 9 is essentially an untested matter.¹³⁰ Further, there is little apparent judicial consensus on the issue. Thus, there is no surety that the FTA could serve as an adequate substitute for a good faith obligation of pre-contractual disclosure

In the Court of Appeal decision of *Unilever NZ Ltd v Cerebos Greggs Ltd* Gault J sought to define what conduct would contravene s 9:

What must be shown are misrepresentations by words or conduct or a combination of words or conduct...[S]ilence in particular cases can amount to a misrepresentation as can literal truth but in each case only when as a result there is affirmatively conveyed another meaning that is false.¹³¹

These statements have been interpreted to mean that s 9 conduct must contain or convey a traditional misrepresentation.¹³² This proposition has subsequently received judicial

Cashmore v Sands (2007) 8 NZBLC 101,897; *Ladstone Holdings Ltd v Leonora Holdings Ltd* [2006] 1 NZLR 211; *Coburn v Newport* (High Court, Wellington, CP 17/01, 6 August 2004, Durie J); *Mainland Products Ltd v BIL (NZ) Holdings Ltd* (High Court, Auckland, CIV 2002-404-1889, 8 June 2004, Cooper J); *Mills v Nesbitt* [2003] DCR 717.

¹²⁸ *Smythe v Bayleys Real Estate* (1993) 5 TCLR 454, at 464 per Thomas J.

¹²⁹ See Burrows, Finn and Todd, above n 41, at 326.

¹³⁰ See French, above n 120, at 49.

¹³¹ (1994) 6 TCLR 187, at 192.

¹³² See Trotman and Wilson, above n 119, at 89.

support.¹³³ Indeed, non-disclosure unaccompanied by a positive representation or conduct would conceivably be incapable of ‘affirmatively’ conveying a false meaning.

However, the comments of Gault J were subject to criticism by Kelly J in *Heiber v Barfoot & Thompson Ltd*.¹³⁴ Drawing on Australian authority¹³⁵, his Honour suggested that the test should be whether there is a reasonable expectation of disclosure.¹³⁶ The observations relating to silence propounded by Gault J were said to be restrictive. Provided a defendant has information which, on an objective view, should be given to the plaintiff, an omission to do so could amount to misleading and deceptive conduct.¹³⁷ Thus, silence of itself could be actionable under s 9. This would apparently imply that there is no prerequisite for a misrepresentation. This approach was later endorsed by Priestly J in *Guthrie v Taylor Parris Group Cossey Ltd* where it was noted that the question is whether the circumstances of the transaction gives rise to a reasonable expectation that one party will volunteer information as to matters of importance to the other.¹³⁸

The test endorsed by Kelly J raises issues as to the circumstances in which a reasonable expectation of disclosure will arise. It has been observed that:

The test of reasonable expectation of disclosure is inherently flexible, and for this reason the Courts have been reluctant to set out any principles for determining

¹³³ In *Neumegen v Neumegen and Co* [1998] 3 NZLR 310 Richardson P said (at 317) that ‘it may be thought in virtually all cases, a defendant’s conduct will not be deceptive or misleading unless it amounts to a misrepresentation.’ Similarly, in *Bonz Group Pty Ltd v Cooke* [1994] 3 NZLR 216 Tipping J said (at 229) that the ‘essence of a cause of action based on s 9 is some misrepresentation by the defendant. Conduct cannot be described as misleading or deceptive or likely to be so unless it involves a misrepresentation...’ For the corresponding position under the equivalent Australian legislation see *Taco Company of Australia Inc v Taco Bell Pty Ltd* (1982) 42 ALR 177.

¹³⁴ (1996) 5 NZBLC 99,384.

¹³⁵ *Demagogue Pty Ltd v Ramensky* (1992) 110 ALR 608.

¹³⁶ (1996) 5 NZBLC 99,384, at 104,179.

¹³⁷ *Ibid*, at 104,188.

¹³⁸ (2002) 10 TCLR 367, at [21].

when the test will be met, instead preferring to describe it as requiring a consideration of all the surrounding circumstances.¹³⁹

Relevant factors influencing whether disclosure is required have been suggested to include the commercial knowledge of the plaintiff, the relevance of the information to the underlying transaction and the negotiating tactics which each party may expect of the other.¹⁴⁰ Logically there should be no obligation of disclosure where the facts to be disclosed are not known to a defendant.¹⁴¹ It is however arguable that there could be an exception to this rule where the facts ought to be known. This is consistent with the notion that the focus of s 9 is on the effect of the conduct rather than the state of mind of the defendant.¹⁴² Certainly, non-disclosure of a fact which ought to be known by the defendant that has the effect of failing to qualify a positive statement may be sufficient to attract liability.¹⁴³ Ultimately it has been observed that some further judicial consideration of the issue ‘would be helpful.’¹⁴⁴

The reasonable expectation of disclosure test is arguably a similar test to that which may be required to discharge good faith conduct. Critically, absolute disclosure is not required. Instead the focus is on the particular circumstances of the case and what disclosure may objectively be expected.

Notably, leading FTA commentators within New Zealand support a definitive abandonment of a misrepresentation prerequisite for misleading and deceptive conduct.

¹³⁹ Trotman and Wilson, above n 119, at 90.

¹⁴⁰ Ibid, at 90-92.

¹⁴¹ *Ladstone Holdings Ltd v Leonora Holdings Ltd* [2006] 1 NZLR 211. See also Burrows, Finn and Todd, above n 41, at 328.

¹⁴² Trotman and Wilson, above n 119, at 94.

¹⁴³ Such observations have been made in the context of misrepresentation. See *Clarkson v Whangamata Metal Supplies Ltd* (High Court, Auckland, CIV 2003-404-6969, 8 June 2006, Venning J), at [53]. See also Burrows, Finn and Todd, above n 41, at 310-311.

¹⁴⁴ Trotman and Wilson, above n 119, at 94.

They prefer a reasonable expectation of disclosure approach.¹⁴⁵ If this development were to occur then conceivably this could overcome the perceived deficiencies of the common law of misrepresentation to some extent. Moreover, the FTA may be a more appropriate mechanism for regulating pre-contractual conduct than the subject doctrine of contractual good faith in light of the jurisprudential limitations of the latter identified in Chapter 2.

Clearly s 9 of the FTA could not serve as a perfect substitute for a general rule of good faith pre-contractual disclosure.¹⁴⁶ There are limits to the breadth of the FTA. For example, if the defendant is not engaged in trade then there is no cause of action. Similarly, damages under s 9 are non-contractual. Current authority suggests that expectation loss cannot be claimed under the FTA as it is peculiar to contract law.¹⁴⁷ Non-disclosure may only give rise to reliance damages on a tort measure.

However, the two heads of damage are not mutually exclusive¹⁴⁸ and there is an increasing desire for a re-examination of the rule barring the recovery of expectation loss.¹⁴⁹ Further, remedies for breach of the FTA are not confined to damages. A contract may be set aside *ab initio* in the event of non-disclosure.¹⁵⁰ Thus, whilst the provisions of the FTA may not be a perfect substitute for a prospective cause of action based on a failure to disclose in breach of good faith, it may well serve as a meaningful alternative.

¹⁴⁵ Ibid, at 95. The authors note (at 71) that whilst certain cases indicate that a misrepresentation requirement may not be present in s 9, '[s]tronger language is needed to remove what has been clearly stated as a requirement in previous cases.' Notwithstanding, in *Money World NZ 2000 Ltd v KVB Kunlun New Zealand Ltd* (High Court, Auckland, CIV 2003-404-2542, 11 August 2005) Laurenson J suggested (at [148]) that the comments of Gault J in *Unilever* 'must be seen in the light of subsequent, more recent decisions of [the High] Court and the Court of Appeal.'

¹⁴⁶ This proposition was recognised in Chapter 2.

¹⁴⁷ *Cox & Coxon Ltd v Leipst* [1999] 2 NZLR 15. See also *Harvey Corporation Ltd v Barker* [2002] 2 NZLR 213.

¹⁴⁸ *Lane Group Ltd v DI & L Paterson Ltd* [2000] 1 NZLR 129, at 150 per Tipping J.

¹⁴⁹ See Trotman and Wilson, above n 119, at 274. But see David McLauchlan, 'Damages for Misrepresentation Under the Fair Trading Act: The Aftermath of *Cox & Coxon*' (2002) 8 *New Zealand Business Law Quarterly* 14.

¹⁵⁰ Section 43(2)(a) Fair Trading Act 1986.

4.4.4 Précis:

The common law of misrepresentation and the requirements under the FTA implicitly require the observance of notions of good faith conduct. However, the law of misrepresentation, as codified under the CRA, does not currently provide a remedy for bare non-disclosure. The established categories of contract for which duties of disclosure are owed are not properly subject to the provisions of the CRA. However, the jurisprudential underpinnings of the prospective doctrine of good faith are distinct from existing *sui generis* obligations of disclosure owed in particular classes of contracts. As a result, remedies for breach of a universal common law doctrine of good faith arising from pre-contractual conduct, including the right to claim damages and cancel the contract, should be governed by the provisions of the CRA. Conceivably, the CRA would have to be amended to extend past misrepresentation and expressly provide for non-disclosure if a plaintiff is to have a remedy for a bare non-disclosure under the subject doctrine of good faith. That being the case, universal obligations of pre-contractual disclosure would best be developed through a legislative remedy thereby eschewing any necessity for recourse to the subject doctrine.

There is scope for the test for misleading conduct under the FTA to be developed so as to clearly abandon any prerequisite for a misrepresentation. A reasonable expectation of disclosure approach could be definitively adopted. This would clearly render a bare non-disclosure actionable. In this respect, the cause of action under the FTA may serve as a partial substitute to a rule of good faith pre-contractual disclosure.

Therefore, on balance, it is doubtful whether the subject doctrine could provide any significant additional benefit to the developing mechanisms already in place to deal with pre-contractual silence and misrepresentations within New Zealand. As was recognised in Chapter 2, the subject doctrine is contractual in nature and its reach in regulating pre-contractual conduct is likely to be limited.

4.5 Good Faith and Unconscionability:

4.5.1 Unconscionable Bargains:

The equitable jurisdiction to grant relief to set aside an unconscionable bargain was developed in England in the 19th century. During the early stages of the evolution of the unconscionable bargain principle, the courts took the view that mere inadequacy of consideration was sufficient to create a presumption of unfairness capable of justifying relief.¹⁵¹ The doctrine has now been refined to focus less on the inadequacy of consideration and more on the conduct of the defendant. Broadly speaking, equity will intervene where an agreement has been obtained by one party taking advantage of the other in circumstances where the conscience of the stronger party is materially affected. Unconscionability is therefore a species of equitable fraud¹⁵², as is undue influence which falls within the broader principle of unconscionability.¹⁵³

In *Attorney-General for England and Wales v R Tipping J*, in the Court of Appeal, set out the circumstances giving rise to an unconscionable bargain:

[F]or a bargain to be characterised as unconscionable [] there will necessarily be: (1) serious disadvantage on the part of the weaker party known to the stronger party; and (2) the exploitation of that disadvantage by the stronger party in circumstances amounting to actual or equitable fraud. Associated with (1) and (2) will usually, but not necessarily be: (3) some procedural impropriety, established

¹⁵¹ See generally Daniel Clough, 'Trends in the Law of Unconscionability' (1999) 18 *Australian Bar Review* 34.

¹⁵² *Moffatt v Moffatt* [1984] 1 NZLR 600, at 606 per Somers J. See also *O'Connor v Hart* [1985] 1 NZLR 159, at 171 per Lord Brightman.

¹⁵³ See Burrows, Finn and Todd, above n 41, at 369. See also Sir Anthony Mason, 'Contract, Good Faith, and Equitable Standards in Fair Dealing' (2000) 116 *Law Quarterly Review* 66, at 89; James Devenney and Adrian Chandler, 'Unconscionability and the Taxonomy of Undue Influence' [2007] *Journal of Business Law* 541.

or presumed, and attributable to the stronger party; and (4) a substantial inadequacy of consideration.¹⁵⁴

Exploitation or victimisation by the stronger party can ‘consist of either active extortion of a benefit or the passive acceptance of a benefit in unconscionable circumstances.’¹⁵⁵

There is a potential link between the intervention of equity in unconscionable bargains and the notion of good faith. The idea that a party to a bargain has acted unconscionably tends to suggest that he or she has also acted in breach of good faith. Thus, it is reasoned that the prohibition on unconscionable bargains is one of the clearest examples of the role played by equity in introducing a good faith element into contract law.¹⁵⁶

In the context of unconscionable bargains it is notable that knowledge of the qualifying disability can be actual or constructive knowledge. In *Nichols v Jessup* Somers J suggested that a party may be regarded as unconscientious not only when he or she knew that the other was labouring under a special disability but also when he or she ought to have known that fact.¹⁵⁷ His Honour went on to note:

If the circumstances are such as fairly to lead a reasonable man to believe that another is under some serious disadvantage affecting his ability to protect himself he is bound to make inquiry and will be taken to know whatever such inquiry would have disclosed.¹⁵⁸

It has also been held that knowledge of an agent may be imputed to a principal for the purposes of assessing whether the principal had sufficient knowledge of the qualifying

¹⁵⁴ [2002] 2 NZLR 91, at 118-119. See also *Bowkett v Action Finance Ltd* [1992] 1 NZLR 449, at 460 per Tipping J.

¹⁵⁵ *O'Connor v Hart* [1985] 1 NZLR 159, at 171 per Lord Brightman.

¹⁵⁶ See Tetley, above n 91, at 572. See also Matthew D J Conaglen, ‘Duress, Undue Influence, and Unconscionable Bargains – The Theoretical Mesh’ (1999) 18 *New Zealand Universities Law Review* 509, at 541.

¹⁵⁷ [1986] 1 NZLR 226, at 235.

¹⁵⁸ *Ibid.*

disability.¹⁵⁹ Therefore, the test for whether conduct is to be regarded as unconscionable is largely objective. It is the conscience of the reasonable man or woman which must be affected and not necessarily the conscience of the particular defendant.

Bigwood has criticised this result. He suggests that exploitation of a disadvantage implies intentionality which must be assessed in light of what the stronger party actually knew at the relevant time rather than what a hypothetical person should have known.¹⁶⁰ Supposedly, carelessness is not sufficient to constitute victimisation in equity. As a result, Bigwood would exclude constructive and imputed knowledge from the assessment of the conduct of the defendant.¹⁶¹

The debate in the field of unconscionable bargains as to whether an objective, subjective, or mixed standard of conduct is required is similar to that which is raised in the field of contractual good faith. Waddams has contrasted the prevailing objective test in the context of unconscionable bargains to a potential test under a doctrine of good faith.¹⁶² He suggests that a claim for breach of good faith would require the plaintiff to establish misconduct or bad motive on the part of the defendant.¹⁶³ Accordingly, the substitution of good faith for unconscionable bargain theory would tend to dilute the protection given to weaker parties.¹⁶⁴ On this rationale, the introduction of a doctrine of good faith would limit the responsiveness of the law to unfair dealing. However, the argument appears to

¹⁵⁹ *Gustav & Co Ltd v Macfield Ltd* (Court of Appeal, CA 168/05, 24 May 2007), at [30] per Arnold J.

¹⁶⁰ Rick Bigwood, *Exploitative Contracts* (2004), at 255.

¹⁶¹ *Ibid*, at 258. Cf Mindy Chen-Wishart, *Unconscionable Bargains* (1989), at 63-70. The approach to knowledge of the qualifying disability appears to be wider in Australasia than England. It has been noted that the 'Australian courts take an expansive view on knowledge which includes constructive knowledge but, so far, English law insists on actual knowledge.': Nelson Enonchong, *Duress, Undue Influence and Unconscionable Dealing* (2006), at 325.

¹⁶² See S M Waddams, 'Good Faith, Unconscionability and Reasonable Expectations' (1995) 9 *Journal of Contract Law* 55.

¹⁶³ *Ibid*, at 61.

¹⁶⁴ *Ibid*, at 60.

lose force if it is accepted that an obligation of good faith, like the law of unconscionable bargains, encapsulates an objectively reasonable standard of conduct.

Despite the apparent similarities between notions of good faith and unconscionability, it is submitted that there are fundamental differences between the law of unconscionable bargains and the subject doctrine of contractual good faith.

The most obvious distinction is that the equitable jurisdiction to relieve against unconscionable bargains is intended to focus on the circumstances in which the bargain is made. The conduct of the stronger party in contractual negotiations and formation is being assessed. Thus, in *Tri-Global (Aust) Pty Ltd v Colonial Mutual Life Assurance Society Ltd* Spender J recognised that unconscionability is considered in the formation of an agreement and does not relate to its termination.¹⁶⁵ The equitable doctrine ‘will not generally apply in relation to the conduct of parties in an on-going contractual relationship.’¹⁶⁶ This can be contrasted with a doctrine of contractual good faith. As concluded in Chapter 2, a common law doctrine of good faith would not generally extend to the regulation of pre-contractual negotiations unless a contract comes into existence. Thus the equitable jurisdiction is concerned with pre-contractual conduct whereas a common law doctrine of good faith would be concerned primarily with contractual performance and enforcement.

However, there has been a recent judicial attempt to allow a transaction to be set aside as unconscionable, even if the conscience of the stronger party is not affected strictly at the time of entering into the bargain. In *Gustav & Co Ltd v Macfield Ltd*¹⁶⁷ the Court of Appeal held that the date for assessing whether the stronger party had the requisite

¹⁶⁵ (1992) ATPR ¶41-174, at 40,382.

¹⁶⁶ Clough, above n 151. It has been observed that ‘[u]nconscionable dealing as a vitiating factor is concerned with unconscionability in the conduct of the defendant before the transaction [is] concluded whereas in the case of [] equitable defences the court is concerned with unconscionability in the conduct of the claimant after the transaction.’: Enonchong, above n 161, at 242.

¹⁶⁷ (Court of Appeal, CA 168/05, 24 May 2007), at [46] per Arnold J.

knowledge of the weaker party's qualifying disability was not necessarily the date that the conditional contract was executed. It could extend to the date on which the contract was confirmed by the weaker party. Notably, the stronger party had no discretion whether or not to accept the confirmation.¹⁶⁸ Notwithstanding, the Court suggested that it was sufficient that the stronger party might retain the benefit of the bargain unconscientiously, even if the bargain was not necessarily struck in unconscionable circumstances.¹⁶⁹ The decision could perhaps be cited in support of a greater judicial willingness for the doctrine of unconscionability to be extended to contractual performance and enforcement. The notion of a broader principle of unconscionability will be discussed in more detail further below.

However, the observations of the Court of Appeal were overruled on appeal to the Supreme Court.¹⁷⁰ It was found that the relevant time for assessing knowledge of the qualifying disability is properly the time when the contract is made and not the time of confirmation. The Court rejected any possible policy grounds for keeping 'flexible' the equitable remedy to relieve against unconscionable bargains.¹⁷¹ Arguably, a doctrine of contractual good faith may have been a more suitable mechanism for the Court of Appeal to invoke to regulate the conduct of the stronger party during the currency of the contract. There would have been no need to compromise the traditional understanding of unconscionable bargain jurisprudence.

Another fundamental distinction between unconscionable bargains and the subject doctrine of good faith is that the remedies would likely be distinct. An agreement deemed to have been made in unconscionable circumstances is voidable.¹⁷² The victim may affirm the contract or it may be set aside, in which case the plaintiff is entitled to a

¹⁶⁸ Ibid, at [49].

¹⁶⁹ Ibid, at [45]-[50]. The claim ultimately failed because it was found that the stronger party did not have the requisite knowledge of the qualifying disability either at the date of entering into the contract or at the date of confirmation.

¹⁷⁰ [2008] 2 NZLR 735.

¹⁷¹ Ibid, at 745 per Tipping J.

¹⁷² See Burrows, Finn and Todd, above n 41, at 342.

declaration that it has been validly rescinded.¹⁷³ It follows that a deserving plaintiff can also use the doctrine as a valid defence to an action for specific performance. However, a victim cannot claim damages. Similarly, proprietary remedies such as a constructive trust are generally unavailable.¹⁷⁴ Thus the equitable remedies available for unconscionable conduct do not cater for the regulation of a continuing contractual relationship.¹⁷⁵ On the other hand, the remedy for a plaintiff as a result of a breach of good faith must arise from the contract itself. Damages may be awarded or the contract may be cancelled if the breach is sufficiently serious. The agreement will not however be set aside *ab initio*.

It is therefore suggested that the subject doctrine of good faith and the law relating to unconscionable bargains is distinct. In this regard, the equivalence thesis does not hold. Should a doctrine of contractual good faith be introduced, it would appear that the law relating to the equitable jurisdiction to set aside an unconscionable bargain would remain largely unaffected. Prima facie, a doctrine of contractual good faith would be unable to provide a remedy for the victim of an unconscionable bargain. Thus, there is no reason why the subject doctrine of good faith and the law of unconscionable bargains could not co-exist.

Notably, the same conclusions can be drawn in respect of the equitable doctrine of undue influence. Whilst unconscionability and undue influence represent a concept of good faith¹⁷⁶, they apply in the context of contractual negotiation or, in some instances, contractual variation¹⁷⁷, and act to vitiate the agreement. In this regard they are distinct from an obligation of good faith in contractual performance. Accordingly, it is not proposed to embark on a further discussion of undue influence relative to a doctrine of good faith.

¹⁷³ See generally Clough, above n 151.

¹⁷⁴ Ibid.

¹⁷⁵ Ibid.

¹⁷⁶ Conaglen, above n 156, at 545.

¹⁷⁷ An unconscionable bargain may be found in respect of a contractual variation. See *Gustav & Co Ltd v Macfield Ltd* [2008] 2 NZLR 735, at 741 per Tipping J.

4.5.2 A Wider Principle of Unconscionability in Contract?

A modern analysis of the principle of unconscionability cannot be confined to the equitable jurisdiction to set aside unconscionable bargains. In recent times the understanding of unconscionable conduct has sought to be expanded. It has been suggested that a broad underlying principle of unconscionability is potentially becoming a common theme, if not a unifying principle, of the law of contract.¹⁷⁸ That contention, like proposals for a good faith doctrine, is met with concerns about self-interested competition and freedom of contract being sacrificed for altruism and vagueness.

Nonetheless, the Australian courts appear to be welcoming of the expansion of the unconscionability doctrine. In *Alcatel Australia Ltd v Scarcella* Sheller JA suggested that a court may interpret a contract in such a manner that a contracting party may not be permitted to exercise a contractual power where it would be unconscionable to do so in the circumstances.¹⁷⁹ Similarly, in *Stern v McArthur*¹⁸⁰ a majority¹⁸¹ of the High Court of Australia held that although a contract for the sale of land had been lawfully rescinded in accordance with the agreement, the vendors had insisted on their strict legal rights in unconscionable circumstances. The purchasers were entitled to relief against forfeiture and specific performance.

¹⁷⁸ See generally Clough, above n 151. It has been observed that despite ‘lip service to the notion of absolute freedom of contract, relief is every day given against agreements that are unfair, inequitable, unreasonable or oppressive. Unconscionability, as a word to describe such control, might not be the lexicographer’s first choice, but it seems to be the most acceptable general word...[A] compelling reason for adopting a general principle of unconscionability is the need to fill the gaps between existing islands of intervention...Given the open recognition of a general principle of unconscionability, one would expect the courts to develop guidelines.’: S M Waddams, *The Law of Contracts* (5th ed, 2005) at 384 and 385.

¹⁷⁹ (1998) 44 NSWLR 349, at 368.

¹⁸⁰ (1988) 81 ALR 463. See also *Legione v Hately* (1983) 46 ALR 1. For a comprehensive discussion of the Australian position on relief against forfeiture on the grounds of unconscionability see *Tanwar Enterprises Pty Ltd v Cauchi* (2003) 201 ALR 359.

¹⁸¹ Deane, Dawson and Gaudron JJ. Mason CJ and Brennan J dissenting.

As a result, one Australian contract text has observed that the courts have increasingly utilised unconscionability as an ultimate basis of liability in disputes between contracting parties.¹⁸² It is further suggested that the law of Australia endorses the view that a party may not assert a contractual right, or deny a contractual obligation, if it would be unconscionable to do so.¹⁸³ This implies that the doctrine of unconscionability might be extended not only to the formation of a bargain but also its performance and enforcement. Finn has observed this development in Australia:

[T]he revitalisation of the unconscionable dealings doctrine and the more general elaboration of an unconscionability principle have paralleled growing judicial preparedness to scrutinise the propriety of conduct in contract formation and performance...¹⁸⁴

Inevitably, there would be an overlap in the application of a doctrine of good faith and a doctrine of unconscionability if the latter could be applied to contractual performance. Some commentators suggest that the developed equitable principle of unconscionability has occupied the position of an informing principle of good faith by default.¹⁸⁵ Accordingly it is reasoned that a broad concept of unconscionability is a practical manifestation of some notion of a duty of good faith.¹⁸⁶

It is certainly arguable that there are similarities in the meaning and application of good faith and unconscionability, particularly in light of the ongoing expansion of the latter. Whereas unconscionable dealing was previously thought of as conduct which shocked the conscience of the Court, there is now an inclination towards a less strict standard. This may embody synonyms such as unfairness, fair dealing and good faith.¹⁸⁷ Similar to

¹⁸² See Nicholas C Seddon and M P Ellinghaus, *Law of Contract* (9th ed, 2008), at 6.

¹⁸³ *Ibid*, at 9.

¹⁸⁴ Finn, above n 84, at 82.

¹⁸⁵ Paula Baron, 'Resistance: A Consideration of the Opposition to a Duty of Good Faith in Australian Commercial Contracts' (2005) 11 *New Zealand Business Law Quarterly* 408, at 420.

¹⁸⁶ See generally Clough, above n 151.

¹⁸⁷ Sir Anthony Mason, above n 153, at 90.

good faith, unconscionability is better described than defined.¹⁸⁸ Finn reasons that unconscionable conduct is conduct which is unfair to another where good faith can properly be expected by the other party.¹⁸⁹ A contracting party who acts in disregard of the reasonable expectations of his or her contracting counterparty may be said to have acted unconscionably. Stapleton has equated good faith and unconscionability on the basis that the 'principle of good faith restrains the deliberate pursuit of self-interest where this is judged unconscionable.'¹⁹⁰ She goes on to recognise that a contracting party will act unconscionably where he or she acts dishonestly, goes back on his or her word, or exploits a position of dominance over a vulnerable contracting counterparty.¹⁹¹ The contended similarity between good faith and unconscionability is supported by the number of cases where the two principles have been concurrently pleaded in Australian cases.¹⁹² Ultimately it may be that, at least in Australia, unconscionability is perceived as a sufficient substitute for good faith thereby negating the need for a universal doctrine. Harland asserts:

[T]he increasing emphasis [] on unconscionable or unconscientious conduct as an element of other doctrines of the law of contract results in an emphasis on ideas of justice and fair dealing that may ultimately differ little from standards of good faith more familiar in many other legal systems.¹⁹³

However, the enthusiasm in Australia for an expansion of the principle of unconscionability in contract law has not been reciprocated in England and New Zealand.

¹⁸⁸ *Antonovic v Volker* (1986) 7 NSWLR 151, at 165 per Mahoney JA.

¹⁸⁹ Paul Finn, 'Unconscionable Conduct' (1994) 8 *Journal of Contract Law* 37, at 38.

¹⁹⁰ Jane Stapleton, 'Good Faith in Private Law' (1999) 52 *Current Legal Problems* 1, at 7. See also Agasha Mugasha, 'Good Faith Obligations in Commercial Contracts' (1999) 27 *International Business Lawyer* 355, at 357.

¹⁹¹ *Ibid*, at 7-8.

¹⁹² Baron, above n 185, at 422. For case examples see *Gary Rogers Motors (Aust) Pty Ltd v Subaru (Aust) Pty Ltd* (1999) ATPR ¶41-703; *Alcatel Australia Ltd v Scarcella* (1988) 44 NSWLR 349; *Walker v Australian & New Zealand (ANZ) Banking Group Ltd (No 2)* [2001] NSWSC 806.

¹⁹³ David Harland, 'Unconscionable and Unfair Contracts: An Australian Perspective' in Brownsword, Hird and Howells (eds), above n 1, at 267.

It is reasonable to suggest that a wider unconscionability principle has received some limited recognition in New Zealand. For example, under the Credit Contracts and Consumer Finance Act 2003, a party to a consumer credit contract may have it reopened in the event that another party seeks to exercise a power under the contract in an oppressive manner.¹⁹⁴ Oppressive is defined to mean, *inter alia*, unconscionable.¹⁹⁵ Thus it has been observed that ‘common law unconscionability looks to the formation of the contract rather than the performance of it and in this regard oppression is the wider doctrine.’¹⁹⁶ Similarly the Disputes Tribunal¹⁹⁷ and the Tenancy Tribunal¹⁹⁸ is given jurisdiction to vary or set aside a contract where a power conferred by the agreement is sought to be exercised in an unconscionable manner.

Despite these limited legislative concessions, there is strong authority to suggest that unconscionability will not acquire a more interventionist role in English and New Zealand contract law. In *Allen v Flood* Wills J suggested that contractual rights may be exercised in any manner, no matter how unconscionable:

[A]ny right given by contract may be exercised against the giver by the person to whom it is granted, no matter how wicked, cruel or mean the motive may be which determines the enforcement of that right.¹⁹⁹

Likewise, in *Bridge v Campbell Discount Co Ltd* Lord Radcliffe observed that “[u]nconscionable” must not be taken to be a panacea for adjusting any contract between competent persons when it shows a rough edge to one side or the other.²⁰⁰ Unless it can be shown that an agreement was reached through unconscionable means, the courts will

¹⁹⁴ Section 120(b) Credit Contracts and Consumer Finance Act 2003.

¹⁹⁵ Section 118 Credit Contracts and Consumer Finance Act 2003.

¹⁹⁶ Brookers, *Gault on Commercial Law*, (at 10 August 2008), at [CF118.06].

¹⁹⁷ Section 19(1)(e) Disputes Tribunals Act 1988.

¹⁹⁸ Section 78(1)(f) Residential Tenancies Act 1986.

¹⁹⁹ [1898] AC 1, at 46.

²⁰⁰ [1962] 1 All ER 385, at 396.

not entertain whether a term is fair in all the circumstances or is harsh and unconscionable.²⁰¹ Thus, in *Union Eagle* Lord Hoffman opined:

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.²⁰²

Accordingly, arguments that the vendor was acting unconscionably in seeking to enforce its strict contractual rights did not find sway with the House of Lords.

Subsequent to the *Union Eagle* decision, the broader approach to unconscionability taken within the Australian cases has apparently been doubted by one New Zealand Court.²⁰³ Likewise, in *Gustav Tipping J* suggested that a 'supervening' doctrine of unconscionability would risk undermining properly acquired contractual rights and would be detrimental to the security of contractual relationships.²⁰⁴

²⁰¹ *Suisse Atlantique Société D'armement Maritime S A v N V Rotterdamsche Kolen Centrale* [1966] 2 All ER 61, at 76 per Lord Reid.

²⁰² [1997] 2 All ER 215, at 218-219.

²⁰³ *Frost v Carr* (High Court, Dunedin, CIV 2007-412-507, 29 February 2008, Randerson J), at [143]. Randerson J considered the greater willingness of the Australian courts to grant relief against forfeiture based on unconscionability in respect of cancellation for breach under an agreement for sale and purchase of land. His Honour suggested that unconscionability was not likely to be found in New Zealand unless the purchaser is in possession such that there is statutory jurisdiction to grant relief under the Property Law Act 2007. For the less stringent Australian approach see *Legione v Hately* (1983) 46 ALR 1; *Stern v McArthur* (1988) 81 ALR 463.

²⁰⁴ [2008] 2 NZLR 735, at 745.

It is therefore reasonable to conclude that a broader principle of unconscionability is an improbable substitute for contractual good faith within New Zealand. Unconscionability is unlikely to be developed as a means to restrain the lawful exercise of contractual rights. It is submitted that the hostility towards the development is logical. Unconscionability is characterised by a disability or vulnerability. In an arms length transaction it is anomalous to suggest that a contracting party is vulnerable or under a disability merely because he or she is at the mercy of his or her contracting counter party in exercising rights conferred by their contractual terms. The undesirability of equitable intervention is manifest where both parties have freely agreed upon their respective contractual rights. Unless a plaintiff can establish some qualifying disability on which to justify a claim of unconscionability, it is proper that equity should not intervene. As McKay J recognised in *Attorney-General v Equiticorp Industries Ltd (In Statutory Management)*, it is not enough for a party to cry equity and expect relief.²⁰⁵ Thus, whilst unconscionability may be an informing principle of specific doctrines such as promissory estoppel, undue influence and the jurisdiction to relieve against unconscionable bargains, unconscionability should not be applied in the abstract without the protection of the prescribed requirements and operative criteria applying to those specific doctrines.²⁰⁶ The equitable jurisdiction must be operated on a principled and restricted basis.

Despite unconscionability not serving as a substitute for good faith, it is conceivable that the courts would not allow good faith to override the restrictions hitherto placed on the unconscionability doctrine. The law in England and New Zealand has favoured certainty. For example, a contracting party should be able to rely on the strict terms of the contract to terminate an agreement. Although the other party may have an action in restitution, he or she ordinarily cannot claim that the contract is wrongfully terminated. Good faith should not alter this result. It has been recognised that one of the ‘hallmarks of English common law is that it does not have a doctrine of abuse of rights: if one has a right to do

²⁰⁵ [1996] 1 NZLR 528, at 537.

²⁰⁶ See Joachin Dietrich, ‘Giving Content to General Concepts’ (2005) 29 *Melbourne University Law Review* 218, at 223-224.

an act then, one can, in general, do it for whatever reason one wishes.’²⁰⁷ On this rationale, the hostility shown towards expanding unconscionability may also be reflected in a restricted application of good faith should a general doctrine be introduced. Based on the prevailing judicial approach, the courts may well strive to avoid a situation where plaintiffs could succeed under a doctrine of good faith where they would fail under the equitable notion of unconscionability.²⁰⁸

4.5.3 Précis:

To summarise, the foregoing analysis has found that the equitable jurisdiction to set aside unconscionable bargains and a general doctrine of contractual good faith could co-exist and would have little impact on each other. That outcome neither opposes nor supports the introduction of a good faith obligation.

At this stage, it is improbable that the principle of unconscionability will extend further into New Zealand contract law. Thus, unconscionability is unlikely to serve as a substitute for a doctrine of good faith in the context of the performance and termination of contracts. Although that may lend support to the positive theory, the resistance to unconscionability interfering with contractual performance and termination on the grounds of uncertainty may foreshadow a correspondingly restricted application of good faith should the subject doctrine be introduced. In this regard there is potential for the application of a good faith doctrine to be reduced to equate with existing legal methodology.

²⁰⁷ Jack Beatson, ‘Public Law Influences in Contract Law’ in Beatson and Friedman (eds), above n 13, at 266-267.

²⁰⁸ See Elizabeth Peden, ‘When Common Law Trumps Equity: the Rise of Good Faith and Reasonableness and the Demise of Unconscionability’ (2005) 21 *Journal of Contract Law* 226, at 247.

4.6 Good Faith and Estoppel:

The doctrine of estoppel has undergone significant development in recent times. The doctrine is perceived as a means of enforcing a promise made without consideration.²⁰⁹ There are now dicta within New Zealand to suggest that the various categories of estoppel previously recognised such as proprietary estoppel, promissory estoppel and estoppel by election or convention are now merged into one universal doctrine.²¹⁰ Further, in *National Westminster Finance NZ Ltd v National Bank of NZ* Tipping J suggested that the notion of unconscionability runs through all manifestations of estoppel.²¹¹ The doctrine exists to prevent a party from going back on his or her word where it would be unconscionable to do so. Certainly promissory estoppel is founded on a general principle of unconscionability given that it is grounded in equity.²¹²

According to Richardson J in *Gillies v Keogh*, there are three elements required to give rise to promissory estoppel.²¹³ Firstly, an encouragement of a belief or expectation is needed. Secondly, there must be reliance on that belief or expectation.²¹⁴ Thirdly, detriment must result from that reliance.²¹⁵

²⁰⁹ See Burrows, Finn and Todd, above n 41, at 369.

²¹⁰ *Gillies v Keogh* [1989] 2 NZLR 327, at 331 per Cooke P; *Gold Star Insurance Co Ltd v Grant* [1998] 3 NZLR 80. There are similar judicial observations in Australia. See *The Commonwealth v Verwayen* (1990) 170 CLR 394, at 413 per Mason CJ.

²¹¹ [1996] 1 NZLR 548, at 549.

²¹² See Burrows, Finn and Todd, above n 41, at 137. Because promissory estoppel is based in equity, the promisee must act equitably if he or she is to rely on the doctrine. See *Re Goile, ex parte Steelbuild Agencies Ltd* [1963] NZLR 666.

²¹³ [1989] 2 NZLR 327, at 346.

²¹⁴ The promisor must intend or know the promisee will rely on the promise. See *Crabb v Arun District Council* [1975] 3 All ER 865.

²¹⁵ Abstaining from action may be sufficient to constitute detriment. See *Australasian Temperance and General Mutual Life Association v Johnston* [1933] NZLR 408. However, there must be proportionality between the expectation and the detriment suffered in order to justify relief. See *Boys v Calderwood* (High Court, Auckland, CIV 2004-404-290, 14 June 2005, Ronald Young J).

The doctrine of estoppel is a paradigm example of the courts seeking to ensure good faith conduct. It protects against unfairness.²¹⁶ A promisor who seeks to renege on his or her word, leaving the promisee to suffer the detrimental consequences, fails to exercise good faith behaviour. Thus, promissory estoppel reinforces good faith by giving effect to the reasonable expectations of the parties.²¹⁷ Indeed, proponents of good faith suggest that the evolution of promissory estoppel evidences the inadequacy of classical contract law to meet the needs and expectations of contracting parties and the commercial community.²¹⁸

Despite the fact that notions of good faith are embodied in the principle of estoppel, it is evident that the subject doctrine would have little impact on the law of estoppel to the extent that estoppel may apply to parties without a pre-existing contractual arrangement. As was recognised in Chapter 2, a common law doctrine of good faith would apply only if a concluded contract comes into existence.

The extent to which promissory estoppel can apply to pre-contractual conduct continues to divide the common law jurisdictions. In the United Kingdom it is still widely understood that the principle is limited to preventing the enforcement of existing rights.²¹⁹ Accordingly, a pre-existing contractual relationship is required.

²¹⁶ See Justice Forrie Miller, 'Equitable Estoppel' in, *The Law of Obligations – "Contract in Context"* (New Zealand Law Society Intensive, 2007), at 51.

²¹⁷ Tetley, above n 91, at 578. It has been argued that an estoppel is created where the promisee is entitled to expect good faith behaviour by the promisor. See Barbara Mescher, 'Promise Enforcement by Common Law or Equity?' (1990) 64 *Australian Law Journal Reports* 536, at 543. See also Sir Anthony Mason, above n 153, at 90; Woo Yee, 'Protecting Parties' Reasonable Expectations: A General Principle of Good Faith' (2001) 1 *Oxford University Commonwealth Law Journal* 195, at 206.

²¹⁸ See Thomas, above n 24, at 405. See also J F O'Connor, *Good Faith in English Law* (1990), at 20. Lord Steyn has contended that in 'the absence of a generalised duty of good faith the specific and concrete rules of estoppel are needed to deal with demonstrated problems of unfairness.': Justice Johan Steyn, 'The Role of Good Faith and Fair Dealing in Contract Law: A Hair Shirt Philosophy?' in Lord Steyn, *Democracy Through the Law* (2004), at 215.

²¹⁹ *Combe v Combe* [1951] 2 KB 215; *The Proodos C* [1980] 2 Lloyd's Rep 390; *The Kanchenjunga* [1990] 1 Lloyd's Rep 391; *Baird Textile Holdings Ltd v Marks and Spencer plc* [2002] 1 All ER (Comm) 737. See

However, the approach in Australasia is not so restricted. It is now clear that promissory estoppel can apply to parties who do not have a contractual relationship.²²⁰ The catalyst for this development was the decision of the High Court of Australia in *Waltons Stores (Interstate) Ltd v Maher*²²¹ where an estoppel was found in an arrangement falling short of a legally binding contract. The plaintiff owned commercial premises. He arranged to demolish the existing buildings and rebuild custom-designed premises for lease to the defendant. Construction began but the defendant reneged on the arrangement some two months later. The Court held that the plaintiff was entitled to reliance damages. These would relieve against the detriment caused by relying on the understanding induced by the defendant.

In cases analogous to *Waltons*, it is clear that a deserving plaintiff could not rely on a contractual claim for breach of good faith in lieu of an action for equitable estoppel. The subject doctrine would therefore be incapable of subsuming the doctrine of promissory estoppel within New Zealand.

However, the situation may be different where the parties are in a pre-existing contractual arrangement. For example, a doctrine of contractual good faith may have had some application to the facts in *Central London Property Trust Ltd v High Trees House Ltd*.²²²

also Piers Feltham, Daniel Hochberg and Tom Leech, *The Law Relating to Estoppel by Representation* (4th ed, 2004), at 467-472 and 497. For an opposing view see Margaret Halliwell, 'Estoppel: Unconscionability as a Cause of Action' (1994) 14 *Legal Studies* 15.

²²⁰ *Burberry Mortgage Finance and Savings Ltd v Hindsbank Holdings Ltd* [1989] 1 NZLR 356; *Secureland Mortgage Investment Nominees Ltd v Harman & Co Solicitor Nominee Co Ltd* [1991] 2 NZLR 39. See also Burrows, Finn and Todd, above n 41, at 131. Cf *McCathie v McCathie* [1971] NZLR 58. Promissory estoppel cannot arise in respect of pre-contractual statements where those statements are contrary to a legally enforceable agreement which the parties subsequently enter into. See *Krukzeiner v Hanover Finance Ltd* (Court of Appeal, CA 198/07, 26 June 2008).

²²¹ (1988) 76 ALR 513. See also *McDonald v Attorney-General* (High Court, Invercargill, CP 13/86, 20 June 1991, Holland J).

²²² [1947] KB 130. For other cases where it may have been possible to argue good faith in lieu of estoppel to prevent a contracting party from relying on his or her strict legal rights see *Jackson v Blagojevich* (1997)

The plaintiff promised to reduce the rental paid by the defendant for a block of flats on account of the adverse economic conditions presented by the Second World War. The defendant paid the reduced rental from 1940 to 1945. The plaintiff sued to recover the difference between the contractual rate and the reduced rate after the War ended. The promise was unsupported by consideration. Nonetheless, Denning J held that the expectation created by the plaintiff presented a valid defence for the defendant. It has subsequently been argued that a doctrine of contractual good faith could have been utilised as an alternative to estoppel. The defendant could have asserted that the plaintiff was seeking to enforce its contractual right in breach of good faith.²²³

Despite the recent development of the estoppel doctrine, justifiable limits have been placed on its application. For example, the representation must be clear and unambiguous. In *The Scaptrade*²²⁴ the owner of a vessel lawfully cancelled the contract of hire on account of a monthly payment being four days late. The hirer argued that the owner should have been estopped from relying on its strict legal right because it had tolerated late payments on previous occasions. The English Court of Appeal found that there was no clear representation or promise that the owner would not rely on its strict rights.²²⁵ The claim for relief against forfeiture failed. It has since been noted that it will be difficult to establish an estoppel when the only representation asserted is by conduct rather than express words.²²⁶

3 NZ ConvC 192,564; *Young v New Bay Holdings Ltd* (1998) 3 NZ ConvC 192,802; *Minaret Resources Ltd v McLellan* (2003) 5 NZCPR 161.

²²³ See generally Powell, above n 23, at 24. Equally however, the doctrine of waiver may have been invoked as a defence.

²²⁴ [1983] 1 All ER 301.

²²⁵ *Ibid*, at 305 per Robert Goff LJ. See also *John Burrows Ltd v Subsurface Surveys Ltd* (1968) 68 DLR (2d) 354; *The Laconia* [1977] 1 All ER 545.

²²⁶ Andrew Grubb and Michael Furmston (eds), *The Law of Contract* (1999), at 255. For a discussion as to the extent to which a promise may be implied from conduct or silence see Feltham, Hochberg and Leech, above n 219, at 454-462.

Conceivably if a doctrine of good faith were applied to the facts in *The Scarptrade*, it could be argued that the contractual right to cancel was not exercised in good faith. The previous course of dealing may have been sufficient to justify the claim that the owners were not acting in good faith, notwithstanding that the hirer could not point to an unequivocal representation. If this were the case then a doctrine of good faith may render the requirements to establish an estoppel nugatory. A plaintiff bringing such a claim would inevitably rely on good faith rather than estoppel if the elements required to establish bad faith were less demanding than the various criteria required to make out an estoppel.

Nonetheless, there is good reason to suspect that a good faith doctrine would not be permitted to subvert the estoppel criteria. It would be an unusual result for a defendant to be subject to a less demanding equitable duty than a related common law duty. Further, it was recognised above that the courts will not prevent legal rights from being relied upon on the grounds of some broad notion of unconscionability. By analogy it follows that the courts will be reluctant to utilise good faith as a means to prevent a contracting party from relying on a strict contractual right. Therefore, unless the criteria for estoppel can be made out such that equity will intervene, it is plausible that the courts will not prevent a party from relying on a contractual right even if judges were to be armed with a contractual good faith doctrine.

Further, the courts have sought to limit the application of estoppel in order to avoid the doctrine of consideration from being unduly undermined. A good faith obligation unrestricted by criteria analogous to that associated with estoppel would potentially run roughshod over the requirement for consideration. As a result, estoppel may be more desirable than good faith due to its familiarity and reasonably clear bounds.²²⁷ In any event there are powerful arguments to suggest that the courts should be squarely addressing and reformulating the doctrine of consideration to remedy unfairness rather

²²⁷ See Donal Nolan, 'The Classical Legacy and Modern English Contract Law' (1996) 59 *Modern Law Review* 603, at 607.

than undermining it with equitable estoppel and notions of good faith.²²⁸ This development would serve to promote greater coherence and consistency and may abate the perceived need for a good faith doctrine.

It is therefore submitted that the doctrine of estoppel would be unlikely to be affected by the introduction of a doctrine of contractual good faith in New Zealand, particularly in the application of estoppel to parties without a pre-existing contractual relationship. Further, there is little evidence to support the positive view when a doctrine of contractual good faith is compared against the developed doctrine of promissory estoppel in light of the general unwillingness of the courts in New Zealand to interfere with established contractual rights in the absence of clear circumstances giving rise to an equitable estoppel.

4.7 Good Faith and the Exercise of Contractual Discretions:

Many contractual provisions are framed in terms of affording a discretionary power to a particular contracting party. Often a contract will expressly require the power to be exercised 'reasonably' or 'genuinely'. Absent such wording, conceivably a doctrine of good faith could be utilised to construe a contractual term conferring a discretion to be exercised in good faith.

However, there is evidence to suggest that obligations akin to good faith are already being imposed on contractual parties exercising contractual discretions. The instances in which this may occur requires examination to determine whether a good faith doctrine would have any beneficial effect over and above the approach taken under the existing law.

²²⁸ For a discussion of the preference for an expansion of the doctrine of consideration over the use of estoppel see Feltham, Hochberg and Leech, above n 219, at 513.

Before undertaking this analysis it should be noted that it is the exercise of a contractual power or discretion rather than the exercise of a contractual right which is being appraised. As discussed above, the courts are generally unwilling to place any fetter on a clear contractual right such as a right of cancellation under an agreement or a right arising at law to rescind or to claim damages.²²⁹ The courts will not examine the reasonableness of the exercise of a contractual right or whether it would be unconscionable to exercise the right in the particular circumstances.

However, that reluctance is not evident when a court is asked to scrutinise the exercise of contractual discretions. Peden rationalises the distinction:

It is clear that the courts want to impose some fetter on the exercise of discretions...It is uncontroversial that powers or discretions must be exercised according to their intended purpose, which can be construed from the particular context. In contrast, the exercise of contractual rights (as opposed to discretions or powers) arguably should be completely unfettered, as contracting parties are not obliged to enter contracts, and presumably they do so for some advantage, commercial or otherwise, accepting that certain rights are given to each side, which can be exercised when triggered.²³⁰

Distinguishing between a contractual right and a power or discretion may not be a straightforward task. Discretionary powers are generally thought to postpone to a different time, and allocate to a single party, the distribution of a benefit under the contract.²³¹ A contractual discretion may include, for example, an election to permit an assignment²³² or select a port for delivery of goods²³³ or consent by an insurer to the settlement of litigation²³⁴ or variance by a mortgagee of an interest rate²³⁵ or the

²²⁹ Cf *LeMesurier v Andrus* (1986) 25 DLR (4th) 424, at 430 per Grange JA.

²³⁰ Elizabeth Peden, *Good Faith in the Performance of Contracts* (2003), at 167.

²³¹ See Stephen Kós, 'Constraints on the Exercise of Contractual Powers' (Centre for Commercial and Corporate Law 2008 Seminars, 2008), at 1.

²³² *Western Metals Resources Ltd v Murrin Murrin East Pty Ltd* [1999] WASC 257.

²³³ *Abu Dhabi National Tanker Co v Product Star Shipping Ltd (The Product Star) (No 2)* [1993] 1 Lloyd's Rep 397.

²³⁴ *Gan Insurance Co Ltd v Tai Ping Insurance Co Ltd (No 2)* [2001] 2 All ER (Comm) 299.

²³⁵ *Paragon Finance Plc v Staunton* [2002] 2 All ER 248.

distribution of commissions by an employer to employees.²³⁶ It has been argued that if discretions of this kind were subject to an unrestricted choice the outcome would be inconsistent with the foundation of a binding contract.²³⁷ The promise might be too uncertain to constitute good consideration and may indicate a lack of intention to create legal relations. Indeed, there are a number of cases supporting the notion that the exercise of contractual powers is not completely unrestrained.

In *Equitable Life Assurance Society v Hyman*²³⁸ the House of Lords considered the exercise of a discretion to apportion the profits of a pension fund under retirement annuity contracts. It was held that the directors of the funds exercised their discretion in a way which subverted the basis of the retirement policies. Lord Cooke reasoned that no legal discretion, however widely worded, can be exercised for purposes contrary to those of the instrument under which it is conferred.²³⁹ His Lordship saw no difficulty in applying what is traditionally an administrative law principle to the exercise of a contractual discretion. It was further reasoned that a breach of the rule could result in a breach of contract, which would require rectification.²⁴⁰ Notably, Lord Steyn reached the same outcome in the case but did so by implying in a term in fact into the policy.²⁴¹

A restriction was also placed on a contractual discretion by the English Court of Appeal in *Gan Insurance Co Ltd v Tai Ping Insurance Co Ltd*.²⁴² It was held that the discretion of reinsurers to withhold approval to a compromise of claim or admission of liability by the insured had to be exercised in good faith after a consideration of the facts giving rise to the particular claim. The discretion could not be exercised with reference to considerations wholly extraneous to the subject-matter of the policy.²⁴³ The obligation

²³⁶ *Greenberg v Meffert* (1985) 18 DLR (4th) 548.

²³⁷ See Beatson, above n 207, at 267.

²³⁸ [2000] 3 All ER 961.

²³⁹ *Ibid*, at 971.

²⁴⁰ *Ibid*, at 972.

²⁴¹ *Ibid*, at 971.

²⁴² [2001] 2 All ER (Comm) 299.

²⁴³ *Ibid*, at [67] per Mance LJ.

was found by way of construction. The requirement was derived from the nature and purpose of the relevant contractual terms.²⁴⁴

In *Paragon Finance plc v Staunton*²⁴⁵ the English Court of Appeal was again quite willing to apply administrative law principles to the exercise of a contractual discretion. Thus, the discretion afforded to a mortgagee to vary interest rates was subject to an implied obligation that the rates of interest would not be set dishonestly, for an improper purpose, capriciously or arbitrarily.²⁴⁶

The apparent willingness of the English courts to fetter the exercise of contractual discretion has received endorsement and support within New Zealand. In *S P Bates & Associates Ltd v Woolworths (NZ) Ltd*²⁴⁷ Fisher J held that a discretion given to a provider of technology services to monitor the information technology usage of its client did not give the provider the right to covertly rummage through communications in order

²⁴⁴ Ibid, at [68] per Mance LJ.

²⁴⁵ [2002] 2 All ER 248. See also *Horkulak v Cantor Fitzgerald International* [2004] EWCA Civ 1287; *Lymington Marina Ltd v MacNamara* [2007] 2 All ER (Comm) 825. In *Socimer International Bank Ltd v Standard Bank London Ltd* [2008] EWCA Civ 116 Rix LJ noted (at [66]) 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...’

²⁴⁶ Ibid, at 261 per Dyson LJ. The obligation was justified on the basis that it was needed to give effect to the reasonable expectations of the parties. However, one commentator has suggested that the notion of reasonable expectations adds nothing to the content of the obligation. See Catherine Mitchell, ‘Leading a Life of its Own? The Roles of Reasonable Expectation in Contract Law’ (2003) 23 *Oxford Journal of Legal Studies* 639, at 660.

²⁴⁷ (High Court, Auckland, CL 15/02, 13 March 2003). Analogy might also be drawn with those New Zealand cases recognising that a condition inserted for the sole benefit of one of the parties gives rise to an implied term that reasonable efforts must be taken to satisfy the condition. See *Connor v Pukerau Store Ltd* [1981] 1 NZLR 384. Accordingly, a party exercising the discretion whether or not to confirm the contract cannot rely on reasons extraneous to the intended purpose of the condition to assert that the condition has not been fulfilled. See *Provost Developments Ltd v Collingwood Towers Ltd* [1980] 2 NZLR 205; *New Zealand Wines and Spirits (Properties) Ltd v Commercial Realities (NZ) Ltd* (1984) 2 NZCPR 156.

to use them against the client should the provider and the client later fall out.²⁴⁸ In the course of his judgment, Fisher J cited the observations of Leggett LJ in *Abu Dhabi National Tanker Co v Product Star Shipping Ltd*:

Where A and B contract with each other to confer a discretion on A, that does not render B subject to A's uninhibited whim. In my judgment, the authorities show that not only must the discretion be exercised honestly and in good faith, but having regard to the provisions of the contract by which it is conferred, it must not be exercised arbitrarily, capriciously or unreasonably.²⁴⁹

Similarly in *Aztrazeneca Ltd v Pharmaceutical Management Agency*²⁵⁰ Miller J held that an apparently unfettered power to make a calculation affecting the amount payable under a pharmaceutical contract was subject to a requirement of reasonableness in the exercise of the discretion. His Honour suggested that the obligation was found as a matter of construction although, if necessary, such a term could also be implied to give business efficacy to the contract.²⁵¹

Ultimately, whether a contractual discretion will be subject to an obligation of reasonableness or good faith will depend on the wording of the clause itself. The courts will not impose an additional obligation contrary to the intention of the contracting parties. For example, if the parties include in the contract a provision that the discretion can be exercised for any reason or at the 'sole discretion' of one party, this may exclude any obligation of reasonableness or requirement to have regard to the interests of the other contracting party.²⁵²

²⁴⁸ Ibid, at [34].

²⁴⁹ [1993] 1 Lloyd's Rep 397, at 404. See also *Marshall v Bernard Place Corp* 58 OR (3d) 97.

²⁵⁰ (High Court, Wellington, CIV 2003-404-5056, 14 June 2005).

²⁵¹ Ibid, at [82]. In the context of contractual discretions, it has been recognised that 'the good faith duty appears to arise by proper construction of the agreement rather than as a result of the imposition of an independent and free-standing good faith duty.' John McCamus, 'Abuse of Discretion, Failure to Cooperate and Evasion of Duty: Unpacking the Common Law Duty of Good Faith Contractual Performance' (2004) 88 *Advocates' Quarterly* 72, at 83.

²⁵² See generally *Thiess Contractors Pty Ltd v Placer (Granny Smith) Pty Ltd* (2000) 16 BCL 130. It has been held that a clause including the words 'sole discretion' excludes any constraint upon the exercise of

On balance, it is submitted that there is sufficient authority to assume that the exercise of unfettered contractual powers is likely, where necessary, to be subject to judicially imposed restraints.²⁵³ Further, these restraints have been implemented by explicitly drawing on the concept of good faith.²⁵⁴

Judicial control of contractual discretions has been suggested to present a challenge to freedom of contract and party autonomy.²⁵⁵ However, this reasoning must be questioned. To find that contracting parties intend an unfettered contractual discretion to confer a right to exercise the discretion in a capricious or arbitrary manner is a strained and untenable interpretation.

In light of the prevailing acceptance of a good faith or reasonableness obligation in the exercise of contractual discretions, it is submitted that a general doctrine of contractual good faith would be unlikely to be of any additional benefit in this field of contractual

the discretion and weighs against any implied obligation of reasonableness or good faith in respect of the contractual power. See *Vodafone Pacific Ltd v Mobile Innovations Ltd* [2004] NSWCA 15, at [195] per Giles JA. However, it has been observed that the ‘law does not love an ouster clause. A “sole discretion” clause cannot be expected to be treated as effective authority to permit the wholesale hijacking of the original bargain. [T]he unremitted exercise of a “sole discretion” clause, if asserted to be valid at law, merely serves to attract equity’s attention instead.’: Kós, above n 231, at 13. See Chapter 2 for further discussion.

²⁵³ For Australian authority see *Alcatel Australia Ltd v Scarcella* (1998) 44 NSWLR 349, at 368 per Sheller JA; *Pierce Bell Sales Pty Ltd v Fraser* (1973) 130 LR 575. For Canadian authority see *Mason v Freedman* [1958] SCR 483; *Greenberg v Meffert* (1985) 18 DLR (4th) 548; *LeMesurier v Andrus* (1986) 25 DLR (4th) 424; *Mesa Operating Ltd Partnership v Amoco Canada Resources Ltd* (1994) 149 AR 187.

²⁵⁴ Vanessa Sims and R J Goddard, ‘Controlling Contractual Discretion’ (2002) 61 *Cambridge Law Journal* 268, at 271. See also Terence Daintith, ‘Contractual Discretion and Administrative Discretion: A Unified Analysis’ (2005) 68 *Modern Law Review* 554.

²⁵⁵ See generally Hugh Collins, ‘Discretionary Powers in Contracts’ in David Campbell, Hugh Collins and John Wightman (eds), *Implicit Dimensions of Contracts: Discrete, Relational and Network Contracts* (2003).

performance. The equivalence thesis is satisfied. The point is well advanced by Kós in the context of the exercise of contractual powers:

[T]here is a shapeless melange of cases dealing in broad terms with general obligations of good faith *inter se* the contracting parties. These inferred obligations, which frequently defy rational analysis (e.g. whether they arise in contract or in equity) or definition (e.g. how far they reach) [] are not needed in the present context, because contract law has developed its own effective mechanism to ensure good faith exercise of contractual discretions...²⁵⁶

The willingness of the courts to fetter the exercise of contractual discretions, by importing obligations of reasonableness, honesty, good faith and administrative law principles, is evidence of the desire to give effect to the reasonable expectations of contracting parties. Thus, in the context of contractual discretions, the courts are essentially achieving the purpose of a general good faith doctrine without requiring its explicit recognition or incorporation into the law of contract within New Zealand.

4.8 Good Faith, Penalty Provisions and Liquidated Damages:

4.8.1 The Juristic Rationale for Sanctioning Penalty Clauses:

Often parties to a contract may include a term stipulating that certain damages are payable in the event of breach. The particular clause may simply state the sum to be remitted. Alternatively, the term may provide a specific formula for calculating the quantum of damages. Such clauses may be commercially desirable and economically efficient. They provide certainty and save the expense of proving loss.²⁵⁷ Unlike an exclusion of liability clause, an agreed damages clause is likely to be of benefit to both

²⁵⁶ Kós, above n 231, at 7 (citation omitted).

²⁵⁷ *Phillips Hong Kong Ltd v Attorney General of Hong Kong* (1993) 61 BLR 41; *Robophone Facilities Ltd v Blank* [1966] 3 All ER 128, at 141 per Diplock LJ.

parties.²⁵⁸ From a more general policy perspective, agreed damages clauses are of advantage to society as a whole because they reduce the incidence of litigation and the need to resort to the courts to resolve contractual issues.

However, the law does not countenance agreed damages clauses which seek to penalise the party in breach rather than compensate the innocent party. As a general rule, punitive or exemplary damages are not appropriate in the field of contract law.²⁵⁹ This rule is sound for a number of reasons. Damages in contract are confined to compensating for pecuniary loss and, in some instances, non-pecuniary loss.²⁶⁰ The defendant is not to be punished further. A contract represents a private arrangement under which each party voluntarily assumes the risk of a breach by the other. Thus there is no justification to confer a windfall on the innocent party to a breach.

Further, damages representing a penalty distort efficient breach. This dictates that a contract should be breached where the victim is paid compensatory damages and the other is made better off than if he or she performed. The result is Pareto efficient. No party is worse off and one is better off. A penalty clause increases the cost of breach and therefore diminishes the incidence of efficient breach.

²⁵⁸ *Suisse Atlantique Société D'armement Maritime S A v N V Rotterdamsche Kolen Centrale* [1966] 2 All ER 61, at 85 per Lord Upjohn. See also John Carter and Elizabeth Peden, 'A Good Faith Perspective on Liquidated Damages' (2007) 23 *Journal of Contract Law* 157.

²⁵⁹ *Paper Reclaim Ltd v Aotearoa International Ltd* [2006] 3 NZLR 188; *Ruxley Electronics and Construction Ltd v Forsyth* [1995] 3 All ER 268; *Butler v Fairclough* (1917) 23 CLR 78; *Gray v Motor Accident Commission (formerly State Government Insurance Commission)* (1998) 158 ALR 485. The Canadian approach is somewhat distinct. See *Royal Bank of Canada v W Got & Associates* [1999] 3 SCR 408; *Whiten v Pilot Insurance Co* [2002] 1 SCR 595.

²⁶⁰ It is evident that in some cases damages may be recovered for mental injury, discomfort and inconvenience. See *Attorney-General v Gilbert* [2002] 2 NZLR 342; *Farley v Skinner* [2002] 2 AC 732. See generally Burrows, Finn and Todd, above n 41, at 703.

Moreover, punishment is best confined to the criminal law which contains appropriate procedural safeguards.²⁶¹ Despite exemplary damages being allowed in other areas of the civil law such as tort, there is justifiable argument to abandon punitive damages altogether in the civil law.²⁶²

Ultimately, it follows that if the judiciary is not prepared to award punitive damages in contract, public policy dictates that contracting parties should be precluded from voluntarily agreeing to them.

Accordingly, it is necessary for the courts to distinguish between an agreed damages clause which represents a genuine pre-estimate of contractual damages and a clause which is held over the other party *in terrorem*. The former represents liquidated damages. The latter constitutes a penalty. Thus, a penalty extends past indemnifying the promisee for the actual loss suffered if the promisor does not discharge his or her contractual obligations. Instead, it is held as a threat over the promisor in order to secure performance of the agreement.²⁶³

The courts have traditionally intervened to regulate contracts involving penalty clauses. This results in a departure from the notion of freedom of contract. The juristic basis for this intervention is not entirely clear. The general approach of the courts is to regard a

²⁶¹ For example, a defendant is entitled to be charged with a clearly defined defence and he or she should conceivably enjoy evidential safeguards such as an increased burden of proof and privilege against self-incrimination. See Law Commission (England and Wales), *Aggravated, Exemplary and Restitutionary Damages: A Consultation Paper*, LCCP No 132 (1993), at 110. See also *Daniels v Thompson* [1998] 3 NZLR 22, at 61 per Thomas J; Peter Jaffey, 'The Law Commission Report on Aggravated, Exemplary and Restitutionary Damages' (1998) 61 *Modern Law Review* 860, at 862.

²⁶² See Stephen Todd, 'A New Zealand Perspective on Exemplary Damages' (2004) 33 *Common Law World Review* 255. Although some favour exemplary damages in contract in some instances. See Elizabeth Tobeck, 'Exemplary Damages in Contract' [2006] *New Zealand Law Journal* 145; Andrew Phang and Pey-Woan Lee, 'Restitutionary and Exemplary Damages Revisited' (2003) 19 *Journal of Contract Law* 1; James Edelman, 'Exemplary Damages for Breach of Contract' (2001) 117 *Law Quarterly Review* 539.

²⁶³ See generally *Bridge v Campbell Discount Co Ltd* [1962] 1 All ER 385, at 391 per Lord Morton.

penalty clause as void and ineffective.²⁶⁴ Consequently, the promisee is required to establish his or her claim for unliquidated damages.²⁶⁵ This solution is said to represent a common law approach.²⁶⁶ Alternatively, the courts may permit the promisee to enforce the agreed damages provision to the extent that it represents actual loss, but refuse to enforce any residual amount, being penal in nature and therefore unconscionable.²⁶⁷ This outcome is based on equitable principles. Historically it was thought that the intervention of the Court was founded on its equitable jurisdiction. However, the High Court of Australia has recognised that ‘the equitable jurisdiction to relieve against penalties [has] withered on the vine’²⁶⁸ because in most instances equity offers no additional remedy to that which the promisor may obtain at common law.²⁶⁹ Ultimately, the distinction between the two approaches may be semantic.

The refusal to uphold penalty provisions is another clear example of the courts giving effect to general principles of good faith.²⁷⁰ A promisee who seeks to recover a penalty and a windfall fails to discharge good faith behaviour. In lieu of the existing jurisdiction

²⁶⁴ *Workers Trust & Merchant Bank Ltd v Dojap Investments Ltd* [1993] 2 All ER 370. See also Carter and Peden, above n 258, at 158.

²⁶⁵ Ibid.

²⁶⁶ See Carter and Peden, above n 258, at 158.

²⁶⁷ Thus, ‘the strict legal position is not that such a clause is simply struck out of the contract, as though with a blue pencil, so that the contract takes effect as if it had never been included therein. Strictly, the legal position is that the clause remains in the contract and can be sued upon, but it will not be enforced by the court beyond the sum which represents, in the events which have happened, the actual loss of the party seeking payment.’: *Jobson v Johnson* [1989] 1 All ER 621 at 633 per Nicholls LJ.

²⁶⁸ *AMEV-UDC Finance Ltd v Austin* (1986) 68 ALR 185, at 200 per Mason and Wilson JJ.

²⁶⁹ Arguments have been made favoring the equitable approach. See Elizabeth V Lanyon, ‘Equity and the Doctrine of Penalties’ (1996) 9 *Journal of Contract Law* 234. It has been contended that the recognition of the doctrine of penalty at common law rather than in equity has ‘prevented the courts from developing a more sensitive and discriminating principle.’: *Citicorp Australia Ltd v Hendry* (1985) 4 NSWLR 1, at 23 per Kirby P.

²⁷⁰ *Interfoto Picture Library Ltd v Stiletto Visual Programmes Ltd* [1988] 1 All ER 348, at 353 per Bingham LJ. See also Kelda Groves, ‘The Doctrine of Good Faith in Four Legal Systems’ (1999) 15 *Construction Law Journal* 265, at 284.

to relieve against penalty provisions, conceivably a common law doctrine of good faith could be invoked by a promisor to preclude a penalty provision from being enforced. Nonetheless, it seems unlikely that a doctrine of good faith would provide any additional benefit to a promisor than the remedy currently available under the existing law.

However, it has been suggested that a doctrine of good faith could be utilised by the courts to determine whether a particular clause is a liquidated damages clause or a penalty provision.²⁷¹ This proposition requires further consideration.

4.8.2 Utilising Good Faith to Distinguish Between Penalties and Liquidated Damages:

In *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd* Lord Dunedin set out certain rules of guidance for determining whether a clause is a penalty:

- (a) It will be held to be penalty if the sum stipulated for is extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably be proved to have followed from the breach...
- (b) It will be held to be a penalty if the breach consists only in not paying a sum of money, and the sum stipulated is a sum greater than the sum which ought to have been paid...
- (c) There is a presumption (but no more) that it is penalty when "a single lump sum is made payable by way of compensation, on the occurrence of one or more or all of several events, some of which may occasion serious and others but trifling damage"...

On the other hand:

- (d) It is no obstacle to the sum stipulated being a genuine pre-estimate of damage, that the consequences of the breach are such as to make precise pre-estimation almost an impossibility. On the contrary, that is just the situation when it is probable that pre-estimated damage was the true bargain between the parties...²⁷²

²⁷¹ See generally Carter and Peden, above n 258.

²⁷² [1915] AC 79, at 87-88.

What is therefore required is a genuine pre-estimate of loss or damage.²⁷³ The time for assessing whether the estimate is genuine is at the time of making the contract, not the time of the breach.²⁷⁴

In *Ringrow Pty Ltd v BP Australia Pty Ltd*²⁷⁵ the High Court of Australia, whilst accepting that the dicta of Lord Dunedin continues to represent the law in Australia, suggested that it is not enough that the stipulated amount is lacking in proportion to the potential loss. Instead, it must be ‘out of all proportion.’²⁷⁶ However, this approach is open to criticism. It shifts the focus away from a genuine pre-estimate of loss towards the degree of accuracy.²⁷⁷ The latter is undoubtedly circumstantial evidence of the former. However, arguably it should not be determinative. For example, an estimate which is based on a wholly inappropriate formula might constitute a penalty even though the calculated sum may approximately equate with the loss. In other cases, the loss may be so easy to predict that any contractual figure above the amount that can be readily predicted may be considered penal, notwithstanding that it is not out of all proportion. In either instance the pre-estimated sum may not be determined reasonably and in good faith.²⁷⁸

²⁷³ *Smith Developments Ltd v Dormer Construction Ltd* (High Court, Christchurch, CIV 2005-409-2742, 26 May 2006, Pankhurst J), at [35]; *Workers Trust & Merchant Bank Ltd v Dojap Investments Ltd* [1993] 2 All ER 370, at 373 per Lord Browne-Wilkinson; *Camatos Holdings Ltd v Neil Civil Engineering (1992) Ltd* [1998] 3 NZLR 596, at 608 per Giles J; *Dunlop Pneumatic Tyre Company Ltd v New Garage and Motor Co Ltd* [1915] AC 79, at 86 per Lord Dunedin.

²⁷⁴ *Lombank Ltd v Excell* [1963] 3 All ER 486; *Dunlop Pneumatic Tyre Company Ltd v New Garage and Motor Co Ltd* [1915] AC 79.

²⁷⁵ (2005) 222 ALR 306.

²⁷⁶ *Ibid*, at 314 per Gleeson CJ, Gummow, Kirby, Hayne, Callinan and Heydon JJ.

²⁷⁷ Carter and Peden, above n 258, at 167. Indeed, it has been contended that the ‘question in issue should be not the accuracy of the pre-estimate, but the reasonableness of the agreement.’: Waddams, above n 178, at 323.

²⁷⁸ It has been observed that ‘a liquidated damages clause could be reasonably proportionate to anticipated or actual harm and yet not be enforceable because it is not a good faith attempt to pre-estimate damages.’: William S Harwood, ‘Liquidated Damages: A Comparison of the Common Law and the Uniform Commercial Code’ (1977) 45 *Fordham Law Review* 1349, at 1365.

Peden and Carter have therefore recognised the limitations of the dictum in *Ringrow* and the importance of good faith:

One conclusion which might be drawn from *Ringrow* is that the out of all proportion test is applicable in all cases. However, in our view that conclusion is wrong. Because good faith is the underlying concept, and because determination of a sum which is not out of all proportion is not synonymous with a good faith assessment, there must be limitations on the test.²⁷⁹

Accordingly, it appears logical that the estimate of loss embody a requisite degree of accuracy, but also be based on appropriate considerations. Thus, it is suggested that only good faith pre-estimations of damage should be effective to liquidate damages.²⁸⁰ The question is one of construction having regard to the intention of the parties.²⁸¹ A good faith pre-estimation of damage may require the parties to have regard to the conventional measure of damage that would be applied by the courts in respect of the loss.²⁸² The Court may need to look behind the figure stipulated to the suitability of the calculation used to arrive at the sum, particularly where there is no formula provided in the agreement. In this respect, the promisee may have incentive to adduce evidence of how the amount was arrived at, notwithstanding that the promisor bears the onus of showing that a clause is a penalty.²⁸³ It is therefore submitted that whether a particular clause represents liquidated damages or a penalty can be informed by evaluating whether it has been determined reasonably and in good faith.

²⁷⁹ Carter and Peden, above n 258, at 170.

²⁸⁰ Ibid, at 160.

²⁸¹ The determination of whether a particular clause represents liquidated damages or a penalty is regarded as a matter of construction. See *Law v Redditch Local Board* [1892] 1 QB 127. However, seemingly the determination goes past 'pure' construction in the sense that the Court is entitled to examine all of the extrinsic evidence which it might not otherwise consider under ordinary principles of contractual interpretation. See Gerard McMeel, *The Construction of Contracts* (2007), at 495.

²⁸² Carter and Peden, above n 258, at 171.

²⁸³ The contracting party seeking to avoid payment of an agreed sum on the basis that it is a penalty bears the onus of proof. See *Robophone Facilities Ltd v Blank* [1966] 3 All ER 128.

Some commentators have suggested that an open recognition of unconscionability or good faith is required to rectify the perceived difficulties that ‘bedevil the law of penalty clauses.’²⁸⁴ One of those difficulties is the apparent anomaly between the willingness of the courts to strike down penalties payable on breach and the willingness to enforce clauses analogous to penalties which are payable on some other event. For example, a hirer under a hire purchase contract who defaults in breach may be relieved of the consequences of a ‘minimum payment’ clause requiring a fixed payment regardless of when the breach occurs. On the contrary, a hirer who determines the contract in accordance with an option in the agreement may have no claim to relief from payment of the stipulated amount because there has been no breach of contract. In *Bridge v Campbell Discount Co Ltd* Lord Denning described the granting of relief to a man who breaks his contract but not to a man who keeps it as an ‘absurd paradox.’²⁸⁵

Accordingly, some have suggested that there needs to be a move away from rigid classifications of particular clauses to a focus on substantive fairness. It has been argued that the distinction between penalties and liquidated damages must be rejected in favour of a general good faith criterion for the enforceability of such clauses.²⁸⁶

Nonetheless, it is submitted that there is no need for a general doctrine of good faith in the field of contractual penalties.²⁸⁷ The existing legal rules effectively embody an unexpressed requirement of good faith. There is no reason why the rules in *Dunlop* cannot continue to prevail and undergo judicious development if necessary. For example, the courts could extend the *Dunlop* principles to deal with concerns relating to the distinction between penalties payable on breach and those payable on some other event. Notwithstanding, there is a cogent argument to suggest that this should not occur given that the value of contractual undertakings is properly a matter for the parties rather than

²⁸⁴ Waddams, above n 178, at 324.

²⁸⁵ [1962] 1 All ER 385, at 391.

²⁸⁶ See Lucinda Miller, ‘Penalty Clauses in England and France: A Comparative Study’ (2004) 53 *International and Comparative Law Quarterly* 79, at 104.

²⁸⁷ See Carter and Peden, above n 258, at 177-178.

the courts. Thus, in *Export Credits Guarantee Department v Universal Oil Products Co*²⁸⁸ the House of Lords declined to extend the jurisdiction to relieve against penalties to circumstances where the payment of money was required on the occurrence of a specified event rather than a breach. Lord Roskill recognised that it was not for the courts to relieve a contracting party from a commercially imprudent bargain.²⁸⁹

Further, to abandon the defined guiding criteria in favour of a general doctrine of good faith might defeat the purpose of agreed damages clauses. Contracting parties may be left subject to too much judicial discretion. Conceivably, liquidated damages clauses would be regularly challenged by hopeful promisors. Contrary to the purpose of such clauses, the incidence of litigation would increase. Accordingly, whilst the distinction between penalties and liquidated damages may be informed by notions of good faith, the defined legal criteria should not be abandoned.

4.8.3 Précis:

The willingness of the courts to strike down penalty clauses is evidence of the courts sanctioning bad faith conduct. Further, the determination of whether a clause represents liquidated damages or a penalty can be explained with reference to good faith considerations. Nonetheless, it is submitted that a common law doctrine of good faith would be unlikely to be of any additional benefit to the existing law in this field of contract regulation. The existing law is adequate and is desirably certain. To discard the defined guiding criteria in favour of a general principle of good faith in determining whether an agreed damages clause can be enforced might result in uncertainty which would frustrate the purpose of liquidated damages clauses.

²⁸⁸ [1983] 2 All ER 205.

²⁸⁹ Ibid, at 224.

4.9 Good Faith and Cancellation for Breach – Conditions, Warranties, Innominate Terms and the Contractual Remedies Act 1979:

4.9.1 Conditions and Warranties:

The common law traditionally treats contractual terms as falling into two distinct categories. The first category is a condition.²⁹⁰ The second is a warranty. A condition is seen as an essential term of the contract. A breach of a condition may be considered a substantial failure to perform the contract at all.²⁹¹ Accordingly, a breach not only gives rise to an action for damages, but also a right to rescind the contract. A warranty on the other hand is a less important term of the contract. The term is collateral to the main contractual purpose.²⁹² Breach of a warranty gives rise to an action in damages, but not a right to terminate.²⁹³

The Court will look to the intention of the parties in determining whether a contractual term is a condition or a warranty.²⁹⁴ Each case depends upon a construction of the contract.²⁹⁵ Use of the word condition or warranty within a contract to describe a particular term will be presumptive but not definitive.²⁹⁶

²⁹⁰ The word ‘condition’ in this context should not be confused with its more orthodox meaning that a condition is an external event upon which the obligations of the contracting parties depend.

²⁹¹ *Wallis Son & Wells v Pratt and Haynes* [1910] 2 KB 1003.

²⁹² For example, the definition of warranty under s 2(1) Sale of Goods Act 1908 provides that a warranty ‘means an agreement with reference to goods which are the subject of a contract of sale, but collateral to the main purpose of such contract, the breach of which gives rise to a claim for damages, but not to a right to reject the goods and treat the contract as repudiated.’

²⁹³ See Burrows, Finn and Todd, above n 41, at 186.

²⁹⁴ See Butterworths, *Commercial Law in New Zealand*, (at 19 June 2008), at [13.1].

²⁹⁵ Section 13(2) Sale of Goods Act 1908.

²⁹⁶ *Wickman Machine Tool Sales Ltd v Schuler AG* [1973] 2 All ER 39.

4.9.2 The Innominate Term – Giving Effect to Good Faith?

The traditional distinction between conditions and warranties came under scrutiny in the mid to late 20th century. The distinction is problematic because it focuses only on a classification of a particular term at the time of entering into the contract. No cognisance is taken of the seriousness and consequences of the breach of the term. This criticism was the catalyst for the celebrated judgment of Diplock LJ in *Hong Kong Fir Shipping Co Ltd v Kawasaki Kisen Kaisha Ltd* where it was recognised:

There are, however, many contractual undertakings of a more complex character which cannot be categorised as being "conditions" or "warranties"...Of such undertakings, all that can be predicated is that some breaches will, and others will not, give rise to an event which will deprive the party not in default of substantially the whole benefit which it was intended that he should obtain from the contract; and the legal consequences of a breach of such an undertaking, unless provided for expressly in the contract, depend on the nature of the event to which the breach gives rise and do not follow automatically from a prior classification of the undertaking as a "condition" or a "warranty".²⁹⁷

Those terms contemplated by Diplock LJ which cannot be characterised as conditions or warranties have since become known as ‘innominate’ terms.²⁹⁸ Arguably, the desire to avoid the classical distinction between conditions and warranties is an attempt to introduce an element of good faith and fairness into contract law.²⁹⁹ The effect of the innominate term theory is to recognise that breach of a warranty may be sufficiently

²⁹⁷ [1962] 1 All ER 474, at 487.

²⁹⁸ For discussion of the distinction between conditions, warranties and innominate terms see John Carter, Greg Tolhurst and Elizabeth Peden, ‘Developing the Intermediate Term Concept’ (2006) 22 *Journal of Contract Law* 268; G Applebey and Frank Meisel, ‘Hongkong Fir Revisited: The House of Lords and Certainty in Contracts’ [1982] *Lloyd’s Maritime and Commercial Law Quarterly* 592; Jane Swanton, ‘Discharge of Contracts for Breach’ (1981) 13 *Melbourne University Law Review* 69; John Carter and C Hodgekiss, ‘Conditions and Warranties: Forebears and Descendants’ (1977) 8 *Sydney Law Review* 31; Lord Devlin, ‘The Treatment of Breach of Contract’ [1966] *Cambridge Law Journal* 192; Michael Furmston, ‘The Classification of Contractual Terms’ (1962) 25 *Modern Law Review* 584.

²⁹⁹ See generally Roger Brownsword, ‘Two Concepts of Good Faith’ (1994) 7 *Journal of Contract Law* 197.

serious to warrant termination.³⁰⁰ Alternatively, the theory endeavours to prevent a party from cancelling a contract for a trivial breach. Seemingly a party who attempts to rescind for an insignificant breach acts in contravention of good faith. The innominate term rationale therefore neutralises withdrawals in bad faith.³⁰¹ Thus, Tetley recognises:

The distinction between “warranties”, “conditions” and “innominate terms” is another way in which good faith is enforced in the common law of contract, by ensuring that relatively minor contractual breaches [] do not permit the injured party to be released from his contractual obligations, as if they were breaches of conditions.³⁰²

Initially the *Hong Kong Fir* case was interpreted liberally. In a trio of cases³⁰³, the House of Lords demonstrated a general reluctance to find that a particular term was a condition. Perhaps the most exceptional case in that trio was *Wickman Machine Tool Sales Ltd v Schuler AG*.³⁰⁴ Notwithstanding that the parties had expressed a term relating to the frequency by which sales representatives were to visit customers to be a condition, the majority³⁰⁵ found that the clause could not be given that effect. The decision was rationalised on the basis that the term was not a condition when properly construed. However, this construction was arrived at by observing that a breach of the term could be so trivial that a right to cancel could not have been intended by the parties. It would produce an unreasonable result.³⁰⁶ Seemingly the Lords were really looking to the effect of the breach rather than the intention of the parties. Lord Wilberforce dissented. He opined that the words used indicated an intention for ‘aggressive, insistent punctuality and efficiency.’³⁰⁷ Thus, his Lordship reasoned that the clause was a condition.

³⁰⁰ Carter, Tolhurst and Peden, above n 298, at 269.

³⁰¹ See Brownsword, above n 299, at 197.

³⁰² Tetley, above n 91, at 575. See also Nolan, above n 227, at 613.

³⁰³ *Wickman Machine Tool Sales Ltd v Schuler AG* [1973] 2 All ER 39; *Cehave NV v Bremer Handelsgesellschaft mbH* [1975] 3 All ER 739; *United Scientific Holdings Ltd v Burnley Borough Council* [1977] 2 All ER 62.

³⁰⁴ *Ibid.*

³⁰⁵ Lord Reid, Lord Morris, Lord Simon and Lord Kilbrandon.

³⁰⁶ [1973] 2 All ER 39, at 45 per Lord Reid.

³⁰⁷ *Ibid.*, at 55.

Notwithstanding, the majority decision in *Wickman* suggested a clear desire to avoid an unfair outcome. Indeed, the cases around the time evidence an unwritten preference for innominate terms over conditions when construing contractual terms.³⁰⁸

However, in *Bunge Corp v Tradax SA*³⁰⁹ the English Court of Appeal diluted the effect of the dicta of Diplock LJ. It was suggested that in some contracts certainty in the performance of a particular term is so essential that the term should be treated as a condition. A stipulation as to time in a mercantile contract would almost always be deemed to be a condition. Accordingly, notice of the readiness of the vessel given four days late was sufficient to warrant cancellation of the agreement by the innocent party.

Thus, the right to cancel for breach remains unaffected where the parties have expressly agreed that a particular term is a condition or the law deems a particular stipulation to be a condition by virtue of the nature of the term and the class of contract in which it falls. The trivialness of the breach is irrelevant. Although the innominate term theory goes some way to ensuring good faith conduct, it does not go so far as to totally preclude a party for cancelling for minor breach.

4.9.3 Codification Under the Contractual Remedies Act 1979 – A Limit on Good Faith?

Although the distinction between conditions and warranties has been retained under the Sale of Goods Act 1908, the right to cancel a contract in New Zealand is now principally governed by the CRA. The ability to cancel on the grounds of breach is specifically provided for under ss 7(3) and 7(4), which state:

- (3) Subject to this Act, but without prejudice to subsection (2) of this section, a party to a contract may cancel it if—

³⁰⁸ Carter, Tolhurst and Peden, above n 298, at 273.

³⁰⁹ [1981] 2 All ER 513. See also *The Mihalis Angelos* [1971] 1 QB 164; *Barber v NSW Bank plc* [1996] 1 All ER 906.

- (a) He has been induced to enter into it by a misrepresentation, whether innocent or fraudulent, made by or on behalf of another party to that contract; or
 - (b) A term in the contract is broken by another party to that contract; or
 - (c) It is clear that a term in the contract will be broken by another party to that contract.
- (4) Where subsection (3)(a) or subsection (3)(b) or subsection (3)(c) of this section applies, a party may exercise the right to cancel if, and only if,—
- (a) The parties have expressly or impliedly agreed that the truth of the representation or, as the case may require, the performance of the term is essential to him; or
 - (b) The effect of the misrepresentation or breach is, or, in the case of an anticipated breach, will be,—
 - (i) Substantially to reduce the benefit of the contract to the cancelling party; or
 - (ii) Substantially to increase the burden of the cancelling party under the contract; or
 - (iii) In relation to the cancelling party, to make the benefit or burden of the contract substantially different from that represented or contracted for.

The effect of s 7 arguably embodies the considerations of fairness and good faith which Diplock LJ was apparently seeking to propound in *Hong Kong Fir* case.³¹⁰ The right to cancel an agreement under the CRA is *prima facie* governed by the effect of the breach. Thus, the CRA takes a pragmatic approach. Parliament has recognised the reasonable expectations of both innocent and breaching parties by limiting the right of a contracting party to cancel for a trivial breach or, alternatively, by allowing cancellation for a substantial breach irrespective of the classification of the term.

However, the effect of s 7(4)(a) is to retain the common law condition. This result may not be altogether satisfactory to proponents of good faith.³¹¹ It remains possible for a

³¹⁰ The legislature has effectively adopted and codified the *Hong Kong Fir* approach. See David McLauchlan, 'Contract Law Reform in New Zealand: The Contractual Remedies Act 1979' (1981) 1 *Oxford Journal of Legal Studies* 284, at 287.

³¹¹ Some commentators have suggested that it would be better to abandon the notion of an essential term which requires an artificial *a priori* construction and instead treat each term as neutral, analysing the consequences of the breach. See Carter and Hodgekiss, above n 298, at 64.

party to cancel a contract if it has been agreed that performance of the term is essential, regardless of the seriousness or consequences of the breach. It might be argued that this outcome effectively sanctions behaviour by the non-breaching party in contravention of good faith. It is clear that the focus of the Court under s 7(4)(a) is on the intention of the parties at the time of entering into the contract. The Court will not take into account the consequences of the breach in determining essentiality.³¹² For example, in *Rick Dees*³¹³, where time was agreed to be of the essence, the cancellation of the contract on the grounds that notice of tender was given seven minutes late was justified even though the vendor had apparently suffered no adverse consequences as a result of the breach.

The retention of the common law condition on the ground of certainty has been subject to scrutiny by good faith proponents, particularly because it ignores the potential reasons for the cancellation. For example, some suggest that there is a lack of good faith where a cancellation for breach of a condition is not motivated by the negative consequences of the breach but instead by a prior movement in market prices.³¹⁴ The excessive technicality of the condition allows a party to extricate himself or herself from a bad bargain.³¹⁵

However, there are logical reasons for focusing on the effect of the breach and the essentiality of the term, rather than on the motive for cancellation. Waddams recognises:

There would [] be a practical problem in a rule that termination is permissible only if the motives of the party seeking to terminate are not self-interested, or if they do not include considerations extraneous to the breach itself...Such a rule, if it could even be seriously contemplated, would involve costly inquiries into the

³¹² *Wilson v Hines* (1994) 6 TCLR 163.

³¹³ [2007] 3 NZLR 577.

³¹⁴ See Carter, Tolhurst and Peden, above n 298, at 273.

³¹⁵ See Sir Guenter Treitel, *Some Landmarks of Twentieth Century Contract Law* (2002), at 110-11 and 119. See also Andrew Phang, 'On Architecture and Justice in Twentieth Century Contract Law' (2003) 19 *Journal of Contract Law* 229.

state of mind of the party purporting to terminate, and would create perverse incentives.³¹⁶

In addition to the cogent arguments against examining contractual motives, it is submitted that it is highly unlikely that the introduction of a common law doctrine of good faith would act to fetter or limit the right of an innocent party to cancel a contract for breach. If the parties have plainly expressly or impliedly agreed that a particular term in a contract is ‘essential’ such that a breach, no matter how serious, gives rise to a right to cancel, then it is difficult to see how a construction of the contract based on good faith could limit that right.³¹⁷ It is highly arguable that by agreeing that a particular term is a condition, that the parties did not intend the right to cancel for a breach of that term to be subject to an obligation of good faith.

Further, s 7(1) of the CRA provides:

- (1) Except as otherwise expressly provided in this Act, this section shall have effect in place of the rules of the common law and of equity governing the circumstances in which a party to a contract may rescind it, or treat it as discharged, for misrepresentation or repudiation or breach.

Thus, the CRA would override a common law doctrine of good faith in so far as an obligation of good faith might place additional restrictions on the right of a contracting

³¹⁶ Waddams, above n 162, at 63. It has been contended that ‘the notion of depriving a party of rights afforded it under a contract because of ulterior purposes smacks of a punitive approach which is seldom attractive to the Court in determining contractual rights and obligations. Ex post facto views by the Court on motive are hardly conducive of contractual certainty.’: *GXL Royalties Ltd v Swift Energy New Zealand Ltd* (High Court, Wellington, CIV 2008-485-1776, 30 January 2009, Dobson J), at [16]. This general reluctance for a discretionary approach may be the fundamental reason why there is no ‘general duty of good faith in the exercise of remedy by a promisee.’: Len Sealy, ‘Ties That Bind: Security of Contract in England at the End of the 20th Century’ (2000) 6 *New Zealand Business Law Quarterly* 134.

³¹⁷ However, it has been argued that ‘parties may themselves classify a particular term as a condition or specify that a breach of it is fundamental and, in such cases, a good faith doctrine would empower the courts to differentiate between repudiations which are opportunistic and those that are not.’: Nolan, above n 227, at 613.

party to cancel the contract for breach. In *Vero Insurance New Zealand Ltd v Fleet Insurance & Risk Management Ltd* Asher J recognised the inconsistency:

When a contract is terminable for [] breach that would give rise to a right to cancel [] it is unlikely that a Court would limit that power by applying a requirement of good faith. That has never been such a restriction on the common law right to rescind or the Contractual Remedies Act right to cancel.³¹⁸

Accordingly, unless an obligation of contractual good faith were to be put in place by Parliament, a contracting party who cancelled the contract in accordance with the provisions of the CRA should have a valid defence to any claim for a breach of good faith. Indeed, the ability to rely on the CRA would be put in disarray if the result were any different.

4.9.4 Précis:

The advent of the theory of the innominate term is evidence of the courts seeking to give effect to notions of good faith in the context of cancellation for breach. Nonetheless, the judiciary remains willing to defer to the clearly expressed intentions of the parties over considerations of fairness.

Within New Zealand, a doctrine of good faith would conceivably have little impact on the existing law relating to the right to cancel contracts for breach. A good faith doctrine would be confined to the considerations of good faith and fair dealing implicit in the CRA in the absence of further legislative intervention.

4.10 Summary:

This chapter has demonstrated that unless a doctrine of contractual good faith is to produce different legal outcomes to those under the existing law, then the introduction of the subject doctrine should not be supported. This conclusion is based on the potential for

³¹⁸ (High Court, Auckland, CIV 2007-404-001438, 21 May 2007), at [55].

the administration of the law in New Zealand to be detrimentally affected by the introduction of a general, unfamiliar and uncertain principle. Accordingly, a neutral or agnostic outlook of good faith should tend towards a negative view of the subject doctrine.

The brief and select case analysis undertaken revealed little support for the positive view. It demonstrated that the law in New Zealand has, to some extent, developed to give effect to outcomes which proponents of good faith believe would be achieved under the subject doctrine. In other instances the case examples propounded by advocates simply do not lend support to the efficacy of a general good faith doctrine.

The comparative study has evidenced that the relevant existing legal and equitable doctrines, particularly those relating to pre-contractual conduct, would be unlikely to be affected by the introduction of a universal doctrine of good faith. There is however little evidence to suggest that a doctrine of good faith would provide additional legal remedies for a plaintiff than those under the existing law. This result is explained by two fundamental reasons. Firstly, many of the existing piecemeal doctrines already embody notions of good faith, fairness and reasonableness or, at least, are capable of being developed to achieve this result. Secondly, to the extent that those doctrines may fall short of upholding notions of good faith conduct, there is normally a good reason premised either on contractual autonomy or contractual certainty. There is little evidence to suggest that the courts will depart from these considerations should good faith be introduced into New Zealand contract law by means of the subject doctrine. Accordingly, the doctrine is more likely to be reduced to equate with the existing law. Due to the administrative problems associated with good faith, this result suggests that an express universal doctrine of contractual good faith would be neither a necessary nor desirable addition to New Zealand law.

Chapter 5

Economic Analysis of a Good Faith Doctrine

5.1 Chapter Introduction:

The purpose of this chapter is to examine the subject doctrine of good faith from a law and economics perspective. Economic analysis of the law embodies the concept of efficiency. A legal rule is more desirable when it is efficient.¹ Economic efficiency can be measured in terms of wealth or value. However, there are differing efficiency criteria. One measure of efficiency is achieving an allocation of resources which maximises net wealth or value. This methodology aggregates wealth across persons rather than treating them as individuals. The concept of Pareto efficiency on the other hand is more sympathetic to the interests of all affected persons. An allocation of resources is said to be Pareto efficient when no person can be made better off without making another worse off. Generally, a regime of contract law will be most efficient where the benefit of individual transactions is maximised and the associated costs are minimised.

An examination of whether a universal obligation of good faith would be economically efficient requires a comparison between the current state of contract law within New Zealand and the envisaged system under a doctrine of good faith. Contract economics dictates that the subject doctrine could only be supported if it would result in more efficiency than the prevailing regime of contract law within New Zealand.

Part 5.2 of this chapter gives a brief account of the importance of law and economics scholarship and its relevance to good faith. Part 5.3 identifies the primary contract economics view of good faith. The subject doctrine is seen as a potential deterrent to

¹ Muriel Fabre-Magnan, 'Duties of Disclosure and French Contract Law: Contribution to an Economic Analysis' in Jack Beatson and Daniel Friedman (eds), *Good Faith and Fault in Contract Law* (1995), at 107.

opportunistic behaviour. Therefore, the notion of opportunism is discussed. It is recognised that opportunistic conduct is likely to arise from two intrinsic phenomena of contracts being incompleteness and sequential performance. The importance of behavioural economics to good faith and the discouragement of opportunistic conduct is also considered. Part 5.4 endeavours to bring together the analysis of the above concepts in a transactions cost model of good faith. The model permits predictions to be made as to whether, and in what circumstances, a good faith doctrine in New Zealand would be more efficient than the prevailing law of contract. Part 5.5 evaluates the economic efficiency of two specific potential applications of the good faith doctrine. The first is pre-contractual disclosure and the second is quantity variations under requirements contracts and output agreements. Both applications have attracted considerable academic comment. Part 5.6 summarises the findings and the economic desirability of a good faith doctrine within New Zealand.

5.2 The Relevance of Law and Economics Scholarship to Good Faith:

5.2.1 Law and Economics Generally:

There are two fundamental reasons why economic principles are relevant to the law. Firstly, economics is concerned with the allocation of scarce resources. The law is also necessarily involved in controlling the use of the resources of society. Indeed, if there were an infinite abundance of resources there would be no need for control and hence no need for law.² Economic theory can therefore inform the manner in which the law should manage the use of limited resources. Secondly, economics focuses on behaviour. The law seeks to control behaviour by regulating conduct and imposing consequences for a failure to adhere to those regulations. Economic principles can be utilised to predict how rational individuals will respond to the law. As a result, the law can be formulated to create appropriate incentives to achieve desired economic outcomes.³

² Frank Easterbrook, 'The Inevitability of Law and Economics' (1989) 1 *Legal Education Review* 1, at 3.

³ Thomas Miceli, *The Economic Approach to Law* (2004), at 1.

Law and economics scholarship underwent significant development in the latter part of the 20th century.⁴ It was not until around 1960 that attempts were made to apply economic analysis systematically to specific areas of the law.⁵ Whereas ‘old law and economics’ was concerned primarily with competition law, this wave of ‘new law and economics’ sought to examine the efficiency of legal rules in a wide variety of legal fields including property, tort, crimes and contract. Further progress was made during the 1980s. This was characterised by a departure away from an abstract approach focusing solely on how the rational person should act. Social norms and behavioural considerations became more relevant. Law and economics scholars engaged in more rigorous empirical analysis. Efforts were made to test the validity and application of the rational actor model. This development has allowed law and economics scholarship to embrace a more sophisticated and realistic methodology.⁶ As a result it is possible to more precisely anticipate the effect of a legal rule. This is beneficial for society. McGuinness notes:

Too often legal policy makers (principally judges and legislatures) justify the rules that they adopt solely in terms of their underlying objective. The real value of a particular rule to society is not what the policy maker wished the rule to achieve, but rather what it actually achieves or what it can be expected to achieve, given our understanding of human affairs in general. The standard of measurement is one of legal consequence not intent. One hope which the economic analysis of law offers is the ability to measure more accurately the real world effect of legal rules.⁷

Law and economics study is perceived as immensely important within the United States.⁸ America is the leader in the application of law and economic analysis to the common law.

⁴ See generally Steven Burton and Eric Andersen, *Contractual Good Faith: Formation, Performance, Breach, Enforcement* (1995), at 414.

⁵ See generally Richard A Posner, *Economic Analysis of Law* (6th ed, 2003), at 24.

⁶ See Sir Ivor Richardson, ‘Law and Economics – and Why New Zealand Needs It’ (2002) 8 *New Zealand Business Law Quarterly* 151, at 154.

⁷ Kevin McGuinness, ‘Law and Economics – A Reply to Sir Anthony Mason CJ Aust’ (1994) 1 *Deakin Law Review* 117, at 119.

⁸ See Sir Ivor Richardson, above n 6, at 157.

Almost every major law school in the United States offers papers on the subject. Entire law reviews are devoted to the theory.⁹ Further, several highly regarded academics specialising in the field have gone on to take up judicial appointment on the United States Courts of Appeals.¹⁰

By comparison, economic analysis of the law has not received significant attention within academic institutions in New Zealand. However, the school of thought is not completely foreign. Some law and economics papers are offered in New Zealand universities and work in the field has been published by New Zealand academics.¹¹ Indeed, it is elementary that economic theory forms a central part of law making. Thus, economic implications of legal rules can be described as a fundamental common law value.¹² Economic considerations are invariably linked to legal fields such as trade practices law, company law, tax law, intellectual property law and contract law. The legislature has explicitly acknowledged the relevance of economic policy for some decades now.¹³ Judges and lawyers have begun to follow suit. Many judicial decisions can be shown to

⁹ Ibid.

¹⁰ Frank Easterbrook, Richard A Posner and Gaudo Calabresi.

¹¹ See Sir Ivor Richardson, above n 6, at 158-159. Papers in the subject are offered by the economics departments at the University of Auckland, Massey University, the University of Waikato, Victoria University and the University of Canterbury. However, the only undergraduate paper offered by a law school in New Zealand is that offered at Victoria University. See <http://www.leanz.org.nz/SITE_Default/SITE_Education/Education.asp>, at 20 December 2008. See also Jason Varuhas, 'The Economic Analysis of Law in New Zealand' (2005), at 10-11 <http://www.leanz.org.nz/SITE_Default/SITE_papers/x-files/14202.pdf>, at 20 December 2008. In addition, the Law and Economics Association of New Zealand was founded in 1994 with the objectives of: 'Communicating and disseminating information in New Zealand about law and economics literature and research, and promoting its application to legal and public policy issues in New Zealand and overseas; Enhancing understanding of law and economics in New Zealand amongst legal, economic and other relevant professions, including academia, the private sector and government and; Fostering teaching, research, publication and education about law and economics in New Zealand.': <http://www.leanz.org.nz/SITE_Default/SITE_about/what_is_LEANZ.asp>, at 20 December 2008.

¹² Ibid, at 154.

¹³ Ibid.

have an economic character, although not expressly recognising economic principles.¹⁴ Further, some New Zealand judgments have overtly discussed economic theory. For example, the concept of ‘efficient breach’ was one reason to preclude awards of exemplary damages in contract.¹⁵ Similarly, ‘opportunity cost’ is a relevant consideration in determining an appropriate rate of rent under a lease.¹⁶ Likewise, a shareholder acting ‘opportunistically’ in an attempt to receive more than the market value of his or her shares is likely to be denied a remedy under the Companies Act 1993.¹⁷ The concepts of ‘marginal cost’ and ‘transaction costs’ are also now occurring more frequently in judgments.¹⁸ Sir Ivor Richardson has recently endorsed the ongoing development of law and economics scholarship within New Zealand:

While economic analysis alone cannot dictate the results of judicial decisions, it has an important role to play in a very wide range of cases. I would hope that in the years to come we will see more use of rigorously argued and realistically grounded economic analysis – in the legislature, in and before the courts, and in the professional legal education arena – and also in the academic environment...¹⁹

The increasing importance and prevalence of law and economics analysis is undeniable. It follows that judges and the legislature should have regard to the dictates of economic principle when formulating and developing the law.

¹⁴ See Posner, above n 5, at 25.

¹⁵ *Paper Reclaim Ltd v Aotearoa International Ltd* [2006] 3 NZLR 188, at 221 per Chambers J. For further discussion of efficient breach see *Todd Petroleum Mining Company Ltd v Shell (Petroleum Mining) Company Ltd* (High Court, Wellington, CIV 2005-485-819, 19 June 2006, Wild J), at [118]; *Cooperative Insurance Society Ltd v Argyll Stores (Holdings) Ltd* [1996] Ch 269, at 304 per Millett LJ.

¹⁶ *General Distributors Ltd v Casata Ltd* [2004] 2 NZLR 824, at 842 per France J; [2005] 3 NZLR 156 (CA).

¹⁷ *Latimer Holdings Ltd v SEA Holdings NZ Ltd* [2005] 2 NZLR 328, at 336 per Hammond J.

¹⁸ Between 1982 and 2002, 44 judgments mentioned these economic principles. See Sir Ivor Richardson, above n 6, at 159.

¹⁹ *Ibid*, at 173.

5.2.2 Limitations of Law and Economics:

There are fundamental limitations to applying an economic analysis to formulate and assess legal principles. Despite an increasing recognition of irrational behaviour patterns, many economic principles proceed on the basis of the rational actor model. This assumes that individuals have a defined set of preferences and act in a manner that maximises the satisfaction of those preferences within a prescribed set of constraints. Individuals who adhere to such a pattern are presumed to be acting rationally. An individual will choose a course of action that maximises his or her utility. It has been argued that in some instances this model is too simplistic. Assumptions as to how a person will act do not always bear out in practice.²⁰

Nonetheless, law and economics academics have responded to this criticism. An economic model may contain assumptions or antecedent conditions that do not always hold in reality. However, the model may yield sufficiently accurate ‘results [] in the normal case, and tolerably reliable quantitative results’²¹ when gauged against the predictions of rival hypotheses. In other words, a model may still be satisfactorily precise despite the simplicity of the assumptions. After all, the focus is on the merits of the predictions rather than the merits of the assumptions.

Another criticism of law and economics is that wealth maximisation and other efficiency criteria cannot be the only goal of the law.²² This reality is generally conceded by law and economics scholars. Efficiency has limitations as an ethical criterion for societal decision making.²³ For example, the Kaldor-Hicks theory of efficiency whereby the result is economically desirable if the gain of one exceeds the loss of another is often criticised

²⁰ See generally Michael Trebilcock, ‘The Value and Limits of Law and Economics’ in Megan Richardson and Gillian Hadfield (eds), *The Second Wave of Law and Economics* (1999).

²¹ Richard A Posner, ‘Some Uses and Abuses of Economics in Law’ (1979) 46 *University of Chicago Law Review* 281, at 303.

²² See Sir Ivor Richardson, above n 6, at 171.

²³ See Posner, above n 5, at 12.

as repugnant to justice and social policy.²⁴ Accordingly, it is reasoned that economic efficiency is relevant but should not be the sole determinant when assessing the desirability of a legal rule.²⁵ Indeed, it is highly unlikely that every common law rule and judicial decision will produce an efficient outcome.²⁶ Notwithstanding, it is notable that legal outcomes regarded as efficient by economists and legal outcomes regarded as fair by lawyers may frequently coincide.

5.2.3 Economics and Good Faith:

Economic analysis is particularly important to the good faith debate despite the limitations identified above. Economics is highly relevant to contract law. Economics can be used to explain why individuals enter into contracts and how contract law can facilitate the operation of markets.²⁷ Thus, economics will assist in determining the function of contractual good faith and its appropriate limits.

The necessity to have regard to economics principles in the appraisal of a good faith doctrine is enhanced by the fact that a significant interest group is the commercial community. The manner in which contract law is framed may have a fundamental impact on commerce within New Zealand. This implies that efficiency and wealth maximisation are critical considerations in the development of contract law. In *Austotel Pty Ltd v Franklins Selfserve Pty Ltd* Kirby P recognised the importance of promoting efficiency in commercial dealings:

²⁴ However, Posner questions whether Kaldor-Hicks efficiency is so at variance with the legal system. *Ibid*, at 26.

²⁵ Although, it has been postulated that contracting parties will move towards rejecting inefficient but 'fair' terms and will frame their contract accordingly. See Alan Schwartz, 'Legal Contract Theories and Incomplete Contracts' in Lars Werin and Hans Wijkander (eds), *Contract Economics* (1992), at 78.

²⁶ Posner, above n 5, at 12.

²⁷ Anthony T Kronman and Richard A Posner, 'Introduction: Economic Theory and Contract Law' in Anthony T Kronman and Richard A Posner (eds), *The Economics of Contract Law* (1978), at 1.

[C]ourts should be careful to conserve relief so that they do not, in commercial matters, substitute lawyerly conscience for the hard-headed decisions of business people...The wellsprings of the conduct of commercial people are self-evidently important for the efficient operation of the economy. Their actions typically depend on self-interest and profit-making not conscience or fairness.²⁸

Arguably, contract regulation is more apt for economic analysis as compared to other areas of the law which may invoke stronger moral and social considerations which are not particularly amenable to economic theory. Thus, contractual good faith is a prime candidate for an application of economic principles. Law makers in New Zealand should have close regard to the policy recommendations of the law and economics movement when evaluating the good faith argument.²⁹

Contractual good faith has not received significant attention from law and economics scholars despite the importance of contract economics. Good faith tends to be recognised incidentally in economics literature. Thus, the good faith issue has not been significantly informed by economic theory.³⁰ Notably, there is no recognised literature emanating from New Zealand evaluating the economic efficiency of a doctrine of good faith. Most academic comment derives from the United States and Europe. This trend is inevitably a consequence of the greater popularity of law and economics scholarship on the Continent and in the United States. The fact that obligations of contractual good faith are explicitly imposed within those jurisdictions is also an explanatory factor.

²⁸ (1989) 16 NSWLR 582, at 585-586.

²⁹ For similar comments from an Australian commentator see Arlen Duke, 'A Universal Duty of Good Faith: An Economic Perspective' (2007) 33 *Monash University Law Review* 182, at 202. The importance of economics to legal analysis has been recognised by John Smillie who notes that 'voluntary exchange-bargains promote the collective welfare of society as a whole creating and sustaining markets which tend to allocate scarce resources to those who value them most highly and can use them most productively. So contracting is good for us all, and citizens must be encouraged to pursue their goals and realise their choices by negotiating exchanges of binding promises. This view of the purpose of the law of contract explains why the classical common law rules place such a high value on certainty and predictability.' John Smillie, 'Certainty and Civil Obligation' (2000) 9 *Otago Law Review* 633, at 639.

³⁰ *Ibid*, at 184.

Law and economics commentaries which are of relevance to the subject doctrine of good faith tend to be couched either in very general terms or, alternatively, in very specific terms. This is explained by the fact that very few articles focus explicitly on a doctrine of good faith. Some commentaries engage in a general analysis of how to efficiently frame contract law. Other dissertations analyse specific elements of contract law such as disclosure³¹, unconscionability³², mistake³³ and frustration.³⁴ Such particular doctrines are closely related to notions of good faith as was recognised in Chapter 4. An economic analysis of good faith can therefore be approached from a very general level in terms of assessing the efficiency implications of a general and universal doctrine. Conversely, the analysis may centre on specific applications of good faith. This chapter endeavours to provide an appraisal from both perspectives. The starting point is the general approach to good faith. This is reflected in the notion that good faith acts as a deterrent to opportunistic behaviour.

³¹ See for example Kimberly Krawiec and Kathryn Zeiler, 'Common-Law Disclosure Duties and the Sin of Omission: Testing the Meta-Theories' (2005) 91 *Virginia Law Review* 1795; Melvin Eisenberg, 'Disclosure in Contract Law' (2003) 91 *California Law Review* 1645. See below for a discussion of duties of disclosure.

³² See for example Russell Korobkin, 'Bounded Rationality, Standard Form Contracts, and Unconscionability' (2003) 70 *University of Chicago Law Review* 1203; Mark Klock, 'Unconscionability and Price Discrimination' (2001) 69 *Tennessee Law Review* 317; Megan Richardson, 'The Utilitarian-Economic Model of Contractual Obligation: Unconscionability at the Frontier' (1995) 20 *Melbourne University Law Review* 481; Richard A Posner, 'Contract Law in the Welfare State: A Defense of the Unconscionability Doctrine, Usury Laws, and Related Limitations on the Freedom of Contract' (1995) 24 *Journal of Legal Studies* 283.

³³ See for example Eric Rasmusen and Ian Ayres, 'Mutual and Unilateral Mistake in Contract Law' (1993) 22 *Journal of Legal Studies* 309; Janet K Smith and Richard Smith, 'Contract Law, Mutual Mistake, and Incentives to Produce and Disclose Information' (1990) 19 *Journal of Legal Studies* 467.

³⁴ See for example Andrew Kull, 'Mistake, Frustration and the Windfall Principle of Contract Remedies' (1991) 43 *Hastings Law Journal* 1; Alan O Sykes, 'The Doctrine of Commercial Impracticability in a Second-Best World' (1990) 19 *Journal of Legal Studies* 43; Michelle White, 'Contract Breach and Contract Discharge Due to Impossibility: A Unified Theory' (1988) 17 *Journal of Legal Studies* 353; Richard A Posner and Andrew Rosenfield, 'Impossibility and Related Doctrines in Contract Law: An Economic Analysis' (1977) 6 *Journal of Legal Studies* 83.

5.3 Deterring Opportunism – An Economic View of Good Faith:

From around the mid 1970s but predominantly during the 1980s, an economic approach to contract law was developed which focused on the need to deter opportunistic behaviour. This school of thought has subsequently been labeled as the ‘opportunism tradition.’³⁵ The following section explains the concept of opportunism and its relevance to a universal doctrine of good faith. Prior to defining opportunism, it is necessary to identify and explain two basic economic principles relating to contracts. The first is that contracts are incomplete. The second is that contracts involve sequential performance. Opportunistic conduct may arise as a result of these phenomena.

5.3.1 Contracts are Incomplete:

It is elementary that all contracts are ontologically incomplete. A contract will never provide for every possible contingency that may arise. Contracts may be incomplete for a variety of reasons.³⁶

Firstly, contractual incompleteness may arise simply because of the ambiguity or vagueness of the words used. This may be ascribed to the inherent fallibility and imperfection of language.³⁷

Secondly, the parties may have unintentionally failed to address a particular issue. This inadvertence could arise because the parties simply neglected to provide for the particular contingency. Alternatively, the contingency may have been entirely unforeseeable prior to entering into the contract.

³⁵ George M Cohen, ‘The Negligence-Opportunism Tradeoff in Contract Law’ (1992) 20 *Hofstra Law Review* 941, at 953.

³⁶ For a discussion of those reasons see generally Schwartz, above n 25, at 80.

³⁷ *River Wear Commissioners v Adamson* (1877) 2 App Cas 743, at 763 per Lord Blackburn.

Thirdly, a contract may be incomplete because the parties have specifically elected not to include a particular matter within their contract. This will generally result where parties make an economic decision not to include the contingency. A rational contracting party will not include a contingency where the cost of so doing exceeds the anticipated benefit of having the contingency within the contract. Indeed, it is in the interests of both parties to minimise the dead-weight losses involved in the formation of a more comprehensive agreement.³⁸ Naturally the benefit of including the contingency will be a function of the estimated probability of the contingency arising and the severity of the consequences of the contingency. Thus, contractual specification for improbable and insignificant contingencies is less likely than those that have a high probability of occurring and which have a material effect.

There are other rational explanations for incompleteness where the contingency is foreseen. For example, two parties may wish to conclude a bargain but cannot agree on some particular aspect which may be of less significance to the contractual exchange. Often the issue will be resolved by deliberately adopting language of equivocation so that the contract may be signed and its main objective achieved.³⁹ The parties elect to defer to the courts should the words have to be called into operation.

Further, a contingency may be foreseen but not addressed during negotiations for fear of putting the counterparty off the agreement. Negotiating agents operate under the same dilemma. A lawyer who “wakes these sleeping dogs” by insisting that they be resolved may cost his client the bargain.⁴⁰ Thus, it is evident that the rational actor model can explain why particular contractual contingencies may be foreseen but not contractually provided for, or clearly provided for.

³⁸ See Justice Edward Thomas, ‘Good Faith in Contract: A Non-Sceptical Commentary’ (2005) 11 *New Zealand Business Law Quarterly* 391, at 402. Dead-weight loss has been defined as ‘the reduction in total surplus that results from a market distortion.’: Joshua S Gans, Stephen P King and N Gregory Mankiw, *Principles of Microeconomics* (1999), at 481.

³⁹ *Klienwort Benson Ltd v Malaysia Mining Corporation Berhad* [1988] 1 WLR 799, at 806 per Hirst J quoting Staughton J.

⁴⁰ E Allan Farnsworth, ‘“Meaning” in the Law of Contract’ (1967) 76 *Yale Law Journal* 939, at 954.

A contract may also be incomplete as a result of information asymmetry. One party may possess information which if disclosed to the other would have resulted in a more complete or different agreement. Information may be asymmetric *ex-ante*, that is, before the agreement is reached, but becomes symmetric *ex-post*, that is, after the agreement is struck. This occurrence may often result in litigation based on misrepresentation or non-disclosure. The plaintiff claims that the bargain was tainted as a result of the inequality of correct information. Alternatively, information may remain asymmetric *ex-post* and even after the performance and termination or expiration of the contract.

Indeed, information asymmetry is central to the more modern school of thought that contracts can be endogenously incomplete.⁴¹ This reasoning departs from the traditional law and economics understanding that incompleteness is a consequence of high transactions costs. The theory of endogenous incompleteness recognises that transaction cost explanations account for less incompleteness than is observed.⁴² Even where transactions costs are zero, parties may not write complete contracts because they cannot observe relevant economic variables or cannot verify those variables to the courts, or because they prefer not to disclose relevant information about themselves.⁴³

Information asymmetry may lead to endogenous incompleteness where a market is characterised by heterogeneous participants.⁴⁴ For example, a warranty offered by the seller of a car could increase in price depending on the propensity of the driver to operate the car in a manner likely to wear it out. However, such warranties do not usually distinguish between types of drivers and are therefore incomplete. The market is

⁴¹ See Alan Schwartz, 'Incomplete Contracts' in Peter Newman (ed), *The New Palgrave Dictionary of Economics and the Law* (1998) vol 2, at 278; Robert Scott, 'A Theory of Self-Enforcing Indefinite Agreements' (2003) 103 *Columbia Law Review* 1641, at 1642.

⁴² *Ibid.*, at 282.

⁴³ *Ibid.* Thus a contract can be said to be incomplete 'if the parties would like to add contingent clauses, but are prevented from doing so by the fact that the state of nature cannot be verified...': Oliver Hart and John Moore, 'Foundations of Incomplete Contracts' (1999) 66 *Review of Economic Studies* 115, at 134.

⁴⁴ Schwartz, above n 25, at 81.

characterised by pooling equilibria. Screening between different types of driver is infeasible despite the fact that the distribution of types of driver may be known. Aggressive drivers have incentive to conceal their type. Accordingly, a universal warranty price will be set with reference to the distribution of types of driver. Careful drivers will pay too much for the warranty, subsidising the aggressive drivers who pay too little.

Contracting parties may also write a deliberately incomplete contract where self-enforcement is effective and more efficient than legal enforcement. Contracts are likely to be self-enforcing where the reputation of the contracting parties is important or repeated interaction between the parties is required.⁴⁵ In such cases, extra-legal factors will cause the parties to cooperatively renegotiate their agreement as contingencies arise.⁴⁶ The parties prefer to leave their contract incomplete to allow scope for adjustment.

For example, parties to an ongoing supply contract could fix the price and quantity without reference to changes in market price and demand. The agreement is

⁴⁵ Although it has been suggested that endogenous incompleteness is not limited to these types of contracts. Scott notes that ‘the domain of self-enforcing contracts extends to environments in which a reputation for trustworthiness and the discipline of ongoing relationships are relatively weak forces. Intentionally incomplete contracts of the sort routinely dismissed by the courts have a common feature: The agreements are in simple form, clear in commitment, and structured to create opportunities for parties to reciprocate in ways that expand the contractual surplus.’: Scott, above n 41, at 1692-1693. For a discussion of circumstances in which self-enforcement is likely to be effective see Benjamin Klein, ‘Why Hold-Ups Occur: The Self-Enforcing Range of Contractual Relationships’ (1996) 34 *Economic Inquiry* 444, at 449-450.

⁴⁶ See generally Robert Scott, ‘Conflict and Co-Operation in Long Term Contracts’ (1987) 75 *California Law Review* 2005, at 2047. It has been recognised that contracts which ‘last for a long time, such as a contract between a coal mine and a power plant built next to it, are often written in a way that explicitly contemplates renegotiations when economic conditions change. The contracts are *incomplete*...The way the terms shape the course of renegotiation rather than their suitability to the conditions in which the parties find themselves may be what matters most.’: Douglas G Baird, Robert H Gertner and Randal C Picker, *Game Theory and the Law* (1998), at 112.

‘obligationally’⁴⁷ and legally complete. It can be enforced by the courts. However, economists are likely to take a different view than lawyers. They would regard the contract as incomplete. It cannot adjust for future contingencies such as an escalating market price. In this instance the contracting parties might elect to contract using deliberately vague standards in order to facilitate subsequent adjustment. They may agree to negotiate the price in good faith rather than fixing the price.⁴⁸ The contracting parties prefer negotiation as the mechanism to achieve *ex-post* efficiency and they indicate this to the Court employing discretionary language like good faith.⁴⁹

It is therefore apparent that contractual incompleteness will arise for a number of reasons. Plainly, it would be impossible to write complete contracts. Critically, it would also be economically inefficient to attempt to do so. Despite the fact that contracts are incomplete, most can operate without the need for recourse to the courts. Issues of incompleteness may not ever arise during the life of an agreement. Even if a dispute occurs, extra-legal mechanisms may be sufficient to resolve the problem.

Nonetheless, within New Zealand legal measures have been put in place to deal with contractual incompleteness. Elaborate and comprehensive rules of construction have been developed. These are utilised to fill contractual gaps and elucidate the intention of

⁴⁷ Schwartz, above n 41, at 278.

⁴⁸ It has been suggested that ‘if initial drafting costs are high, the parties [] might draft a simple contract with vague standards, i.e., “soft” terms that invite subsequent adjustment to take account of new facts on the ground. Thus, for example, the parties might agree to adjust in good faith the price term in the contract if subsequent events imposed significant hardship on one party or the other. By agreeing to good faith adjustment, the parties seek to ensure that their contract is efficient *ex post* and that the resulting surplus is shared in some manner between both of them.’: Robert Scott, ‘The Law and Economics of Incomplete Contracts’ (2006) 2 *Annual Review of Law and Social Science* 279, at 292. For further discussion of the distinction between the use of rules and standards when drafting contractual terms see Robert Scott and George G Triantis, ‘Anticipating Litigation in Contract Design’ (2006) 115 *Yale Law Journal* 814.

⁴⁹ The Court may still have a role to play if the parties cannot successfully negotiate. Parties who express their contractual obligations in general terms ‘rely on a court to assign outcomes based on the evidence presented at trial. A vague term (such as an obligation to make a good faith effort to deliver goods on a certain date) gives the court much more discretion than a precise or specific term.’: *Ibid*, at 289.

contracting parties. Where an agreement appears to be incomplete, the courts will work with the document to find the solution in the interstices of the contract.⁵⁰ On occasions, the courts have supplemented contractual machinery to remedy contractual incompleteness and give effect to the bargain reached between the parties.⁵¹ The judiciary endeavours to facilitate a market exchange. Similarly, the courts will imply contractual terms in particular classes of contracts to prescribe the particular conduct required of parties. As was recognised in Chapter 3, obligations of good faith are implied into some contracts in order to address incompleteness.

All of these measures can be rationalised through economic terms. The courts will strive to give effect to an agreement provided contractual intention is established. Ordinarily the exchange will enhance welfare. Rules of construction can also reduce *ex-ante* transactions costs. The parties will not be required to incur the expense of stipulating certain matters in contracts. They can be content in the knowledge that the courts will read those matters into the contract as a matter of law and convention. Moreover, where a dispute as to contractual interpretation arises, well-defined rules of construction should assist the parties in resolving their difficulties without the need to resort to costly litigation. Therefore, *ex-post* transactions costs are desirably reduced. Consequently, the value of the contractual surplus is maximised.

5.3.2 Contractual Performance is Sequential:

Most contracts are not only incomplete but also require sequential performance. This gives rise to a risk which is often labeled as ‘transactional insecurity.’⁵² Where one contracting party is required to perform his or her side of the bargain first, there is an inherent risk that the other may default or threaten to default on his or her obligations. As

⁵⁰ See Gerard McMeel, *The Construction of Contracts* (2007), at 5.

⁵¹ *Money v Ven-Lu-Ree Ltd* [1989] 3 NZLR 129. See also John Burrows, Jeremy Finn and Stephen Todd, *Law of Contract in New Zealand* (3rd ed, 2007), at 87.

⁵² Anthony T Kronman, ‘Contract Law and the State of Nature’ (1985) 1 *Journal of Law, Economics and Organization* 5, at 6.

a result, the performing party may be denied the benefit of the bargain. A simple loan contract is a paradigm example of transactional insecurity. A lender who advances an unsecured principal sum incurs the risk that the borrower may default. The lender may not receive repayment of the principal amount or the agreed interest or either.

In respect of the loan scenario, the act of the lender advancing the principal sum to the borrower is a sunk investment. It is not possible for the lender to recover the advance unless the borrower has the money to perform his or her obligations. Not all contracts involving sequential performance will require a sunk or non-recoverable investment. The investment might be redeployed to an alternative use. For example, a vendor of real estate who commits to sell his or her property can resell to a third party should the purchaser default on his or her contractual obligations.

Notwithstanding, alternative investments may be limited and inferior.⁵³ Thus, a landlord who renovates premises for the specific purpose of accommodating the unique business activities of a tenant may be unable to find an alternative lessee should the existing tenant default. Additional investment may be required to reconvert the premises to render it more suitable for general use. In some instances, the transactions costs involved in redeployment of the investment may be so high as to be prohibitive.

Accordingly, once an investment is made in a contract involving sequential performance there is often a fundamental transformation from a competitive market *ex-ante* to an uncompetitive or bilateral monopoly *ex-post*.⁵⁴ This transformation creates incentive for a contracting party to take advantage of this monopoly. Exploitative behaviour becomes more profitable and more likely in instances of sunk or illiquid investments in contracts.⁵⁵

Contracting parties often recognise the risks posed by sequential performance and will take steps to protect themselves via their contractual terms. For example, a lender may

⁵³ See Cohen, above n 35, at 955.

⁵⁴ Ibid.

⁵⁵ Ibid.

take some security over the assets of the borrower in order to guard against default. This protection may decrease the cost of credit that may otherwise be paid by the borrower if security were unavailable. Similarly, payments under a construction contract may be made by way of instalment based on the progress of the builder. However, as is recognised below, contractual mechanisms may be costly and ineffective in some instances.

Having established that contracts are incomplete and involve sequential performance it is necessary to identify the meaning of opportunistic conduct and its relationship to good faith. It will be seen that incompleteness and sequential performance are catalysts for opportunism.

5.3.3 What is Opportunism?

Opportunism is now frequently mentioned in law and economics literature. Like good faith, it is difficult to find a universal definition for the concept.⁵⁶ Economists tend to agree more on examples of opportunistic behaviour than a general conceptualisation. Nonetheless, certain definitions have been advanced.

Some have suggested that opportunism is taking advantage of the vulnerability of another.⁵⁷ This explanation is of limited pragmatic utility. As was outlined above, contracting parties are vulnerable to exploitation because contractual performance is sequential. Similarly, contracting parties are susceptible due to contractual incompleteness. One party may take advantage of the other where the contract does not specify for a particular contingency. The proffered definition therefore focuses on the conditions under which opportunistic behavior is likely to occur. It fails to prescribe a threshold for what conduct will be considered opportunistic.⁵⁸ The other fundamental difficulty is that it remains unclear what ‘taking advantage’ actually means. Arguably it

⁵⁶ Ibid, at 954.

⁵⁷ See Posner, above n 5, at 17.

⁵⁸ Cohen, above n 35, at 954.

suggests blatant exploitative conduct.⁵⁹ Conceivably, opportunism can take on more subtle guises.

Opportunistic behaviour has also been characterised as the advancement of self-interest with guile.⁶⁰ Again this definition is impracticable. It imports a moralistic standard, which is inevitably subjective. It potentially requires a consideration of societal norms. Thus, the meaning of 'guile' is uncertain. The definition only serves to replace one ambiguous term with an equally vague synonym.

Perhaps a more meaningful and economic definition of opportunistic behaviour is conduct which seeks to redistribute contractual benefits that have already been allocated.⁶¹ The opportunist attempts a reallocation of an already apportioned contractual pie.⁶² Certainly this conceptualisation does not involve moralistic perspectives. The test is ostensibly objective. A party acts opportunistically in altering contractual performance to capture for himself or herself an advantage not assigned to him or her by the agreement where this is done at the expense of the contracting counterparty.⁶³ The definition focuses on *ex-post* outcomes. It applies to both contractual benefits and contractual costs. Accordingly, a party will act opportunistically when he or she seeks to recapture the opportunities forgone upon contracting. This includes circumstances where he or she refuses to pay the expected cost of performance.

⁵⁹ Ibid, at 956.

⁶⁰ See Oliver E Williamson, *The Economic Institutions of Capitalism: Firms, Markets, Relational Contracting* (1985), at 47.

⁶¹ See generally Steven Burton, 'Breach of Contract and the Common Law Duty to Perform in Good Faith' (1980) 94 *Harvard Law Review* 369, at 373; Timothy Muris, 'Opportunistic Behaviour and the Law of Contracts' (1981) 65 *Minnesota Law Review* 521.

⁶² Charles Goetz and Robert Scott, 'Principles of Relational Contracts' (1981) 6 *Virginia Law Review* 1089, at 1139.

⁶³ See Ejan Mackaay and Violette Leblanc, 'The Law and Economics of Good Faith in the Civil Law of Contract' (2003), at 10

<<https://papyrus.bib.umontreal.ca/jspui/bitstream/1866/125/1/Article%20papyrus.pdf>>, at 31 July 2008.

The definition has been subject to scrutiny. The idea of a forgone opportunity may only have meaning where the opportunity is known to the contracting party who gives it up by entering into the contract.⁶⁴ The notion of bounded rationality dictates that parties negotiating a contract will not know of all of the options and alternatives open to them. There are inherent limits on cognition and the availability of information. Thus, an opportunity or contingency may arise during the period of contractual performance that may not have been foreseen or foreseeable by one or all of the parties. In this instance it may be unclear which party is entitled to the contractual surplus, or which party should bear the loss, attributable to the unanticipated contingency.

For example, in *Mutual Life Insurance Co of New York v Tailored Woman Inc*⁶⁵ the defendant operated a retail clothing store in premises leased from the plaintiff. The rental payable was a proportion of the profits of the store. An opportunity subsequently arose whereby the defendant acquired an existing clothing business in the same building. The defendant also leased these premises from the plaintiff but under a flat rental. A consequence of the acquisition was that customers were diverted from the existing business of the defendant to the newly acquired business. This decreased the rental payable by the defendant. The plaintiff sued claiming it was entitled to additional rent calculated as a proportion of the profits attributable to the diverted business. The plaintiff alleged a breach of the covenant of good faith and fair dealing. The New York Court of Appeals recognised that the plaintiff ‘did not contemplate’ that the profits of the first business would be diminished.⁶⁶ Nonetheless, it was held that the lack of foresight would not create rights or obligations. The defendant had not breached the obligation of fair dealing.

⁶⁴ Sepe recognises the problem noting that to ‘be chosen or forgone [] an opportunity must first be known.’: Simone Sepe, ‘Good Faith and Contract Interpretation: A Law and Economics Perspective’ (2006), at 17 <www.cleis.unisi.it/site/files/042_Sepe.pdf>, at 29 February 2008.

⁶⁵ 309 NY 248 (NY, 1953). The case has been discussed by Burton and Andersen, above n 4, at 55-57.

⁶⁶ Ibid, at 253 per Desmond J.

It is questionable whether the forgone opportunity methodology would have been of any utility in resolving the case. It would be meaningless to inquire whether the defendant had forgone the right to divert customers away from the first business. Upon entering the original lease, neither of the parties had anticipated that this possibility could arise. It was not contemplated that a similar business would be operated by the defendant in the same building. Dubroff recognises the limitations of the forgone opportunity approach where the opportunity is not foreseen by the parties:

[W]hether forgone opportunities were recaptured can be determined only by interpreting the contract. The forgone opportunities assessment is no more or less than a conclusion that follows a judgment that the contract has been breached or has not been breached. It provides no assistance in determining whether the contract has been breached.⁶⁷

Thus, it is obviously extremely difficult to provide an exhaustive definition of opportunism despite its entrenched status in contract economics theory. Ultimately, three key factors are recognised as conditions for post-contractual opportunistic conduct.⁶⁸ Firstly, the opportunist act takes place *ex-post*. The concept does not relate to a pre-contractual monopoly. Secondly, the victim of the opportunistic conduct must place some value or reliance on the performance of the contract which the opportunist can appropriate or use to extract some other benefit. Finally, the victim must have omitted to plan for the opportunistic behaviour, either negligently or on the basis of bounded rationality. These criteria imply that a party may still behave opportunistically even if he or she complies with the explicit terms of the agreement. In this scenario the opportunist may be acting outside of the reasonable expectations of the parties or the victim's understanding of the contract.⁶⁹

⁶⁷ Harold Dubroff, 'The Implied Covenant of Good Faith in Contract Interpretation and Gap Filling: Reviving a Revered Relic' (2006) 80 *St John's Law Review* 559, at 607.

⁶⁸ See Muris, above n 61, at 523-524.

⁶⁹ Ibid, at 521.

Opportunistic behaviour may take a variety of forms. The notion of shirking is an example of opportunistic behaviour.⁷⁰ This occurs where a contracting party abstains from contribution but nonetheless shares in the spoils with the other contracting party or parties. Joint venture and partnership arrangements may be susceptible to shirking. For example, a partnership agreement may provide for an equal sharing of profits but not prescribe the input expected of each partner. A partner may contribute little leaving the other partners to assume the work not performed by the shirker. Nonetheless, the uncooperative partner is still entitled to an equal share in the surplus according to the agreement. Although the partner has not breached the contract he or she has certainly acted in contravention of the reasonable expectations of the parties. Arguably such behaviour breaches standards of good faith conduct.

The risk of opportunism through shirking may be deterred in some instances with non-legal mechanisms. In the case of the shirking partner, the risk of a bad reputation may be sufficient to prevent the opportunistic conduct.⁷¹ The partnership may be dissolved on the discovery of the misconduct of the shirking partner. He or she would be unlikely to find willing partners in the future should his or her reputation become public knowledge. Thus, the gains from short-term opportunism may not be worthwhile given the long-run effects. However, shirking becomes harder to detect and respond to where outputs involve a random component. For example, it may be difficult to measure the productivity of a sharefarmer under a sharemilking or sharecropping agreement where output is also subject to the vagaries of climate, disease and equipment breakdown. This phenomenon coupled with the fact that a sharefarmer cannot capture the full marginal

⁷⁰ See Mackaay and Leblanc, above n 63, at 10.

⁷¹ See generally Muris, above n 61, at 527. The need to maintain a good reputation extends past relational contracting. It has been recognised that even ‘in a community in which any particular pair of people meet rarely, it is still possible [] for an individual’s reputation in the group as a whole to serve as a bond for his good and honest behaviour towards each individual member.’: Paul R Milgrom, Douglass C North and Barry R Weingast, ‘The Role of Institutions in the Revival of Trade: The Law Merchant, Private Judges, and the Champagne Fairs’ in Daniel B Klein (ed), *Reputation: Studies in the Voluntary Elicitation of Good Conduct* (1997), at 243.

product of his or her output if required to share part of it with the landowner creates incentive to shirk.⁷²

Opportunism is also subsumed in moral hazard. A party protected from risk may behave in a more opportunistic manner than if he or she was fully exposed to the risk. For example, a party who enjoys the benefit of insurance coverage may behave less carefully than promised or may exaggerate a claim.⁷³ Such conduct, if unregulated and unpunished, will have the effect of redistributing wealth between contracting parties.

Opportunism also manifests itself in hold out behaviour. This arises where the consent or performance of one contracting party is required in order for the contract to proceed. Consent or performance may be withheld in anticipation of securing additional benefits. Opportunistic hold out behaviour will therefore result from the phenomenon of sequential performance. As was noted above, such conduct is more likely where the contract requires transaction-specific investments which cannot be fully salvaged outside of the agreement.⁷⁴

A clear example of the hold out problem can be seen in the case of *Atlas Express Ltd v Kafco (Importers and Distributors) Ltd*.⁷⁵ The plaintiff was a national road carrier. It entered into a contract to deliver cartons owned by the defendant, a small company which imported and distributed basketware. The defendant committed itself to using the services of the plaintiff. Soon after carriage began, the plaintiff sought to increase the minimum

⁷² For a comprehensive discussion of how to most efficiently structure arrangements analogous to sharecropping or sharemilking agreements under which one party owns the land and the other provides the labour see Yoram Barzel, *Economic Analysis of Property Rights* (2nd ed, 1997), at 33-54.

⁷³ See generally *Insurance Corporation of the Channel Islands Ltd v The Royal Hotel Ltd* [1998] Lloyd's Rep IR 151.

⁷⁴ See also G Richard Shell, 'Opportunism and Trust in the Negotiation of Commercial Contracts: Toward a New Cause of Action' (1991) 44 *Vanderbilt Law Review* 221, at 229; Benjamin Klein, Robert G Crawford and Armen A Alchian, 'Vertical Integration, Appropriable Rents, and the Competitive Contracting Process' (1978) 21 *Journal of Law and Economics* 297, at 228-229.

⁷⁵ [1989] 1 All ER 641.

amount payable by the defendant under the contract. The plaintiff knew that the defendant was heavily dependent on obtaining carriage to satisfy its contracts with retailers of the basketware. The plaintiff was also aware that the defendant would be unable to find an alternate carrier at short notice. Accordingly, the defendant succumbed to paying the additional amount. It was subsequently held that the defendant was not liable for the extra sum. Its consent has been obtained by economic duress. Clearly, the defendant had committed to the contract and the refusal by the plaintiff to carry out its contractual obligations was opportunistic behaviour arising from transactional insecurity. The conduct of the plaintiff was designed to extract more monies than the plaintiff was entitled to.

The likelihood of an opportunistic threat of non-performance is also strongly linked to the ability of the victim to recover his or her actual damages and litigation costs. It is conceivable that the defendant in *Atlas* may not have recovered the full extent of its loss had it elected to sue for breach rather than pay the additional amount. Its future loss of reputation with the retailers had it failed to supply them in a timely fashion may not have been recoverable as damages.⁷⁶ Further, the defendant would have been unlikely to recoup its full legal costs if it did issue proceedings in lieu of paying the additional amount.⁷⁷ These factors often contribute to the willingness of the victim to yield to the demands of the opportunist rather than resort to the courts.

However, in some instances contractual modification should be encouraged and cannot properly be classified as bad faith opportunistic conduct exploiting sequential performance. A change in circumstances may well mean that one contracting party will suffer a loss if the contract is performed. That party may rationally elect to breach rather than perform. The amount payable to settle the breach may be less than the losses incurred on performance. In such a situation contractual modification is to be encouraged. A reallocation of the anticipated entitlement under the original contract by way of a

⁷⁶ As to remoteness of damage see Burrows, Finn and Todd, above n 51, at 687-710.

⁷⁷ Within New Zealand, indemnity costs are rarely awarded in High Court litigation. The criteria within r48(C)(4) High Court Rules must be satisfied.

contractual variation could render the modified contract *ex-post* efficient provided there is a surplus available for renegotiation. Parties could not commit to efficient performance if modifications of this nature were not permitted. The *ex-ante* value of contracting could be greatly reduced.⁷⁸ The risks associated with committing to a contract would be significantly increased.

An example of efficient modification can be seen in the case of *Goebel v Linn*.⁷⁹ The plaintiff had promised to supply the defendant brewer with all of the ice the defendant may require. The price was fixed in the contract. A few months later it became apparent that the plaintiff would not be able to supply at the stipulated price. The ice ‘crop’ produced by the plaintiff had failed (presumably due to warm weather). The plaintiff was facing ruin. In consequence, it demanded a higher price from its customers, including the defendant. The defendant paid the additional amount. Its entire stock would have been spoiled if it was not supplied with ice for a period of more than two days. The Supreme Court of Michigan upheld the variation and found that there was no duress. It was determined that unexpected and extraordinary circumstances had arisen which rendered the contract worthless and justified the modification.⁸⁰

⁷⁸ See generally Jason Scott Johnston, ‘Default Rules/Mandatory Principles: A Game Theoretic Analysis of Good Faith and the Contract Modification Problem’ (1993) 3 *Southern California Interdisciplinary Law Journal* 335, at 341.

⁷⁹ 47 Mich 489 (Mich, 1882).

⁸⁰ Ibid, at 493 per Cooley J. Occasionally an unforeseen *ex-post* contingency which raises performance costs may result in a claim under s 3(1) of the Frustrated Contracts Act 1944 that the contract has become impossible of performance or otherwise frustrated. Section 3 makes two significant changes to the common law. Firstly, it permits money prepaid to be recovered even if there is no total failure of consideration at the date of frustration. Secondly, it allows a party to a frustrated contract to claim compensation for steps taken towards performance which confer a benefit on the contracting counterparty. Ultimately however, unanticipated increases in performance costs will not lead to a finding of frustration unless it can be shown that there is ‘such a change in the significance of the obligation that the thing undertaken would, if performed, be a different thing from that contracted for.’: *Davis Contractors Ltd v Fareham UDC* [1956] 2 All ER 145, at 160 per Lord Radcliffe. The courts will not generally grant relief where performance has simply become more expensive or onerous. See J Arthur McInnis, ‘Frustration and Force Majeure in Building Contracts’ in Ewan McKendrick (ed), *Force Majeure and Frustration of Contract* (2nd ed, 1995),

The efficacy of the variation in *Williams v Roffey Bros & Nicholls (Contractors) Ltd*⁸¹ is less certain. The defendant was a builder and had agreed to refurbish 27 flats. It subcontracted carpentry work to the plaintiff. The plaintiff commenced work but it soon became apparent that he was in financial difficulty. This was apparently due to the fact that the contract price was too low. It was thought that the plaintiff would have breached the contract if additional payment was not made. The defendant therefore agreed to pay an additional sum. The plaintiff thereafter continued further work for a period of approximately two months on the faith of the promise. During that time the plaintiff substantially completed eight of the 27 flats. This was despite the fact that the defendant only made one payment of £1,500 during the period. This was a relatively small payment as compared to the original contract amount of £20,000 and the additional £10,300 which the defendant had promised to pay. Thus, it was questionable whether the plaintiff was in dire need of additional payment in order to perform the contract. Nonetheless, the primary legal issue facing the English Court of Appeal was whether there was consideration for the promise made by the defendant. It was held that the modification was contractually enforceable. The defendant had received a benefit which amounted to good consideration. In particular, the defendant avoided breaching the head contract including incurring a penalty for delay. It also avoided the expense and trouble of finding alternative carpenters. Glidewell LJ expressed the legal position as follows:

(i) if A has entered into a contract with B to do work for, or to supply goods or services to, B in return for payment by B and (ii) at some stage before A has completely performed his obligations under the contract B has reason to doubt whether A will, or will be able to, complete his side of the bargain and (iii) B thereupon promises A an additional payment in return for A's promise to perform

at 205-206. For case examples in which a contracting party was deemed to have assumed the cost risks of unforeseen contingencies such that claims of frustration failed see *Tsakiroglou & Co Ltd v Noblee and Thorl GmbH* [1961] 2 All ER 179; *Palmco Shipping Co v Continental Ore Corp* [1970] 2 Lloyd's Rep 21; *Wilkins & Davies Construction Ltd v Geraldine Borough* [1958] NZLR 985. It has been observed that a duty to re-negotiate in good faith may be a logical alternative to the doctrine of frustration in such cases. See generally Burrows, Finn and Todd, above n 51, at 664-665.

⁸¹ [1990] 1 All ER 512.

his contractual obligations on time and (iv) as a result of giving his promise B obtains in practice a benefit, or obviates a disbenefit, and (v) B's promise is not given as a result of economic duress or fraud on the part of A, then (vi) the benefit to B is capable of being consideration for B's promise, so that the promise will be legally binding.⁸²

The principle enunciated by Glidewell LJ has received judicial support in New Zealand.⁸³ Indeed, in *Antons Trawling Co Ltd v Smith* the Court of Appeal appeared to suggest that consideration may not always be necessary in respect of a contractual variation:

The importance of consideration is as a valuable signal that the parties intend to be bound by their agreement, rather than an end in itself. Where the parties who have already made such intention clear by entering legal relations have acted upon an agreement to a variation, in the absence of policy reasons to the contrary they should be bound by their agreement.⁸⁴

The law and economics approach to contract variation is concerned less with the requirement for consideration and more on the reasons for the modification. In the opportunistic *Atlas* case, no circumstances arose which increased the cost of performance which could justify a price increase. Conversely, in *Goebel* the cost of performance did rise rendering the modification *ex-post* efficient. However, the willingness of the courts to uphold some contractual modifications creates a negative economic incentive. A contracting party may seek to induce the other to agree to a modification under a false threat of non-performance. The threat amounts to an extortionate bluff.⁸⁵ Such behaviour

⁸² Ibid, at 521-522.

⁸³ See *Attorney-General for England and Wales v R* [2002] 2 NZLR 91, at 109 per Tipping J; *Machirus Properties Ltd v Power Sport World (1987) Ltd* (1999) 4 NZ ConvC 193,066.

⁸⁴ [2003] 2 NZLR 23, at 45-46 per Baragwanath J. See also Karen Scott, 'From Sailors to Fisherman: Contractual Variation and the Abolition of the Pre-Existing Duty Rule in New Zealand' (2005) 11 *Canterbury Law Review* 201; Brian Coote, 'Consideration and Variations: A Different Solution' (2004) 120 *Law Quarterly Review* 19; Duncan Webb, 'Consideration and Variation' [2003] *New Zealand Law Journal* 54.

⁸⁵ See Johnston, above n 78, at 341. Conceivably the legitimacy of the threat might be determined by the *bona fides* of the person making the threat such that good faith is a relevant consideration. See generally *CTN Cash and Carry Ltd v Gallagher Ltd* [1994] 4 All ER 714, at 719 per Sir Donald Nicholls VC; *Huyton*

is opportunistic and is designed to achieve a windfall under asymmetric information conditions. The facts of *Williams* might fall within this category. There was no evidence to suggest that the cost of performance to the plaintiff had increased. Further, he could apparently continue to carry out work without substantial payment. Thus, it is suggested that the courts must examine the evidence to determine whether the ‘modification was prompted by a change in circumstances that made performance of the original contract unprofitable for the party requesting the modification.’⁸⁶ This inquiry should assist in assessing whether the party seeking the variation is acting in good faith. Whilst this may be the most desirable approach to enforcement, it may not be infallible. In particular, information relating to changed circumstances and the cost of performance may not be verifiable to a court.⁸⁷

SA v Peter Cremer GmbH & Co [1999] 1 Lloyd’s Rep 620. See also Nelson Enonchong, *Duress, Undue Influence and Unconscionable Dealing* (2006), at 18-20.

⁸⁶ Ibid, at 339-340. The facts of *Williams* also raise questions as to whether the plaintiff genuinely miscalculated the cost of the project from the outset and whether the defendant therefore acted opportunistically in accepting a low contract price. In these circumstances the plaintiff may have been able to seek relief for a unilateral mistake if he could establish that the defendant knew of the mistake *ex-ante* and failed to inform the plaintiff of the mistake. Indeed, the defendant’s surveyor deposed (at 524) that the defendant knew that the contract price was too low. The evidence is however somewhat equivocal as to whether this information was known to the defendant *ex-ante*. For relief on account of unilateral mistake in England see *Raffles v Wichelhaus* (1864) 2 H & C 906; *Scriven Bros & Co v Hindley & Co* [1913] 3 KB 564; *Hartog v Colin & Shields* [1939] 3 All ER 566. See also Edwin Peel, *The Law of Contract* (12th ed, 2007), at 332-349. Notably however, in *March Construction Ltd v Christchurch City Council* (1995) 5 NZBLC 103,878 it was held that the Council was under no obligation to point out an error in the calculations of a tenderer which resulted in an abnormally low tender price. There was no relief available under the Contractual Mistakes Act 1977 because it was contractually agreed that the tenderer would be responsible for any mistakes. However, in the absence of such contractual agreement, the Contractual Mistakes Act 1977 may respond to opportunistic attempts by an invitor to knowingly take advantage of a miscalculation made by a tenderer.

⁸⁷ Thus, permitting contractual modification may be inefficient in some cases. It has been argued that immutable contracts (contracts which cannot be varied) are desirable where it is difficult for a contracting counterparty or a court to observe ‘a trading partner’s true costs of completing performance.’: Kevin E Davis, ‘The Demand for Immutable Contracts: Another Look at the Law and Economics of Contract Modifications’ (2006) 81 *New York University Law Review* 487, at 497. It may be efficient to prevent

Permitting contractual modification also gives rise to the risk of opportunism in the form of lowballing. Such bad faith behaviour is likely to occur in the context of tendering for construction contracts.⁸⁸ An opportunistic tenderer may submit a deliberately low bid anticipating that the contract price can be renegotiated during the currency of the agreement when it would be costly for the invitor to replace the successful tenderer. Such a strategy may be optimal for a construction business and particularly one facing insolvency. Construction companies can be readily incorporated and dissolved, work can be subcontracted and the principals are generally insulated from personal liability. The potential payoff from lowballing may therefore exceed the potential losses. Indeed, in *Pratt Contractors Ltd v Transit New Zealand* Lord Hoffmann acknowledged suggestions of such behaviour on the part of the plaintiff whose bid, of the eight conforming tenders, was the lowest by nearly \$1,000,000:

Pratt's reputation in the New Zealand road-building industry (in which there are relatively few players) was not uncontroversial. It was thought by some to practise lowballing, that is to say, tendering a low price to obtain the contract in the expectation of being able to make a profit by aggressive claims for additional payments.⁸⁹

It was recognised in Chapter 2 that a public tendering process like that in *Pratt* gives rise to a preliminary contract under which the invitor is obliged to treat the tenderers equally and in good faith. In addition, the public body in *Pratt* was under a statutory duty to employ competitive pricing procedures.⁹⁰ A public agency faces the difficult task of attempting to discharge these duties when confronted with a lowball tender. Although the

modifications in contracts involving sophisticated parties. Knowledge of the ability to vary a contract may lead contracting parties to act in a manner which reduces the potential aggregate surplus. This phenomenon is likely to be seen in owner-worker relationships where the remuneration of the worker is tied to the profits of the owner. See generally Christine Jolls, 'Contracts as Bilateral Commitments: A New Perspective on Contract Modification' (1997) 26 *Journal of Legal Studies* 203.

⁸⁸ See generally Aleix Calveras, Juan-Jose Ganuza and Esther Hauk, 'Wild Bids. Gambling for Resurrection in Procurement Contracts' (2004) 26 *Journal of Regulatory Economics* 41.

⁸⁹ [2005] 2 NZLR 433, at 438 per Lord Hoffmann.

⁹⁰ *Ibid*, at 439.

tender may be the most competitively priced, it may turn out to cost the public body more in the long-run as a result of the necessity to make additional payments at a later date.

Opportunistic lowballing may be controlled by an extra-legal mechanism in the form of a surety bond. This requires a third party to guarantee that the successful tenderer will perform the contract. In the case of a default both the tenderer and the surety are liable. Often the surety will have to satisfy the invitor that it has sufficient assets to back the bond issued. Such a mechanism has been employed in the context of public tendering within New Zealand. Indeed, in *Pratt* the nominated surety of the successful tenderer was required to execute an appropriate bond.⁹¹ Notwithstanding, the fact that a surety bond was required did not appear to allay the concerns of the defendant that the plaintiff had ‘underestimated the project and would recover the costs through “claimsmanship.”’⁹²

Not all contractual breaches and defaults will amount to opportunism in the sense of a redistribution of wealth amongst the contracting parties. An efficient breach will not amount to opportunism. Conduct will not be opportunistic where a breaching party pays full compensation to the victim in the sum of the contractual surplus the victim expected and the breaching party puts his or her remaining contractual resources to a more wealth generating use. The result is Pareto superior than if the contract had been performed. No party is worse off and at least one party is better off. Additionally, a contract may be breached due to circumstances outside of the control of the parties. In this instance both parties may be worse off. There is no opportunism because there is no transfer of wealth.

Having identified the characteristics of opportunistic conduct and some paradigm examples, it is necessary to consider the economic implications of opportunistic conduct.

⁹¹ Ibid, at 440. Recent studies have indicated that the optimal surety bond should be ‘increasing in the number of potential contractors, the support of the underlying uncertainty of the project, the bankruptcy costs; and decreasing in the level of solvency of the industry and the riskless interest rate.’: Calveras, Ganuza and Hauk, above n 88, at 62.

⁹² [2002] 2 NZLR 313, at 321 per McGrath J.

It is universally accepted by contract economists that opportunistic behavior should be deterred. It has been argued that this is an essential function of contract law.⁹³

5.3.4 Why Should Opportunism be Discouraged?

The law should not countenance opportunistic behaviour designed to deprive one contracting party of his or her expected economic surplus. Opportunistic behaviour is not inefficient per se. It merely occasions a redistribution of wealth. It is the consequences of opportunistic behaviour with which lawyers and economists should be concerned. A rational actor who fears that his or her contractual profits will be expropriated may not enter into a contract. Thus, a failure by the law to redress opportunistic behaviour may prevent an otherwise efficient and wealth maximising exchange.

Additionally, contracting parties wary of opportunistic behaviour incur greater transactions costs. Negotiating parties will inevitably write longer and more complex contracts in an attempt to deter or preclude opportunism. More resources may also be expended to assess the background of a contracting counterparty in order to determine his or her propensity for opportunistic conduct. Other costly protective measures may include insistence on preliminary agreements, a requirement for simultaneous performance and a demand for the payment of a deposit.⁹⁴

Unnecessary transactions costs are undesirable. The resources expended do not produce a good or service which is mutually valued by the contracting parties. The net gains from contracting are not maximised. It is therefore clear that an efficient system of contract law should discourage opportunistic behaviour in order to minimise transaction costs.

⁹³ See Posner, above n 5, at 26.

⁹⁴ See Shell, above n 74, at 226.

5.3.5 Preventing Opportunism with a Good Faith Doctrine:

It is often contended that the prevention and punishment of opportunistic behaviour can be achieved through a good faith doctrine. Consequently, opportunistic conduct has been characterised as a breach of good faith.⁹⁵ Good faith is the exact opposite of opportunism.⁹⁶

A common economic argument in favour of a contractual doctrine of good faith is that it would address opportunistic conduct and protect the entitlements of contracting parties whilst minimising transactions costs. Contracting parties could rely on good faith in lieu of contractually specifying for every conceivable opportunistic act.⁹⁷ The argument was judicially advanced in the United States by Judge Posner in *Market Street Associates Ltd Partnership v Frey*:

The concept of the duty of good faith like the concept of fiduciary duty is a stab at approximating the terms the parties would have negotiated had they foreseen the circumstances that have given rise to their dispute. The parties want to minimize the costs of performance. To the extent that a doctrine of good faith designed to do this by reducing defensive expenditures is a reasonable measure to this end, interpolating it into the contract advances the parties' joint goal...The office of the doctrine of good faith is to forbid the kinds of opportunistic behavior that a mutually dependent, cooperative relationship might enable in the absence of [such a] rule...⁹⁸

The primary argument for good faith is therefore directly related to contractual incompleteness. Indeed, there would be no requirement for contractual good faith if contracting parties were able to foresee all present and future contingencies and negotiate appropriate contractual provisions at no cost.⁹⁹ Instead, it is anticipated that good faith

⁹⁵ See Burton, above n 61, at 373; Goetz and Scott, above n 62, at 1139.

⁹⁶ Mackaay and Leblanc, above n 63, at 26.

⁹⁷ See generally Daniel Fischel, 'The Economics of Lender Liability' (1989) 99 *Yale Law Journal* 131, at 141; Thomas, above n 38, at 402.

⁹⁸ 941 F2d 588, at 596 (1991, US App).

⁹⁹ See Sepe, above n 64, at 24.

might remedy incompleteness. The doctrine would mimic the perfect market by incorporating into the contract those rights and obligations that the parties would have imposed *ex-ante* had the parties enjoyed complete knowledge and no transactions costs.¹⁰⁰ Ultimately, good faith is perceived as a solution or partial solution to the trade-off between transactions costs and opportunism arising from, *inter alia*, incompleteness.

5.3.6 Opportunism, Good Faith and Behavioural Economics:

Behavioural economics theories and studies should be taken into account when determining whether good faith is an appropriate regulator of opportunistic conduct. Behavioural economics facilitates a better understanding of economic decisions. This implies that the effect of a good faith doctrine should not be judged solely by responses predicted by the rational economic actor model unless it can be demonstrated that economic agents will respond to good faith in a rational way. Cognisance must be taken of actual human responses to the law.¹⁰¹ Contract economists should be concerned with real responses to a good faith doctrine rather than desired responses.

The courts should seek to achieve a system of contract law which maximises incentive to behave cooperatively and minimises incentive to act opportunistically.¹⁰² It is elementary that cooperative behaviour is to be endorsed. Cooperation results in efficiency

¹⁰⁰ *Market St Associates Ltd Partnership v Frey*, 941 F2d 588, at 596 per Judge Posner (1991, US App).

¹⁰¹ See generally Christine Jolls, Cass Sunstein and Richard Thaler, 'A Behavioural Approach to Law and Economics' (1998) 50 *Stanford Law Review* 1471, at 1476.

¹⁰² It has been recognised that the 'more that contract doctrine provides a security against the risks of opportunism and exploitation to which co-operative dealing exposes a contractor, the more willing (other things being equal) contractors will be to deal in a way that optimises their interests (even though they are thereby exposed to risk). Thus, as good faith finds a place in the law, and as the contractual environment becomes more congenial to trust and risk-taking, it is possible that these reciprocal influences will work together to promote ever more co-operative thinking in both legal doctrine and contracting practice.': Roger Brownsword, 'Positive, Negative, Neutral: the Reception of Good Faith in English Contract Law' in Roger Brownsword, Norma Hird and Geraint Howells (eds), *Good Faith in Contract* (1999), at 32.

improvements through comparative advantage which could not be achieved by economic actors operating individually.

Traditional law and economics analysis generally assumes that individuals are self-interested. However, recent behavioural studies have found that some individuals are also motivated by the desire to act in a reciprocally fair manner.¹⁰³ Such behaviour is distinct from cooperative behaviour. Both self-interested individuals and those who act with reciprocity may act cooperatively. Self-interested parties may act in a cooperative manner if they believe that they will receive a benefit for so doing. However, reciprocally fair individuals are prepared to cooperate and incur costs to reward certain actions and punish other actions even if they do not expect to recoup this cost in the future.¹⁰⁴

Accordingly, individuals exhibit heterogeneous preferences. Empirical studies have sought to test what legal rules are likely to ‘crowd in’ or ‘crowd out’ reciprocal and opportunistic behaviour. Bohnet, Frey and Huck have demonstrated that reciprocal behaviour is crowded in under a contractual enforcement regime where legal interference is minimal (“Low Enforcement”).¹⁰⁵ This preference for reciprocity is positively

¹⁰³ A common experiment is an ultimatum game whereby participants assume the role of a proposer or a responder. The proposer is given a fixed sum of money and is asked to offer part of that sum to the responder. If the responder accepts he or she receives the amount offered. The proposer receives the balance. If the parties were purely motivated by self-interest then the responder would rationally accept any amount above zero. The proposer should recognise this to be the case and offer a low amount. Nonetheless, most studies reveal that the proposer offers between 40 and 50 per cent. There are almost no offers below 20 per cent or above 50 per cent. See Ernst Fehr and Klaus M Schmidt, ‘A Theory of Fairness, Competition and Cooperation’ (1999) 114 *Quarterly Journal of Economics* 817, at 826.

¹⁰⁴ See Duke, above n 29, at 187. Reciprocal behaviour is generally thought to have a positive effect in the sense that reciprocity ‘may cause an increase in the set of enforceable contracts and may thus allow the achievement of nonnegligible efficiency gains.’: Ernst Fehr, Simon Gächter and Georg Kirchsteiger, ‘Reciprocity as a Contract Enforcement Device: Experimental Evidence’ (1997) 65 *Econometrica* 833.

¹⁰⁵ See Iris Bohnet, Bruno S Frey and Steffen Huck, ‘More Order with Less Law: On Contract Enforcement, Trust and Crowding’ (1995) 95 *American Political Science Review* 131, at 132. The authors modeled an evolutionary game in which two contracting parties had the ability to produce a contractual surplus. Player One was required to decide whether to enter into a contract with Player Two but was

correlated to the time the group plays under the Low Enforcement regime. Those entering into contracts will be extremely cautious about the people with whom they deal. They will endeavour to select a non-opportunistic counterparty to ensure that expropriation of contractual benefits is unlikely to occur. This selection process may involve a detailed screening procedure to enhance the prospect of dealing with a non-exploitative and fair individual.

Conversely, reciprocity is crowded out and self-interested norms prevail under a contract law system which imposes some restrictions on freedom of contract ("Medium Enforcement").¹⁰⁶ Contracting is more attractive under Medium Enforcement than under Low Enforcement because the expected pay-off is theoretically higher. However, interpersonal trust is replaced with institutional trust in contract laws.¹⁰⁷ A decision whether to act opportunistically is dominated by the probability of the courts sanctioning the opportunistic conduct. There is less motivation to act in a reciprocal manner. Thus, the likelihood of external legal intervention is the prevailing determinant of contractual behaviour rather than intrinsic considerations. Ultimately, this produces a psychological effect which leads to the crowding out of cooperative behaviour and the crowding in of opportunistic dealing.¹⁰⁸

Alternatively, opportunistic behaviour is liable to be discouraged under a contract law state which significantly regulates contractual dealings ("High Enforcement"). The likelihood of an opportunistic actor being punished raises the opportunity cost of breach to such an extent that performance is encouraged.¹⁰⁹ Cooperation is achieved through an external mechanism irrespective of the preference of individuals for reciprocally fair

unaware whether Player Two would perform. 154 subjects participated. The game was repeated several times with varying payoff probabilities designed to reflect different contract law conditions, namely low, medium, or high enforcement regimes.

¹⁰⁶ Ibid.

¹⁰⁷ Duke, above n 29, at 190.

¹⁰⁸ See generally Bruno S Frey and Reto Jegen, 'Motivation Crowding Theory' (2001) 15 *Journal of Economic Surveys* 589.

¹⁰⁹ Duke, above n 29, at 190.

behaviour.¹¹⁰ Stringent legal accountability reduces the risk of entering into a contractual transaction. This facilitates an atmosphere of confidence conducive to exchange.¹¹¹

The experimental study of Bohnet, Frey and Huck therefore suggests that the Low Enforcement or High Enforcement regimes should be preferred over Medium Enforcement to ensure that reciprocal and cooperative behaviour is promoted over opportunistic dealing. Transactions costs may dictate whether Low Enforcement or High Enforcement is to be preferred. Conceivably a Low Enforcement system could produce high transactions costs. Contracting parties may have to expend considerable resources to determine the *bona fides* of their contracting counterparties *ex-ante*. Also, the findings of Bohnet, Frey and Huck indicate that the incidence of contracting will be lower. Opportunistic actors may not be able to be readily identified and the requirement for screening may decrease the number of contracts entered into. Moreover, contracts concluded under a Low Enforcement regime would have to contain self-enforcing mechanisms. The costs associated with mistrust may therefore render contracting difficult and inefficient.¹¹² Thus, one commentator has concluded that the notion of a Low Enforcement self-policing contract regime can be rejected as unrealistic and a High Enforcement regime is to be preferred.¹¹³ However, the likely transactions costs associated with a High Enforcement regime cannot be ignored. In particular, imposing stringent duties such as an obligation of good faith may compromise the predictability of contract law and may lead to higher litigation costs.¹¹⁴

Nonetheless, Duke has contended that a doctrine of good faith is an appropriate means by which a High Enforcement system can be implemented:

¹¹⁰ Bohnet, Frey and Huck, above n 105, at 132.

¹¹¹ Shell, above n 74, at 223.

¹¹² Paul J Powers, 'Defining the Undefinable: Good Faith and the United Nations Convention on the Contracts for the International Sale of Goods' (1999) 18 *Journal of Law and Commerce* 333, at 351.

¹¹³ Duke, above n 29, at 196.

¹¹⁴ *Ibid*, at 199.

Imposing an obligation to act in good faith is [] an effective way to ensure courts provide a performance-inducing high enforcement environment. Absent the implication of obligations of good faith, there is a chance that parties' reasonable expectations about how the other party will perform the contract will be disappointed if contractual parties are permitted to escape honouring their contractual obligations by resorting to the black letter of their agreements. As contracts are inevitably incomplete and static in nature, contractual doctrines that give unqualified effect to the express terms of the agreement will generate a medium enforcement regime.¹¹⁵

Duke therefore appears to suggest that a regime of contract law without a general obligation of good faith is likely to produce an inefficient Medium Enforcement scenario. However, it is debatable whether this is the case in New Zealand. As was demonstrated in Chapter 4, the outcomes produced under the prevailing contract law within New Zealand might not be significantly dissimilar to those outcomes which may result from a doctrine of good faith. Thus, it is not clear that an introduction of good faith would represent a move to a different category of enforcement regime than that currently applying in New Zealand. Nonetheless, it is clear that behavioural economic theories are a highly relevant determinant of the desirability of a good faith doctrine. Conceivably, such a legal obligation could serve as a motivator for cooperative contractual behaviour within New Zealand.

5.3.7 Précis:

The foregoing analysis has identified that arguments for the introduction of a universal doctrine of good faith are related to the need to deter opportunism and minimise transactions costs. The phenomena of incomplete contracts and sequential performance are the primary catalysts for opportunistic conduct. The importance of behavioural economics to the good faith debate has also been emphasised. It is necessary to achieve accurate predictions of anticipated responses to a good faith doctrine. Empirical research suggests that a good faith doctrine might promote reciprocal and cooperative behaviour thereby discouraging opportunistic conduct. The next section of this chapter endeavours to bring a number of these concepts together in a transactions cost model.

¹¹⁵ Ibid, at 197.

5.4 Transactions Cost Analysis of Good Faith:

As a matter of general principle, the most cost-effective solution should be selected when choosing between different legal rules.¹¹⁶ Thus, a good faith doctrine should reduce the transactions costs currently incurred by contracting parties in New Zealand if it is to be supported. In order to determine whether this is the case, the transactions costs under a regime without good faith and a regime with good faith must be determined and then compared. It was identified in Chapter 3 that the application of a good faith doctrine would be uncertain within New Zealand. This is an essential factor which must be included in any transactions cost analysis of a universal doctrine of good faith. The logical starting point is the predicted transactions costs under the current state of contract law within New Zealand.

5.4.1 Transactions Costs Without Good Faith:

Let the total transactions costs incurred by contracting parties in respect of a particular contract be C .¹¹⁷ These total costs are made up of total specification costs, S , and the total costs arising from the incompleteness of the contract, I .

S comprises various expenses such as the cost of drafting the contract and the time taken to do so. It also includes the cost of discovering contingencies which can be addressed within the contract. Some of these costs are variable and some are fixed. For example, there may be a one-off fee to engage a lawyer to draw up a simple contract. This represents a fixed cost. However, the fee charged by the lawyer is likely to increase as the number of contingencies provided for in the contract increases. His or her time becomes more consumed with drafting the contract. This element is a variable cost. S is therefore a function of n , being the number of contingencies specified in the contract. It is evident that S is increasing in n due to the presence of variable costs. It might be assumed that S will increase at a decreasing rate for low levels of n . Economies of scale are realised

¹¹⁶ Fabre-Magnan, above n 1, at 107.

¹¹⁷ The following model closely follows that formulated by Sepe, above n 64.

as variable costs are spread over fixed costs. However, S may increase at an increasing rate for high levels of n . This reflects the fact that some contingencies may be highly costly to identify and accommodate in a contract. Contingencies which require complex contractual specification produce higher variable costs at the margin. Additionally, marginal costs of specification may differ depending on the nature of contracting parties. For example, an uninformed and inexperienced contracting party may face higher costs to discover, negotiate and write additional contingencies than a practiced and knowledgeable contracting party.

I includes the cost of opportunistic behaviour arising from contractual incompleteness. For example, an unqualified contractual power may be exercised in a manner designed to redistribute the anticipated contractual surplus from one party to the other. A contracting party may seek to expropriate the expected gains of the other where a contingency arises that is not specified within the contract. This risk would be included in I . Conceivably, I will include the aggregate of the expected cost of each incidence of opportunistic behaviour multiplied by the anticipated probability of that specific opportunistic behaviour being carried out by the other contracting party. I also encapsulates the costs of unspecified contingencies that may materialise which could render the contract no longer efficient. Thus, I must also reflect opportunity costs. I is decreasing in n . The probability of opportunism decreases as the number of contingencies specified increases. Logically, the anticipated cost of opportunism falls as the risk of opportunism falls.

The total costs without a good faith doctrine can be expressed as follows:

$$C = S(n) + I(n) \quad (1)$$

The optimal number of contingencies which minimises C is given by n^* . To find n^* it is necessary to differentiate equation (1) with respect to n and set the differential of C with respect to n equal to zero:

$$\frac{dC}{dn} = \frac{dS}{dn} + \frac{dI}{dn}$$

$$\frac{dC}{dn} = 0 \Rightarrow 0 = \frac{dS}{dn} + \frac{dI}{dn}$$

$$-\frac{dS}{dn} = \frac{dI}{dn} \quad (2)$$

Ultimately, n^* is found by solving equation (2) for n . Equation (2) reflects the fact that parties should specify for additional contingencies up to the point where the marginal cost of specification equals the marginal cost resulting from the incompleteness of the contract.

5.4.2 Transactions Costs With Good Faith:

Similar analysis can be applied to a contractual regime in New Zealand with good faith. Conceivably, there would be no change in the determinants of S as a result of the introduction of the subject doctrine. The cost incurred by a party of identifying contingencies and contractually providing for them would correspond.

However, logically there would be a change in I as a result of good faith. The cost of contractual incompleteness under a good faith regime can be denoted by I_{GF} . It is often assumed that I_{GF} is less than I for the same number of contingencies. It is reasoned that there is an increased chance that the courts may intervene to prevent the redistribution of wealth from the victim to the opportunistic actor because a doctrine of good faith can regulate opportunistic behaviour not specified for in the contract.

This reasoning is too simplistic. A doctrine of good faith also has negative implications. A contracting party who calculates that he or she will obtain the surplus arising from an unspecified contingency may be found to be in breach of good faith if he or she retains it at the expense of the other party. Moreover, the discretion given to the Court by virtue of

a good faith doctrine may result in the courts interfering with specified as well as unspecified contingencies. The Court may redistribute expected entitlements under the banner of an enforcement of good faith obligations. Therefore, I_{GF} must also be a function of the Court's 'error', e . This latter component can be defined as the propensity of the Court to redistribute an anticipated entitlement on account of good faith.¹¹⁸ The findings in Chapter 3 suggest that e will be determined by the inherent uncertainty in the prospective definition and application of good faith. As a result, good faith leads to greater uncertainty with respect to the entitlement of contracting parties.

Thus, it is possible that the total transactions costs incurred by a party in respect of a particular agreement under a body of contract law incorporating a doctrine of good faith may be greater than the transactions costs without a good faith obligation even where the same number of contingencies is specified. The transactions costs incurred in the context of a system of contract law incorporating good faith, C_{GF} , can be stipulated as follows:

$$C_{GF} = S(n) + I_{GF}(n, e) \quad (3)$$

The optimal number of contingencies which minimises C_{GF} is given by n^*_{GF} . To find n^*_{GF} it is necessary to differentiate equation (3) with respect to n and set the differential of C_{GF} with respect to n equal to zero. The total derivative can be expressed as follows:

¹¹⁸ Theoretically a doctrine of good faith can be endorsed if 'the courts are able in all cases to determine the efficient outcome (taking into account the effect of any rule on ex ante incentives in future, similar contracts)...The reality of generalist courts, however, is that they possess only limited competence in any one area. Put simply, courts make mistakes about efficient outcomes...[J]udicial competence is more or less limited because courts make errors more or less frequently in "observing" a contract variable or translating an observation into a conclusion about efficiency. In the incomplete contracting context, courts will display varying degrees of competence as they are more or less able to deduce efficient gap-filling terms.' Gillian Hadfield, 'Judicial Competence and the Interpretation of Incomplete Contracts' (1994) 23 *Journal of Legal Studies* 159, at 162.

$$\begin{aligned}
\frac{dC_{GF}}{dn} &= \frac{dS}{dn} + \frac{\partial I_{GF}}{\partial n} + \left(\frac{\partial I_{GF}}{\partial e} \right) \left(\frac{de}{dn} \right) \\
\frac{dC_{GF}}{dn} = 0 &\Rightarrow 0 = \frac{dS}{dn} + \frac{\partial I_{GF}}{\partial n} + \left(\frac{\partial I_{GF}}{\partial e} \right) \left(\frac{de}{dn} \right) \\
-\frac{dS}{dn} &= \frac{\partial I_{GF}}{\partial n} + \left(\frac{\partial I_{GF}}{\partial e} \right) \left(\frac{de}{dn} \right)
\end{aligned} \tag{4}$$

Thus, n^*_{GF} is found by solving equation (4) for n .

5.4.3 The Efficiency Criterion for Good Faith:

Utilising the optimal number of contingencies determined from equations (2) and (4), equations (1) and (3) can be combined to derive an inequality stating when a good faith regime will be more efficient than the status quo in terms of reduced transactions costs:

$$\begin{aligned}
C_{GF} &< C \\
S(n^*_{GF}) + I(n^*_{GF}, e) &< S(n^*) + I(n^*) \\
I(n^*_{GF}, e) - I(n^*) &< S(n^*) - S(n^*_{GF})
\end{aligned}$$

Now let $I(n^*_{GF}, e) - I(n^*) = \bar{I}$, and $S(n^*) - S(n^*_{GF}) = \bar{S}$. A universal doctrine of good faith will only be more efficient where:

$$\bar{S} > \bar{I} \tag{5}$$

Equation (5) mathematically represents the trade-off between savings on specification costs and the expected cost deriving from the uncertainty of good faith which leads to judicial mistake. These two components comprise the transactions cost efficiency

criterion for determining, in relation to a particular contract, whether good faith will be more efficient than a legal regime without good faith.

It has been suggested that it is extremely difficult to determine whether recognition of a general duty of good faith would be economically efficient.¹¹⁹ It is hard to accurately quantify the allocable costs of running a legal system that administers a good faith doctrine.¹²⁰ Nonetheless, the model permits some predictions to be made as to when good faith is likely to be efficient or inefficient.

The size of e is the primary efficiency determinant. The inequality contained within equation (5) is less likely to be satisfied as e increases. Good faith will not be transactions cost efficient if the courts are readily prepared to redistribute contractual surplus. Inefficiency will result if the courts are perceived to be disturbing existing contractual rights. This amounts to judicial interference with attempts by contracting parties to specify for particular foreseen contingencies. The judiciary must therefore be aware of the negative economic consequences of rewriting the express terms of an agreement in the name of good faith.

It is also material that n^*_{GF} and therefore the amount of specification costs incurred, being $S(n^*_{GF})$, will be determined by an *ex-ante* assessment of e . Thus, anticipated court error is more relevant than actual court error. Logically, contracting parties will predict the incidence of perceived error from the quality of previous judicial decisions. It was recognised in Chapter 3 that incorrect trial decisions would be inevitable shortly after an introduction of good faith in New Zealand. There would be no corpus of precedent which judges can utilise. Good faith is therefore liable to be inefficient on its introduction but may become more efficient over time as the doctrine becomes more familiar to the New Zealand judiciary, legal advisors and contracting parties. Thus, the incidence of e may decrease over time.

¹¹⁹ See Robert S Summers, 'The General Duty of Good Faith – Its Recognition and Conceptualization' (1982) 67 *Cornell Law Review* 810, at 827.

¹²⁰ Ibid.

Ultimately, the efficiency criterion for good faith will be heavily influenced by the predictability of the good faith obligation and the confidence which contracting parties have in the ability of the New Zealand judiciary to reach correct outcomes. In this regard behavioural economics is highly relevant to the efficiency of a good faith doctrine.

It is submitted that the prevalence of e will depend largely upon the nature of the contracting parties and the nature of the transaction.

There are a number of situations where good faith might be desirable. For example, e may be insignificant in respect of basic contracts which are of common occurrence. The courts are more likely to be familiar with such contracts and judicial interpretation is likely to be predictable. Contracting parties may therefore more readily rely on the courts to utilise good faith to fill the gaps in contractual specification. This implies that considerably fewer contingencies would need to be specified such that the specification costs savings, namely \bar{S} , would be large.

Often parties entering into such contracts will be unsophisticated and should rationally rely on good faith. These actors are likely to be under resourced and inexperienced. Due to cognitive limitation, the cost of specifying an additional contingency is inevitably high at the margin even for low levels of n . In some cases unsophisticated parties with sufficient resources may remain rationally ignorant and instead hire specialised agents to act on their behalf in the transaction. However, in other instances the costs of specification may be prohibitive. Unsophisticated parties may not be able to afford the services of lawyers, accountants and other advisors who might be consulted during contractual negotiations. Accordingly, specification for the optimal number of contingencies, $S(n^*)$, may not be able to be attained. In this scenario, *ex-post* reliance on good faith should be preferred to *ex-ante* contractual specification. Unsophisticated parties may be more willing to depend on good faith and thereby assume the risk of e as an alternative to sustaining S . Ultimately, an unsophisticated party is more likely to be engaged in an uncomplicated and homogenous transaction such that the incidence of e

will tend to be insignificant. The reliance on good faith is therefore more prone to efficiency.

Good faith is also likely to be favoured by unsophisticated individuals dealing with a commercial party. The weaker party will lack bargaining power both *ex-ante* and *ex-post*. Often there will be no *ex-ante* negotiations in this situation. The sophisticated commercial party may be a repeat player dealing through standard form contracts, the terms of which are accepted by the weaker party without any negotiation. The stronger party may spread costs over a number of these contracts.¹²¹

Traditional economic theory suggests that standard form contract terms produce transaction costs savings and will be beneficial to unsophisticated consumers. It is hypothesised that provided a small proportion of consumers actually read and shop around for standard form contract clauses, then this should place enough pressure on firms to adopt efficient contractual terms. Informed consumers generate a form of notional market assent.¹²² Accordingly, these market forces might be sufficient to prevent opportunism without any need for reliance on a good faith doctrine.

However, the efficiency of standard form terms has been challenged on the basis that because consumers are boundedly rational, they will not be aware of the content of form contracts and will not incorporate certain information into their contracting decisions. As a result, market pressures will not necessarily force businesses to provide efficient standard form terms.¹²³ Accordingly, legislative or judicial intervention may be required in order to prevent opportunistic behaviour. For example, this has occurred in New

¹²¹ See Mackaay and Leblanc, above n 63, at 12.

¹²² For a discussion of the law and economics literature supporting the efficiency of standard form terms see Jason Scott Johnston, 'The Return of Bargain: An Economic Theory of How Standard-Form Contracts Enable Cooperative Negotiation Between Businesses and Consumers' (2005) 104 *Michigan Law Review* 857.

¹²³ See generally Korobkin, above n 32. For further discussion as to why standard form contracts may not produce optimal terms and prospective solutions see Victor P Goldberg, 'Institutional Change and the Quasi-Invisible Hand' in Kronman and Posner (eds), above n 27.

Zealand through the Credit Contracts and Consumer Finance Act 2003. This statutory instrument empowers the Court to intervene in a standard form consumer credit contract where, *inter alia*, the terms of the contract are deemed to be oppressive or the creditor seeks to exercise a contractual power in an oppressive manner. Conceivably these powers are similar to those which might be exercised under the banner of a good faith doctrine. Contract economists have suggested that the courts should be permitted to sanction a standard form contract under a doctrine of unconscionability or good faith where the term in question is not salient to most consumers such that ‘the market check on the seller overreaching is absent.’¹²⁴

Notably, the application of a doctrine of good faith may come at a cost to an unsophisticated party in the form of a less favourable contract price. A contracting party prepared to forgo any recourse to a good faith principle may conceivably obtain better consideration for his or her contract. In instances where notions of good faith are imposed as a compulsory measure, there may be some equalising differential in equilibrium. For example, the duties analogous to good faith imposed on a creditor under the Credit Contracts and Consumer Finance Act 2003 are likely to increase the cost of credit for a consumer. In equilibrium, informed consumers who might not necessarily need to rely on the protective provisions under the Act may pay too much for credit. They effectively subsidise the uninformed.

Despite the price to pay for an unsophisticated party to rely on a good faith doctrine, the alternative risks are likely to outweigh this cost. A commercial party is likely to possess more information about the potential opportunities for opportunistic conduct than an unsophisticated party. Even if the weaker party could wield enough bargaining power to specify for contingencies, he or she may not have the resources to discover those contingencies. It is rational to rely on good faith in this scenario. Sepe emphasises the point:

¹²⁴ *Ibid*, at 1207.

[N]ot including good faith basically legitimates parties to behave opportunistically at the occurrence of unspecified contingencies. Then, due to the large number of contingencies that are unforeseeable for an unsophisticated party, [he or she] is better off by choosing good faith and accepting that [his or her] counterparty might still behave opportunistically (anticipating the possibility of court error in the *ex-post* enforcement of the contract) than, by excluding good faith, giving the counterparty “the right” to do so.¹²⁵

A good faith obligation is therefore likely to be preferred by a weaker party where there is an inequality of bargaining power. Due to the relative weakness of the contracting party, I is likely to far exceed I_{GF} .

It is therefore submitted that the inequality $\bar{S} > \bar{I}$, is most likely to be satisfied in homogenous contracts, low value transactions, consumer transactions, agreements involving unsophisticated parties and bargains in which there is a considerable inequality of bargaining power. In this context relative specification costs savings will be high, I will be greater than I_{GF} and the incidence of e will be minimal.

On the contrary, e is likely to be greater in idiosyncratic contracts.¹²⁶ These arrangements typically involve large contractual surpluses and are more likely to be entered into by sophisticated commercial parties. These players possess considerable economic, organisational and informational resources. They tend to be surrounded by informed and specialised negotiating agents. In consequence, sophisticated parties are readily able to foresee contingencies and assess contracting risks.

Complex and unusual transactions will inevitably involve a vast number of contingencies. The courts are unlikely to be able to appropriately fill gaps in such contracts. It is therefore difficult to avoid express contractual specification such that the difference between $S(n^*)$ and $S(n^*_{GF})$ is likely to be minimal.

¹²⁵ Sepe, above n 64, at 46.

¹²⁶ Ibid, at 51.

Such arrangements will also be characterised by information asymmetry as between the contracting parties and the judiciary if the parties resort to litigation. The Court may not be able to draw on previous experience or discern a common commercial or trade practice to assist in the interpretation of the contract. Further, the judiciary may be ill-equipped to understand highly specialised and technical agreements. This implies that the incidence of e is likely to be high.

Accordingly, idiosyncratic and complex agreements are less suitable to be supplemented by a good faith obligation. I_{GF} is more prone to exceed I due to the significance of e . All of these factors indicate that \bar{I} will tend to be greater than \bar{S} . This implies that the contracting parties and the contracting parties alone should be responsible for allocating their respective contractual entitlements.

Therefore, good faith is less likely to be efficient in complex contractual dealings between commercial parties.¹²⁷ This holds where the parties are well-resourced and well-informed. In this scenario it would be undesirable for the parties to be subjected to mandatory good faith obligations which may give rise to undesirable judicial intervention. The doctrine of freedom of contract should prevail in this scenario.

5.4.4 Précis:

The above analysis has sought to demonstrate that a universal doctrine of good faith in contract law will not always be more transactions cost efficient than a regime of contract without good faith. The proffered efficiency criterion suggests that sophisticated parties engaged in unique contracting scenarios are better to prescribe their own respective rights and obligations and not subject themselves to judicial interpretation of a good faith obligation.

¹²⁷ It has been recognised that ‘an expansive obligation extends the responsibilities of commercial actors beyond bargained-for risk allocations, subjects bargains to inconsistent and uncertain enforcement, and does not produce offsetting benefits in commercial conduct.’: Clayton Gillette, ‘Limitations on the Obligation of Good Faith’ [1981] *Duke Law Journal* 619, at 620.

Consequently, the model purports to verify that it is not economically desirable to impose a mandatory obligation of good faith in all contractual relationships within New Zealand. Introducing good faith as a default rule may also be inappropriate. This presents a risk that parties would seek to contract out of good faith in circumstances where the obligation may be efficient. Contractual exclusion is particularly likely in the case of a self-interested sophisticated party dealing with an unsophisticated party.

Conceivably, the better legal response is to target those contractual relationships in which good faith is more likely to enhance economic efficiency. These include homogenous contracts, consumer transactions, low-value transactions and transactions where there is a significant inequality of bargaining power. However, it is submitted that obligations akin to good faith are already imposed to some extent in these types of relationships via statute. For example, the Disputes Tribunals Act 1988 allows the Tribunal to consider notions of unconscionability and oppression in the exercise of contractual powers in low-value exchanges, the Consumer Guarantees Act 1993 affords contractual protection in consumer transactions, the Credit Contracts and Consumer Finance Act 2003 seeks to prevent overreaching by a sophisticated party over an unsophisticated party who may lack bargaining power and the Employment Relations Act 2000 expressly recognises obligations of good faith in a homogenous class of contracts. It was further demonstrated in Chapter 4 that the courts in New Zealand often give effect to unexpressed notions of good faith.

Ultimately, any failure to attain economic efficiency is more appropriately remedied by addressing the application of contract doctrine to specific classes of contractual transactions rather than imposing a universal good faith doctrine. Although an important issue, it is outside the function of this chapter to extensively explore those categories of contractual relationship in which a good faith obligation may be extended to in the future. The thesis is fundamentally concerned with a general and universal doctrine of good faith rather than an obligation which would only relate to particular contractual relationships. The analysis has established that a universal doctrine is predisposed to inefficiency in

certain contractual interactions such that it is unlikely to be supportable from a law and economics perspective.

5.5 The Efficiency of two Specific Applications of Good Faith:

The foregoing discussion has applied a holistic approach to the law and economics issues relating to the subject doctrine of good faith. By contrast, this section examines two specific applications of a good faith obligation. This permits a more particular evaluation of the efficiency implications of a universal duty of good faith. Reference will be made to the parameters within the transaction costs model where appropriate.

The first of these selected applications relates to pre-contractual disclosure. This area of the law has been discussed throughout the thesis. There is extensive law and economics literature pertaining to the issue. Accordingly, the economic scholarship should serve as a useful supplement to the legal analysis. Pre-contractual disclosure is therefore an appropriate application of good faith to examine.

The second application of good faith which has been selected for consideration is quantity variations under output and requirements contracts. This has proved to be a contentious issue in the United States. By contrast, these contracts rarely feature in litigation in the Anglo-Commonwealth countries. In all likelihood this is due to the fact that those jurisdictions do not observe an obligation of good faith. It will be argued that the application good faith to these contracts is prone to inefficiency thereby supporting the contention that a universal doctrine is not economically desirable.

5.5.1 Duties of Pre-Contractual Disclosure:

The current law within New Zealand relating to pre-contractual disclosure was traversed in Chapter 4. That discussion highlighted the difficulties of extending the subject common law doctrine to regulate non-disclosure in a pre-contractual scenario. Setting

aside those jurisprudential limitations, law and economics may inform whether disclosure is desirable at the contractual bargaining stage under the auspices of good faith.

It is elementary that competitive markets require full information to function efficiently. However, it does not follow that negotiating parties should be under a legal duty to disclose all information. That conclusion is too simplistic.¹²⁸ On the contrary, it is a widely held view that a good faith duty requiring absolute disclosure would be economically inefficient.¹²⁹ It would end arms length bargaining and would impede enterprise and commerce.¹³⁰

The economic rationale against complete disclosure focuses on socially valuable information. Productive or socially useful information is that which allows a resource to be put to a more beneficial use.¹³¹ It is economically desirable that information affecting the value of a resource reach the market as quickly as possible. This ensures allocative efficiency. Accordingly, individuals should not be discouraged from investing in the search for productive information. In most instances, an individual ought not therefore be forced to give away socially valuable information under a doctrine of good faith to his or her negotiating counterparty.¹³² This would limit the incentive to search for socially

¹²⁸ See Miceli, above n 3, at 117.

¹²⁹ See Fabre-Magnan, above n 1, at 99. This outcome is contrary to the traditional views of many legal scholars in the United States who consider that all material facts should be disclosed. See generally W Page Keeton, 'Fraud – Concealment and Non-Disclosure' (1937) 15 *Texas Law Review* 1, at 31; Eric M Holmes, 'A Contextual Study of Commercial Good Faith: Good Faith Disclosure in Contract Formation' (1978) 39 *University of Pittsburg Law Review* 381, at 452; Friedrich Kessler and Edith Fine, 'Culpa in Contrahendo, Bargaining in Good Faith, and Freedom of Contract: A Comparative Study' (1964) 77 *Harvard Law Review* 401, at 444; Frona Powell, 'The Seller's Duty to Disclose in Sales of Commercial Property' (1990) 28 *American Business Law Journal* 245, at 274.

¹³⁰ Nicola Palmieri, 'Good Faith Disclosures Required During Precontractual Negotiations' (1993) 24 *Seaton Hall Law Review* 70, at 179.

¹³¹ Miceli, above n 3, at 121.

¹³² But see Steven Shavell, 'Acquisition and Disclosure of Information Prior to Sale' (1994) 25 *The RAND Journal of Economics* 20 (discussed below n 137 and accompanying text).

beneficial information.¹³³ The reasoning was explained by Judge Posner in *United States v Dial* with the use of a paradigm example:

Liability is narrower for nondisclosure than for active misrepresentation, since the former sometimes serves a social purpose; for example, someone who bought land from another thinking that it had oil under it would not be required to disclose the fact to the owner, because society wants to encourage people to find out the true value of things, and it does this by allowing them to profit from their knowledge.¹³⁴

The hypothetical example mentioned by Posner actually bore out in the Australian case of *Diversified Mineral Resources NL v CRA Exploration Pty Ltd*.¹³⁵ The plaintiff was the vendor of leases and mining claim applications pertaining to a tenement within Queensland. The defendant owned similar rights in adjacent tenements. It had expended considerable resources in the exploration of those tenements. The exploration indicated a valuable zinc ore deposit which was likely to extend into the land in which the plaintiff had an interest. The defendant offered to purchase the rights held by the plaintiff for the

¹³³ See Anthony T Kronman, 'Mistake, Disclosure, Information, and the Law of Contracts' (1978) 7 *Journal of Legal Studies* 1, at 13-14; Randy E Barnett, 'Rational Bargaining Theory and Contract: Default Rules, Hypothetical Consent, the Duty to Disclose, and Fraud' (1992) 15 *Harvard Journal of Law and Public Policy* 783, at 798.

¹³⁴ 757 F2d 163, at 168 (1985, US App). See also *Fox v Mackreth* 2 Cox Eq Cas 320. In support of the principle of caveat emptor, it has been recognised by the Supreme Court of Canada that in 'many if not most commercial negotiations, an advantageous bargaining position is derived from the industrious generation of information not possessed by the opposite party as opposed to its market position as here. Helpful information is often a by-product of one party expending resources on due diligence, research or other information gathering activities. It is apparent that successful negotiating is the product of that kind of industry...It would defeat the essence of negotiation and hobble the marketplace to extend a duty of care to the conduct of negotiations, and to label a party's failure to disclose its bottom line, its motives or its final position as negligent. Such a conclusion would of necessity force the disclosure of privately acquired information and the dissipation of any competitive advantage derived from it, all of which is incompatible with the activity of negotiating and bargaining.': *Martel Building Ltd v Canada* [2000] 2 SCR 860, at [66]-[67] per Iacobucci and Major JJ. See also John Cartwright, *Misrepresentation, Mistake and Non-Disclosure* (2007), at 535.

¹³⁵ (1995) ATPR ¶41,381.

sum of A\$3,000,000. The plaintiff accepted. However, the actual value was considerably more taking into account the exploration findings. The plaintiff subsequently sued on discovering the information which the defendant possessed at the time of contracting. The action failed. Whitlam J held that the standards of ordinary commercial behaviour did not require the defendant to inform the plaintiff of the discovery.¹³⁶

The decision is justified in economic terms. A duty of disclosure would diminish profits arising from the investment in exploration. The result would be less incentive to commission an optimal level of exploration. The Court was effectively assigning a property right in the information by eschewing a disclosure obligation.

Recent studies have however indicated that it may be desirable in some instances for certain classes of sellers to be obliged to disclose productive information which they discover.¹³⁷ Sellers may have a socially excessive motive to obtain information in the absence of such a legal requirement. A regime of voluntary disclosure of productive information could result in a situation where the best strategy for some sellers is to acquire and disclose information notwithstanding that the cost of acquisition exceeds the social benefit of the information. Such a strategy will be occasioned where buyers believe that a silent seller is attempting to conceal information unfavourable to the seller. Buyers will not be willing to pay for socially valuable information that a seller refuses to

¹³⁶ Ibid, at 40,285.

¹³⁷ See Shavell, above n 132. For a worked numerical example demonstrating an optimal equilibrium under a legal regime requiring sellers to disclose known socially valuable information as compared to a regime allowing sellers to voluntarily disclose see Baird, Gertner and Picker, above n 46, at 103-106. Shavell however recognises that the same reasoning does not apply to buyers, who should be permitted to withhold productive information. He rationalises (at 21) that buyers should not be under any obligation to disclose productive information because 'they will not be able to capture any increase in value due to information because sellers, being the holders of property rights, naturally enjoy the option of not selling and instead using valuable information themselves.' The conclusions of Shavell suggest that an optimal law of good faith disclosure could have to distinguish between sellers and buyers in some instances so as to compel the disclosure of productive information by the former but not by the latter. Such a law may be extremely difficult to implement in practice. Difficulties associated with framing disclosure laws are discussed below.

disclose. However, a mandatory good faith obligation of disclosure of productive information discovered by sellers should change the beliefs of buyers. They infer that silent sellers are not necessarily withholding unfavourable information. Instead buyers may assume that sellers who can acquire productive information only at a cost above the social value of the information have not acquired the information at all. The best payoff strategy in this scenario for these high-cost sellers is to not acquire the information in the first place. Mandatory disclosure of known information by sellers should therefore efficiently deter sellers from acquiring information where the cost of acquisition exceeds the social benefit. Further, such a legal requirement is unlikely to prevent sellers from engaging in a socially desirable search for productive information. Eisenberg identifies the intrinsic incentives which sellers have to discover information:

[A]n owner does not normally need special incentives to invest in information about her own property. Ownership already provides a sufficiently strong incentive for such an investment, because the information will maximize her utility while she owns the property, and allow her to set the correct price if she sells.¹³⁸

Productive information is distinguishable from purely distributive information. Non-disclosure of either will usually result in a reallocation of wealth away from the individual labouring under asymmetric information. However, productive information leads to a more beneficial use *ex-post*. Redistributive information does not. *Ex-post* allocation of the resource is the same as its *ex-ante* allocation. Non-disclosure of non-productive information can only serve to redistribute wealth.¹³⁹ Therefore, the withholding of redistributive information is perceived to be solely an opportunistic bargaining device.¹⁴⁰

¹³⁸ Eisenberg, above n 31, at 1676.

¹³⁹ Miceli, above n 3, at 118.

¹⁴⁰ See Robert Cooter and Thomas Ulen, *Law and Economics* (1988), at 259.

Non-disclosure of distributive information is evidenced in the case of *Gloken Holdings Ltd v The CDE Co Ltd*.¹⁴¹ The plaintiff purchased a hotel business from the first defendant relying on a turnover analysis supplied by the first defendant and its agent, the second defendant. However, the defendants omitted to disclose that the turnover figures were uncharacteristically high. The financial accounts reflected a period in which workers involved in a nearby construction project were temporarily lodged at the hotel. It soon became apparent to the plaintiff that the actual turnover was not as expected. It had paid too much for the hotel in consequence. The plaintiff sued. Hammond J found the defendants liable for misrepresentation under s 6(1) Contractual Remedies Act 1979, misleading and deceptive conduct under s 9 Fair Trading Act 1986 and tortious deceit. On an economic rationale, the effect of the non-disclosure or half-truth was to redistribute wealth from the plaintiff to the first defendant. The actual economic value of the hotel was unaltered *ex-post*.

Economists often assert that contract law should compel the disclosure of purely distributive information.¹⁴² The law effectively permits opportunism if such information can be withheld. This produces social waste.¹⁴³ Investment to discover unproductive information is encouraged. Similarly, costly defensive expenditures are made which reduce total contractual surplus.¹⁴⁴ Individuals without full information must draft more protective measures into their contracts or seek out additional information. The *S* parameter within the transactions cost model, which includes the cost of discovery and disclosure, is unnecessarily increased. Further, the law should create incentives for the production and dissemination of information at the lowest cost¹⁴⁵ so as to minimise *C*.

¹⁴¹ (1997) 8 TCLR 278. See also *Hall v Warwick Todd Ltd* (2000) 9 TCLR 448; *Heiber v Barfoot & Thompson Ltd* (1996) 5 NZBLC 99,384; *Smythe v Bayleys Real Estate Ltd* (1993) 5 TCLR 454; *Wakelin v R H and E A Jackson Ltd* (1984) 2 NZCPR 195. In some instances non-disclosure of apparently redistributive information has not attracted a legal remedy. See for example *Bradford House v Leroy Fashion Group* (1983) ATPR ¶40,387; *Eighth SRJ Ltd v Merity* [1997] NSW ConvR 56,380.

¹⁴² See Miceli, above n 3, at 121.

¹⁴³ See Shavell, above n 132, at 21.

¹⁴⁴ See Posner, above n 5, at 111.

¹⁴⁵ See generally Hans-Bernd Schäfer and Claus Ott, *The Economic Analysis of Civil Law* (2004), at 377.

Redistributive information will often be possessed by the least cost avoider. For example, the owner of a car may become aware of an engine defect as a by-product of driving the car. The information is produced at less cost than if a potential buyer was to commission a report by a mechanic. Accordingly, intending vendors, sellers, lessors and licensors will often be least cost avoiders upon which legal obligations of disclosure should be visited.

However, a good faith duty of disclosure determined solely by differentiating productive information from non-productive information would be inappropriate. An additional distinction is required between facts which are deliberately acquired and facts which are casually acquired.¹⁴⁶ Information is deliberately acquired if its acquisition entails costs that would not otherwise have been incurred but for the likelihood of the information being produced.¹⁴⁷ Facts which are obtained without incurring such costs are deemed to be casually acquired.

It is generally contended that there is no economic reason to preclude disclosure of casually acquired information. *Ipsa facto*, compelling an individual to disclose information obtained without expending resources will have no effect on his or her behaviour.¹⁴⁸ The incidence of casually acquired information is not affected by disclosure laws. This result holds even if the information is productive. An individual who has expended no resources to obtain productive information need not be vested with a *de facto* property right in that information.

The above analysis implies that legal good faith duties should generally compel disclosure of all information except that which has been deliberately acquired and which

¹⁴⁶ Miceli, above n 3, at 122.

¹⁴⁷ Kronman, above n 133, at 13.

¹⁴⁸ *Ibid*, at 14. However, it has been contended that in some cases ‘there is a clear benefit in allowing buyers to use information they acquire accidentally...Allowing buyers to use their accidental knowledge can encourage the uncovering of resources, as well as the movement of those resources to those who value them most.’: Marc Ramsay, ‘The Buyer/Seller Asymmetry: Corrective Justice and Material Non-Disclosure’ (2006) 56 *University of Toronto Law Journal* 115, at 125.

can be characterised as socially useful or productive.¹⁴⁹ However, that outcome is entirely theoretical. There are economic factors which undermine the hypothesised utility of a good faith disclosure doctrine. Firstly, it is difficult to frame the duty of disclosure. Secondly, the market and existing regulations often provide an appropriate solution. Thirdly, it is dubious whether good faith disclosure obligations would materially reduce transactions costs. These three issues are explored below.

Framing a good faith disclosure duty presents fundamental problems. Information cannot readily be alienated into distinct categories.¹⁵⁰ For example, the owner of an artwork may be unaware that it has been painted by a famous artist. He or she may sell to an informed art expert for a price significantly below the value which the expert places on the painting. The information could be characterised as redistributive. The painting has always been genuine. Notionally, no new wealth has been discovered. Alternatively, the information could be characterised as productive. The additional wealth in the painting would not exist if the uninformed vendor retained it in his or her private gallery.¹⁵¹ It is

¹⁴⁹ See generally Miceli, above n 3, at 121 and 122. But see Shavell, above n 132, who recognises the potential necessity for sellers to be compelled to disclose productive information. Further, it has been recognised that mixed outcomes might be expected in circumstances where facts are productive but casually acquired and circumstances where facts are redistributive but deliberately acquired. See Alex M Johnson, 'An Economic Analysis of the Duty to Disclose Information: Lessons Learned From the Caveat Emptor Doctrine' (2008) 45 *San Diego Law Review* 79, at 92.

¹⁵⁰ See Jules Coleman, Douglas Heckathorn and Steven Maser, 'A Bargaining Theory Approach to Default Provisions and Disclosure Rules in Contract Law' (1989) 12 *Harvard Journal of Law and Public Policy* 639, at 692. It is doubtful whether the proposed classifications correspond to decided cases in the United States. See S M Waddams, 'Pre-Contractual Duties of Disclosure' in Peter Cane and Jane Stapleton (eds), *Essays for Patrick Atiyah* (1991), at 250.

¹⁵¹ The example is based on an actual French case which related to a painting by the French painter, Nicholas Poussin. For further discussion of the case see Fabre-Magnan, above n 1. It has been observed that information which remains private is of no social value because it does not lead to any improvement in productive arrangements. See Jack Hirshleifer, 'The Private and Social Value of Information and the Reward to Inventive Activity' (1971) 61 *American Economic Review* 561, at 573. For a further analysis of a similar hypothetical example see Christopher T Wonnell, 'The Structure of a General Theory of Non-Disclosure' (1991) 41 *Case Western Reserve Law Review* 329, at 342-343.

proper that ‘mixed’ facts which contain productive and redistributive elements need not be disclosed.¹⁵² The art expert in the above scenario should not be discouraged from revealing valuable paintings. However, most information can be rationalised to contain a productive component.¹⁵³ Therefore, good faith disclosure might rarely oblige a prospective purchaser to divulge information.

Distinguishing between facts which are casually acquired and those which are deliberately acquired is also complex. The requisite causal proximity between the investment and the information obtained is not clear. There are few conceivable instances where facts are obtained without attributable cost. Limited examples have been proffered. A businessperson who accidentally overhears valuable information whilst riding on a bus is suggested to have casually acquired the information.¹⁵⁴ However, he or she may have invested in education which facilitates the interpretation of the information and its application to a beneficial use. The businessperson might also argue that he or she would stop diligently listening to the conversations of others or stop riding the bus altogether if the value of the information was prevented by some legal requirement from being exploited. Thus, it can be reasoned that information will be deliberately acquired in almost all cases.¹⁵⁵ The courts are also likely to favour defendants on this issue. An in-depth *ex-post* analysis of attenuated submissions as to why information is deliberately acquired is undesirable and unrealistic. Again, a duty of good faith disclosure could be of infrequent application.

An additional framing difficulty exists in determining whether a duty of disclosure should apply only to information which is actually known. Alternatively, the obligation could

¹⁵² See Cooter and Ulen, above n 140, at 261.

¹⁵³ See Fabre-Magnan, above n 1, at 111; Coleman, Heckathorn and Maser, above n 150, at 693.

¹⁵⁴ Kronman, above n 133, at 13.

¹⁵⁵ See Fabre-Magnan, above n 1, at 109. Consequently, it has been noted that the greater the likelihood ‘information will be deliberately produced rather than casually discovered, the more plausible the assumption becomes that a blanket rule permitting nondisclosure will have benefits that outweigh its costs.’: Anthony T Kronman, ‘Mistake, Disclosure, Information, and the Law of Contracts’ in Kronman and Posner (eds), above n 27, at 121.

extend to information which ought to be known. This dilemma is primarily applicable to the disclosure of unfavourable information. A requirement to disclose only known facts creates a disincentive to discover beneficial information. For example, the owner of a house has less incentive to discover latent defects during the period of his or her ownership. The vendor must disclose the information to an intending purchaser if it is known. This may decrease the price the owner receives for the house unless the negotiating purchaser was to personally discover the defect. However, the timely discovery of the defect might be economically desirable. The defect may be worsening over time. Cost savings on remedial work would be achieved by early detection. The law might avoid these consequences by deeming that good faith requires disclosure of constructive facts and that a reasonable person in the position of the vendor would have discovered the defect. The vendor has incentive to quickly discover and remedy the defect in a cost-effective fashion.

However, requiring disclosure of matters which ought to be known would also pose serious difficulties. Overproduction of information would result¹⁵⁶ thereby increasing $S(n^*_{GF})$. A party obliged to disclose what he or she ought reasonably to know must make costly inquiries which may not produce any beneficial information. Further, irrelevant information might be disclosed. Accordingly, the New Zealand courts have previously taken the view that no liability can be found where a negotiating party has omitted to address or disclose a fact of which he or she is wholly unconscious.¹⁵⁷

Ultimately, it is evident that duties of disclosure distort market incentives to seek out information. Overproduction or underproduction of information is likely and is strongly linked to the manner in which the good faith duty is framed.¹⁵⁸

¹⁵⁶ The dangers of overinvestment in information have been emphasised. See generally Robert Birmingham, 'The Duty to Disclose and the Prisoner's Dilemma: *Laidlaw v. Organ*' (1988) 29 *William and Mary Law Review* 249. See also Waddams, above n 150, at 251.

¹⁵⁷ *Des Forges v Wright* [1996] 2 NZLR 758, at 766 per Elias J; *Ladstone Holdings Ltd v Leonora Holdings Ltd* [2006] 1 NZLR 211, at 224-225 per Potter J.

¹⁵⁸ See Coleman, Heckathorn and Maser, above n 150, at 694.

The second challenge to the utility of good faith disclosure relates to the ability of the market and the pre-existing regulations within New Zealand to provide an appropriate solution. Opportunistic trading through the non-disclosure of redistributive information will be discouraged in a competitive market. A firm obtaining sales through non-disclosure to customers will be exposed by competitors.¹⁵⁹ It will lose reputation. Players in a long-term competitive market therefore have incentive to trade in a non-opportunistic manner. Trade associations and consumer protection organisations also serve a similar function. These bodies limit the incentives and payoffs for uneconomic non-disclosure.

Further, the market may ensure that disclosure is not necessary. For example, competitive pressures compel sellers of goods and services to offer warranties. A warranty is more economically effective than disclosure in some instances.¹⁶⁰ It is more cost-effective to include a contractual warranty rather than placing an onerous obligation on sellers to disclose the characteristics and potential defects of a good. The legislature has intervened where market competition is not sufficient to induce contractual warranties. Accordingly, warranties may be implied into a contract by statute.¹⁶¹

Good faith disclosure has also sought to be justified on the basis that it places the onus of producing information on the least cost avoider. However, there may be no clear least cost avoider in some cases. Either party may have access to an efficient and cost-equivalent information source where there is a separate market for information.¹⁶² For example, information held by a local body about a particular piece of real estate may be

¹⁵⁹ See Posner, above n 5, at 112.

¹⁶⁰ Ibid, at 113. It has been recognised that ‘people may be able to make the benefits of possession relatively more secure by resorting first to their endogenous transaction resources rather than depending upon legal rules.’: Coleman, Heckathorn and Maser, above n 150, at 695.

¹⁶¹ For example, the Consumer Guarantees Act 1993 imposes mandatory guarantees as to: title; acceptable quality; fitness for purpose; compliance with a description; compliance with a sample; price; repairs and spare parts; reasonable care and skill and; time of completion. The Sale of Goods Act 1908 also imposes a default warranty of quality and fitness for purpose.

¹⁶² See Smith and Smith, above n 33, at 487.

obtained at the same cost to the purchaser or the vendor.¹⁶³ Market considerations dictate that the information will be obtained by the party whose allocative gain is sufficient to offset the cost.¹⁶⁴ This will be the buyer of a property in most instances. He or she stands to lose the most if the information is unfavourable.

The most fundamental limitation of a good faith disclosure duty is that it may not significantly reduce transactions costs within New Zealand. A rational negotiating party will continue to employ defensive measures rather than rely on his or her negotiating counterparty to disclose information under a good faith doctrine. The *ex-post* cost of litigating to recover for the adverse consequences of non-disclosure will almost inevitably exceed the *ex-ante* cost of producing the information. This is exacerbated by the fact that good faith disclosure litigation will be uncertain.¹⁶⁵ A plaintiff would ordinarily have to establish that the defendant had actual knowledge of the relevant fact, that it was solely a redistributive fact and that the fact was casually acquired. These matters would be extremely difficult to prove as recognised above. All of these factors indicate that e may be inherently significant and I is unlikely to significantly exceed I_{GF} .

Reliance by a negotiating party on a good faith disclosure doctrine at an *ex-ante* stage presupposes that contracting parties know and understand the law. A negotiating party who places trust in his or her negotiating counterparty must assume that the counterparty knows that an obligation of disclosure exists and that he or she can differentiate between

¹⁶³ For example, a Land Information Memorandum pertaining to a residential property may be obtained from the relevant local council at the same cost to either buyer or seller but standard form agreements for sale and purchase of real estate generally place this obligation on the buyer. See clause 8.2 Agreement for Sale and Purchase of Real Estate (8th ed, 2006) (approved by the Real Estate Institute of New Zealand Inc and the Auckland District Law Society).

¹⁶⁴ See Smith and Smith, above n 33, at 487.

¹⁶⁵ Notably, a rule ‘which calls for a case-by-case application of a disclosure requirement is likely [] to involve factual issues that will be difficult and expensive to resolve...[I]t is impossible to determine whether the buyer actually made a deliberate investment in acquiring information.’: Kronman, above n 155, at 120.

productive facts, distributive facts, casually acquired information and deliberately acquired information. This is not necessarily a reasonable assumption. Further, a negotiating party weighing up whether to disclose information will naturally be biased towards finding that information is productive and deliberately acquired, particularly given the uncertainties surrounding differentiating the concepts. Ultimately, each negotiating party knows that there is little behavioural motivation for the other to reveal facts which are adverse to his or her bargaining position.

Similarly, the distinction between deliberately or casually acquired information and productive or solely redistributive information is largely irrelevant to a potential victim of non-disclosure at the *ex-ante* stage. The economic model dictates that silence will be permitted in some cases. This non-disclosure will redistribute wealth from the victim. Accordingly, there is still incentive to make defensive expenditures. A negotiating party cannot necessarily differentiate between productive, redistributive, deliberately acquired or casually acquired facts until those facts and the circumstances of their acquisition become known. This implies that a similar level of *ex-ante* expenditure is likely whether good faith operates or not. Specification costs savings, namely \bar{S} , are not likely to meaningfully increase on account of a good faith obligation of disclosure.

The above analysis has demonstrated that it would not be economically desirable for a doctrine of good faith to impose an obligation of complete pre-contractual disclosure. Good faith should not mandate an absolute abandonment of caveat emptor. Traditional economic reasoning implies that disclosure should generally be required in all cases except where information is deliberately acquired and can be classified as productive.¹⁶⁶ However, the utility of a doctrine of good faith disclosure has been challenged. The obligation may distort incentives to produce information. Often the market can obtain appropriate solutions without the intervention of good faith. Critically, there is no evidence to suggest that good faith disclosure would materially reduce transactions costs within New Zealand. Negotiating parties will continue to rely on private measures.

¹⁶⁶ However, in some instances even disclosure of productive facts may be required. See above n 137 and accompanying text.

Accordingly, the theoretical benefits of good faith disclosure must be doubted. It is unlikely to enhance the $\bar{S} > \bar{I}$ inequality.

5.5.2 Quantity Variations in Requirements and Outputs Contracts:

A requirements contract is one in which a seller agrees to supply a specific good to a buyer in quantities which the buyer may require. Ordinarily the contract will stipulate a fixed price but leave open the quantity wholly to the discretion of the buyer. The needs of the buyer determine the quantity of goods which the seller must provide. The seller will usually be the exclusive supplier.¹⁶⁷ Such contracts have been labeled as ‘solus agreements’ by the English courts.¹⁶⁸

Alternatively, an output contract is one in which the buyer agrees to purchase the entire output of the seller of a specific good. Again, the price is likely to be fixed but the quantity produced for sale is liable to fluctuate.

Originally it was thought that open-quantity contracts were illusory and therefore unenforceable for lack of consideration.¹⁶⁹ In the case of a requirements contract it was contended that there could be no binding promise because the buyer is under no duty to purchase the goods. However, this argument was dispelled by the Court of Common Pleas in *The Great Northern Railway Company v Witham*.¹⁷⁰ The defendant had agreed to supply the plaintiff iron at a fixed price in such quantities that the plaintiff may order from time to time. The plaintiff requested supply but the defendant refused to deliver. The defendant argued that there was no consideration for the promise. Brett J disagreed. Although the agreement was effectively a unilateral contract, the act of the plaintiff

¹⁶⁷ See Paulette Kendler Zisk, ‘Requirements Contracts, “More or Less” Under the Uniform Commercial Code’ (1980) 31 *Rutgers Law Review* 105, at 107.

¹⁶⁸ *Esso Petroleum Co Ltd v Harper's Garage (Stourport) Ltd* [1967] 1 All ER 699, at 703 per Lord Reid.

¹⁶⁹ See Victor P Goldberg, *Framing Contract Law* (2006), at 101.

¹⁷⁰ (1873-74) LR 9 CP 16. See also John N Adams, ‘Consideration for Requirements Contracts’ (1978) 94 *Law Quarterly Review* 73.

placing the order meant that the defendant was bound to perform.¹⁷¹ The question as to whether the defendant could absolve himself from further performance by giving notice was left open. Subsequent courts have sought to preclude premature cancellation by reasoning that there is an obligation on the buyer to order goods if they are required.¹⁷² That obligation supposedly amounts to consideration to keep the offer open. Further, an undertaking from the buyer that he or she will order all requirements only from the seller is also capable of constituting consideration.¹⁷³

Solus agreements which absolutely restrict a buyer from purchasing goods from a party other than the contractual seller have been construed as a restraint of trade. The arrangement must be in the public interest. Some requirements contracts have been struck down as unreasonable. An example is seen in the case of *Petrofina (Gt Britain) v Martin*.¹⁷⁴ Martin operated a petrol station. He contracted to purchase fuel only from Petrofina at a stipulated price. However, it soon became evident that the price was too high. Martin could not reach the level of sales required to break even. As a result, he rationally switched to purchasing fuel from an alternate supplier at a lower price. The Court refused to allow the action by Petrofina seeking to uphold the agreement. The contract was too onerous. It rendered the petrol station unsaleable, the contractual minimum period of 12 years was too long and the restriction on oil purchases was too great.¹⁷⁵

Nonetheless, requirements and output contracts provide obvious mutual benefits. The necessity to specify a fixed quantity *ex-ante* is avoided. Instead, quantity can be determined *ex-post* as new information becomes available. Thus, there is contractual flexibility which permits adaptation to changing circumstances. Surety of supply or

¹⁷¹ (1873-74) LR 9 CP 16, at 19-20.

¹⁷² *Re Gloucester Municipal Election Petition* [1901] 1 KB 683.

¹⁷³ See Andrew Grubb and Michael Furmston (eds), *The Law of Contract* (1999), at 198.

¹⁷⁴ [1966] 1 All ER 126. See also *Esso Petroleum Co Ltd v Harper's Garage (Stourport) Ltd* [1967] 1 All ER 699; *Robinson v Golden Chips (Wholesale) Limited* [1971] NZLR 257.

¹⁷⁵ *Ibid*, at 134 per Lord Denning MR.

demand is also achieved. Contracting costs are likely to decrease and the parties can allocate contractual risk to the party most suitable to bear those risks.¹⁷⁶

Open quantity agreements are susceptible to opportunistic conduct. The buyer has incentive to understate his or her requirements if the market price falls below the contract price. The buyer may seek alternate supply or perhaps avoid the solus agreement altogether. The seller incurs additional transactions costs in having to find an alternative buyer in this instance.

Conversely, a buyer has an incentive to overstate his or her actual requirements in the event that a requirements contract price falls short of the market price. Surplus goods may be sold at a profit. In *J L Kier & Co Ltd v Whitehead Iron & Steel Co Ltd* Branson J sought to avoid this problem by construing the word requirement to mean that the buyer could only demand that amount of goods which was actually required in his or her business.¹⁷⁷ The buyer could not buy to sell again.

However, the buyer may be in the business of reselling in some cases. Further, he or she may wish to establish adequate stockpiles of goods. The distinction between whether the goods are or are not actually required may be elusive. Differentiating between opportunistic and non-opportunistic conduct may therefore be complicated.¹⁷⁸

Not all quantity changes responding to fluctuation in market prices can be classified as opportunistic conduct. Some alterations may be made for a legitimate purpose. The courts in the United States have distinguished opportunistic behaviour by imposing a good faith restriction on quantity variations. The obligation of good faith exists at common law¹⁷⁹

¹⁷⁶ See generally David Goddard, 'Long-Term Contracts: A Law and Economics Perspective' [1997] *New Zealand Law Review* 423, at 424.

¹⁷⁷ [1938] 1 All ER 591, at 594.

¹⁷⁸ See Fischel, above n 97, at 141.

¹⁷⁹ See Alphonse Squillante and John Fonseca, *Williston on Sales* (4th ed, 1973), at 390. An obligation to determine quantity reasonably and in good faith may also exist in Canada. See S M Waddams, *The Law of Contracts* (5th ed, 2005), at 357.

but is also set out under the Uniform Commercial Code (“UCC”). Section 2-306(1) states that the quantity demanded or supplied must occur in good faith. Additionally, the amount cannot be unreasonably disproportionate to any stated estimate. Essentially, the Court will examine whether there is a valid business reason that justifies a quantity variation. A party who seeks to manipulate the contract in light of market disparity will be deemed to be acting in bad faith.¹⁸⁰ A buyer cannot use an ordering option to facilitate speculation on rising and falling markets.¹⁸¹ Thus, the stockpiling of goods in anticipation of changing prices is not good faith conduct.¹⁸²

These specific good faith obligations operating under American law have attracted considerable comment from contract and economics scholars.¹⁸³ Obligations of good faith have proved to be a useful deterrent to opportunism in some cases. However, in other instances duties of good faith in open quantity contracts have arguably produced inefficient results. The manner in which the judiciary interprets good faith may give rise to inefficiency. There are various case examples within the United States which support this contention.

In *Feld v Henry S Levy & Sons Inc*¹⁸⁴ the defendant operated a wholesale bread baking business. As part of its ordinary business, the defendant generated waste product in the form of loaves of bread that were unsuitable for sale. This waste could however be

¹⁸⁰ See Stacy Silkworth, ‘Quantity Variation in Open Quantity Contracts’ (1990) 51 *University of Pittsburgh Law Review* 235, at 236.

¹⁸¹ See John N Adams, ‘The Economics of Good Faith in Contract’ (1995) 8 *Journal of Contract Law* 126, at 132.

¹⁸² See E Allan Farnsworth, ‘Good Faith in Contract Performance’ in Beatson and Friedman (eds), above n 1, at 159.

¹⁸³ See Victor P Goldberg, ‘Desperately Seeking Consideration: The Unfortunate Impact of U.C.C. S2-306 on Contract Interpretation’ (2007) 68 *Ohio State Law Journal* 103; Victor P Goldberg, above n 169; Travis W McCallon, ‘Old Habits Die Hard: The Trouble With Ignoring S2-306 of the UCC’ (2004) 39 *Tulsa Law Review* 711; Mark P Gergen, ‘The Use of Open Terms in Contract’ (1992) 92 *Columbia Law Review* 997; Silkworth, above n 180; Muris, above n 61; Zisk, above n 167; John C Weistart, ‘Requirements and Output Contracts: Quantity Variations Under the UCC’ (1973) *Duke Law Journal* 599.

¹⁸⁴ 37 NY 2d 466 (NY, 1975).

converted into toasted breadcrumbs. This was a saleable product. Accordingly, the plaintiff entered into an output contract with the defendant. The plaintiff agreed to purchase all of the toasted breadcrumbs that the defendant produced. The contract stipulated a fixed price and was for an initial term of one year with successive renewal periods of one year. It was terminable on six months notice by either party. The defendant commenced the production of the breadcrumbs. However, within a year it became evident that the operation was not profitable. The defendant ceased production and dismantled its toasting oven. The defendant thereafter used the space for a computer room. The plaintiff sued. It was alleged that the defendant had not given notice of termination and had ceased production in breach of good faith. The Court of Appeals of New York held that ‘since there was a contractual right of cancellation, good faith required continued production until cancellation, even if there be no profit.’¹⁸⁵

The decision can be criticised on a number of grounds. The defendant had not breached the express terms of the agreement. It was open to the defendant to cease production without giving notice of cancellation. The defendant was not required to produce a minimum amount. It was evident that the defendant was not meeting its variable costs at the contractual price.¹⁸⁶ To suggest that the defendant was acting in bad faith by making a commercially rational election to shut down is not logical in economic terms. Ultimately, the effect of the judicial interpretation was to reallocate pre-agreed contractual risk which, according to the transaction costs model, is an undesirable effect of good faith embodied by the e parameter. It cannot be said that the defendant was attempting to redistribute wealth between the contracting parties. Thus, the defendant was not acting opportunistically. It seems anomalous to suggest that the defendant had a contractual duty to stay in business to convert waste product for the benefit of the plaintiff.¹⁸⁷ Certainly, there was no evidence to suggest that the continued production was Kaldor-Hicks efficient. It was not evident that the plaintiff was solely reliant on supply from the

¹⁸⁵ Ibid, at 472 per Cooke J.

¹⁸⁶ See Goldberg, above n 169, at 118.

¹⁸⁷ Ibid, at 119.

defendant. Further, the cost to the defendant of continued production in the form of forgoing the use of the space as a computer room may have been significant.

Another inefficient outcome resulting from the application of good faith might be seen in the case of *Orange and Rockland Utilities Inc v Amerada Hess Corporation*.¹⁸⁸ The plaintiff operated a power generating plant. The defendant contracted to supply fuel at a fixed price to the plaintiff as might be required for power generation. The contract contained non-binding estimates of the amount of fuel that the plaintiff would require. The price of fuel rose significantly five months into the 10 year contract. This coincided with an increase in the quantity of fuel requested by the plaintiff. The amount demanded was more than 60 per cent above the contractual estimate at one point. The increased demand was primarily attributable to increased sales of electricity to the New York Power Pool. The plaintiff had also begun to favour the use of fuel over gas in its plant. However, the defendant refused to supply any additional fuel above 10 per cent of the estimated rate. The plaintiff was forced to purchase the additional fuel required on the market. It sued to recover the difference between the market price and the contract price. The Appellate Division of the Supreme Court of New York held that the plaintiff had not acted in good faith and that its requirements were unreasonably disproportionate to the contractual estimates.¹⁸⁹

The decision produced an economically questionable result. There was no doubt that the plaintiff would utilise the additional fuel to meet its output requirements. The inherent limit on quantity within the contract was the maximum amount of fuel that would be required if the plaintiff operated its plant at full capacity. The Court effectively placed a limit on the quantity short of the capacity of the plant. The plaintiff was deprived of the flexibility it had bargained for as a result. The Court converted the contract into a fixed quantity agreement. Goldberg notes that the Court ‘implicitly ruled that the seller had promised to run its plant at less than full capacity for the life of the agreement, never

¹⁸⁸ 397 NY S2d 814 (NY App Div, 1977).

¹⁸⁹ Ibid, at 819 and 822 per Margett J.

asking why on earth a party would make such an odd promise.’¹⁹⁰ The problem would have been exacerbated had the buyer been unable to readily locate a suitable alternative supplier.

Significant difficulties may also arise in cases where a new technology or substitute good becomes available. This may reduce the requirements of a purchaser. This problem arose in *Southwest Natural Gas Co v Oklahoma Portland Cement Co.*¹⁹¹ The defendant was a cement producing company. The plaintiff agreed to meet the natural gas requirements of the defendant for a term of 15 years. The defendant installed a new and technologically advanced boiler system in its factory during the currency of the contract. The new equipment partially heated the boilers by utilising the waste heat produced by the kilns in the factory. The need for natural gas as a fuel to heat the boilers dramatically decreased as a result. The plaintiff sued to enjoin the defendant from utilising the waste heat in its operations. It was claimed that the defendant was in breach of the requirements contract. The Court rightly held that the defendant had not acted in bad faith. It had exercised a prudent business judgment.¹⁹²

It would be most undesirable for an obligation of good faith in open quantity contracts to be utilised to prevent a contracting party from making use of new technology. The outcome would be to discourage productive investment. The Court must not find that a buyer promises to adapt inefficiently as new technology and information becomes available.¹⁹³ Nonetheless, the *Southwest* case evidences that a good faith obligation has encouraged litigants to bring claims seeking this very outcome.

The above case examples recognise the potential for inefficiency resulting from the Court interfering in open quantity contracts. On occasions judges have seen fit to utilise good faith to redistribute wealth that has already been allocated under the contract.

¹⁹⁰ Goldberg, above n 169, at 134.

¹⁹¹ 102 F2d 630 (1939, US App).

¹⁹² Ibid, at 633 per Judge Phillips.

¹⁹³ Goldberg, above n 169, at 114.

Consequently, a doctrine of good faith may itself be used as a weapon to facilitate opportunism. This is undesirable. A party to a requirements or output contract has an incentive to commence litigation. He or she speculates that the Court may rewrite the agreement in his or her favour. This incentive is exacerbated by the fact that there is likely to be asymmetric information as between the parties and the Court. It is therefore unhelpful for contracting parties to rely on an *ex-post* review by a court guided by uncertain language such as good faith. Such litigation inevitably increases the magnitude of e . As a result, it is suggested that there is a strong tendency for $\bar{S} < \bar{I}$ where good faith is applied to open quantity contracts.

The party claiming a breach of good faith in the cases identified above could have taken adequate *ex-ante* protective steps. The contract price can be pegged to the market price. Similarly, floor or ceiling quantities can be stipulated thereby defining the extent of the risk assumed by each party. Conceivably, these contractual provisions could be achieved without significant additional specification costs. \bar{S} would be unlikely to increase materially. Accordingly, good faith may be an undesirable substitute for a definitive contractual allocation of risk. The argument is noted in general terms by Shell:

[B]usiness parties that are concerned with specific forms of postcontractual opportunism may bargain explicitly to inhibit opportunistic conduct in their original contract, eliminating the need for noncontractual legal protection...[T]he creation of legal claims to deter opportunism may backfire and result in groundless lawsuits by parties who took known risks at the outset of a relationship, but became disappointed with the outcome of the transaction. In short, [] using the legal system to redress the [opportunism] problem could be worse than the danger itself.¹⁹⁴

Further, there is no reason why the contracting parties cannot negotiate *ex-post* to achieve a more suitable allocation of risk in light of changed circumstances. The parties will have incentive to renegotiate if the long-term business relationship is valued or non-performance is imminent. A requirements contract can be readily altered by a simple

¹⁹⁴ Shell, above n 74, at 231-232.

deed of variation.¹⁹⁵ Extra-legal incentives may therefore produce an appropriate outcome. Good faith would not provide any additional benefit in this scenario.

Requirements and output contracts are prevalent within the commercial community.¹⁹⁶ They are perceived to be ordinary commercial contracts.¹⁹⁷ Accordingly, it is unusual that most contract textbooks in New Zealand do not substantively consider such arrangements.¹⁹⁸ The number of cases evaluating such contracts in the Commonwealth pales in comparison to the United States. This occurrence may be reflective of the fact that the Commonwealth courts are generally unwilling to interfere with clearly allocated contractual risk. The above analysis has sought to demonstrate that economically inefficient outcomes could ensue if this position were to change in the Commonwealth. Judicial interference with open quantity contracts would be an economically undesirable element of a good faith doctrine within New Zealand.

5.6 Summary:

This chapter has sought to identify the importance of economics scholarship to contract law and the good faith debate within New Zealand. The primary economic view of good faith is that it could function as a deterrent to opportunistic conduct. Opportunism is a recurring term utilised by contract economics scholars. However, it is difficult to derive a universal definition of the concept. Opportunistic behaviour certainly arises from the fact that contracts are incomplete and involve sequential performance.

Behavioural economics must be taken into account in determining whether good faith would be an appropriate measure to counter opportunism. The desirability of good faith

¹⁹⁵ Richard Austen-Baker, 'A Relational Law of Contract?' (2004) 20 *Journal of Contract Law* 125, at 137-138.

¹⁹⁶ See Adams, above n 170, at 84.

¹⁹⁷ *J L Kier & Co Ltd v Whitehead Iron & Steel Co Ltd* [1938] 1 All ER 591 (see headnote).

¹⁹⁸ Similar observations have been made in respect of the English position. See Adams, above n 170, at 74.

must be appraised with reference to empirical evidence rather than desired results. Good faith should create behavioural incentives to cooperate and avoid opportunistic dealing.

A good faith doctrine is generally perceived as a substitute for contractual specification thereby producing transactions cost savings. However, the uncertainty of good faith must also be factored into account. This reveals a trade-off between the savings on specification costs and the cost of increased uncertainty arising from reliance on good faith. The model outlined allows for predictions to be made as to when good faith could be efficient. The analysis evidenced that good faith would not promote economic efficiency in some instances. This result implies that a universal and mandatory obligation of good faith may not be desirable. A better approach would be to target those contractual dealings and relationships where good faith is likely to be transactions cost efficient.

The difficulties associated with contractual good faith, as it applies to economic efficiency, were also identified in an analysis of two specific applications of the duty. A blanket rule of good faith disclosure in pre-contractual negotiations is undesirable. The utility of a good faith disclosure doctrine is doubted. It is debatable whether negotiating parties will repose sufficient trust in counterparties needed to achieve significant transactions costs savings. Similar difficulties were seen in judicial attempts to apply good faith to open quantity contracts. Often this results in an inefficient reallocation of contractual risk. The subject doctrine is an inappropriate substitute for a contractual specification by the parties in such instances. Applying both of these good faith applications to the transaction costs model certainly verifies that the good faith efficiency criterion is unlikely to be satisfied.

A universal common law doctrine may not therefore be an appropriate means of maximising efficiency. Arguably, it is better to impose good faith or similar duties in those contractual relationships in which the dictates of efficiency require such obligations. Good faith should not be applied to contractual scenarios where it is not justified in economic terms. The prevailing piecemeal approach within New Zealand is

conceivably a better means of achieving economic efficiency than a universal doctrine of contractual good faith.

Chapter 6

International Considerations

6.1 Chapter Introduction:

The purpose of this chapter is to examine international factors which affect the debate as to the desirability of a universal doctrine of contractual good faith within New Zealand. Good faith in contract enjoys a far more open recognition outside of New Zealand law. Thus, there is an abundance of international resources which can be considered when appraising the good faith issue in respect of New Zealand.

Part 6.2 evaluates the argument for good faith based on the perceived need to harmonise the domestic law of contract in New Zealand with other overseas jurisdictions. The ostensible benefits of harmonisation and the existing pressures for this coordination of laws are explored. Part 6.3 describes the ability of contracting parties engaged in international exchange to select foreign jurisdictions as the governing law of their contract which expressly recognise good faith. Conceivably the case for adopting the subject doctrine within New Zealand is enhanced if contractors are prone to favouring jurisdictions which endorse good faith over jurisdictions which do not recognise a general good faith obligation. Part 6.4 analyses the United Nations Convention on Contracts for the International Sale of Goods. This international trade instrument overtly acknowledges good faith. It applies by default to New Zealand parties dealing with overseas counterparties under qualifying contracts. The application of good faith under the Convention may be of utility in evaluating whether good faith is appropriate for domestic New Zealand contract law. Part 6.5 engages in a study of the contractual doctrine of good faith within the United States. The suitability of employing the American experience of good faith as an exemplar for New Zealand is discussed. Similarly, the outstanding issues pertaining to the good faith obligation within the United States are explored. Part 6.6 summarises the foregoing findings.

6.2 Harmonisation of Law – A Justification for Good Faith?

The international community is overwhelmingly disposed to the recognition of an obligation of good faith in contract.¹ A common argument advanced in support of good faith is that New Zealand should achieve comity with other foreign jurisdictions which expressly acknowledge a good faith doctrine.² However, compelling reasons are needed to bring New Zealand law into line with the jurisdictions endorsing good faith. Change merely for the sake of consistency is not a valid justification in itself.³ The assumed benefits of harmonisation must therefore be explored.

6.2.1 Reasons for Harmonisation:

The primary argument for harmonisation of law is to better facilitate trade. It is generally thought that cross-border trade is enhanced by the convergence of national laws which affect international commercial transactions.⁴ Harmonisation reduces legal risk. Commercial trades between states which adopt similar laws will inevitably be viewed as more certain by those involved in the transaction. This means that less defensive expenditure is required. Exchanges between countries with similar laws are therefore more wealth maximising and consequently more attractive. Thus, harmonisation of law minimises divergences between levels of legal protection which may cause businesses

¹ Justice Edward Thomas, 'Good Faith in Contract: A Non-Sceptical Commentary' (2005) 11 *New Zealand Business Law Quarterly* 391, at 406.

² Ibid, at 407. See also Justice Paul Finn, 'Good Faith and Fair Dealing: Australia' (2005) 11 *New Zealand Business Law Quarterly* 378, at 388.

³ Ewan McKendrick, 'Good Faith: A Matter of Principle?' in Angelo Forte (ed), *Good Faith in Contract and Property Law* (1999), at 52.

⁴ See Arthur S Hartkamp, 'Modernisation and Harmonisation of Contract Law: Objectives, Method and Scope' (2003) 8 *Uniform Law Review* 81; Paul B Stephan, 'The Futility of Unification and International Harmonization in International Commercial Law' (1999) 39 *Virginia Journal of International Law* 743; Hugh Collins, 'Good Faith in European Contract Law' (1994) 14 *Oxford Journal of Legal Studies* 229, at 230. International trade has been described as the 'raison d'être of harmonization.': Hannu Honka, 'Harmonization of Contract Law Through International Trade: A Nordic Perspective' (1996) 11 *Tulane European and Civil Law Forum* 111, at 113.

and consumers to confine their transactions to those regulated by the law of the home state.⁵ Accordingly, harmonisation of law promotes cooperation between contractors within different countries.

Simply achieving harmonisation of law governing international trade may not be sufficient. Contract law regulating domestic contractual relationships may also need to be consistent between countries. This should facilitate foreign investment in businesses which trade on a domestic market. Similarly, foreign traders who enter into a national market will often be bound by the domestic laws of that forum. Indeed, empirical evidence confirms that capital investment is more likely to be attracted to a country where its economy is open to trade and domestic legal and regulatory institutions are stable and predictable.⁶

International coordination of laws also enhances legal administration. Harmonisation gives lawyers and judges an improved common endowment of specialised knowledge.⁷ Members of the legal fraternity within different states can more readily utilise information from transnational sources. Further, legal advice may be sought from more suppliers. This should increase competition in the marketplace for legal services.

However, there are counter arguments which can be made in relation to harmonisation. It has been recognised that regulatory diversity might enhance economic competition between legal systems. Goods and services are likely to be more competitively priced in

⁵ See Collins, above n 4, at 230.

⁶ For comprehensive empirical data see Charles I Jones, *Introduction to Economic Growth* (2nd ed, 2002), at 143. See also Michael Trebilcock and Jing Leng, 'The Role of Formal Contract Law and Enforcement in Economic Development' (2006) 92 *Virginia Law Review* 1517; Amanda Perry, 'Effective Legal Systems and Foreign Direct Investment: In Search of the Evidence' (2000) 49 *International and Comparative Law Quarterly* 779.

⁷ Stephan, above n 4, at 750. It has been recognised that harmonisation can lead to a functional comparative methodology which can improve the quality of judicial decision making. See Klaus Peter Berger, 'Harmonisation of European Contract Law: The Influence of Comparative Law' (2001) 50 *International and Comparative Law Quarterly* 877, at 889.

those domestic jurisdictions which impose fewer mandatory legal obligations and which promote contractual autonomy.⁸ Uniform laws would inhibit this potential for price competition. Similarly harmonised law could lead to a monopoly scenario which could limit efficient contractual regulation and the attainment of regulatory goals at the lowest possible cost.⁹

Harmonisation may also result in more rigid and all-encompassing legal rules. It is feared that this might compromise flexibility. In consequence, contracting parties could have to engage in more negotiations under harmonised law to give effect to their intentions. This becomes counterproductive at some point.¹⁰ Harmonisation therefore generates a trade-off in terms of flexibility.

It has further been contended that the assumed foreign trade benefits arising from harmonisation are overstated.¹¹ Certainly, the extent to which harmonisation has a positive effect on international exchange is unclear.¹² It is difficult to empirically measure the advantages of harmonisation or prove that synchronisation of law would improve welfare.¹³ Notably, some suggest that international contractual disputes can be settled without impediment from the difficulties associated with uncoordinated laws. Resolution is often achieved with reference to the agreement which the parties themselves have negotiated against a background of law which they select.¹⁴ Thus, certain commentators opine that harmonised contract law is not necessary and is unlikely to produce any significant benefit.

⁸ See Collins, above n 4, at 232.

⁹ See generally Joel P Trachtman, 'International Regulatory Competition, Externalization, and Jurisdiction' (1993) 34 *Harvard International Law Journal* 47, at 65.

¹⁰ See Stephan, above n 4, at 747.

¹¹ Hartkamp, above n 4, at 82.

¹² See E Allan Farnsworth, 'Modernization and Harmonization of Contract Law: An American Perspective' (2003) 8 *Uniform Law Review* 97, at 98.

¹³ Hartkamp, above n 4, at 82.

¹⁴ *Ibid.*

A further objection to harmonisation is that it is difficult to attain. Contract law is inherently complex. There are numerous divergences between countries in relation to the manner in which contracts are regulated. Thus, the time and effort required to synthesise domestic laws between countries could well outweigh the benefits. Further, the formulation of harmonised law inevitably requires compromise to reconcile inconsistent legal rules applying in different states. This compromise may often yield unclear and unpredictable results. Indeed, this has occurred in relation to the United Nations Convention on Contracts for the International Sale of Goods. This issue will be explored later in this chapter.

Despite these countervailing considerations, it appears the balance of opinion is that harmonisation is a desirable goal. The current pressure to achieve global harmonisation of law is significant. These pressures and the relevance to the good faith debate are explored below.

6.2.2 Existing Pressures for Harmonisation:

Pressure for harmonisation of contract law is stimulated by the current and ongoing phenomenon of globalisation. The number of countries engaged in extensive and sophisticated international trade is increasing. This has been facilitated by the advent of new technologies which have decreased the costs of international exchange. As a result, cross-border trade has become more desirable. These new technologies have also led to more knowledge based economies. These factors have fueled demand for full and free access to overseas markets.

It is envisaged that open exchange can be facilitated by consistent laws regulating trade and which avoid imposing artificial barriers to liberal exchange.¹⁵ Justice Paul Finn,

¹⁵ See Simon Fisher, 'International Influences Affecting Australian Commercial Law' (2000) 5 *International Trade and Business Law* 43, at 47. It has further been observed that the 'convergence of the ways business is being done in different countries and regions of the world is an almost automatic result of the globalization of deals and markets...In this context, the establishment of a legal environment that

speaking extra-curially, has suggested that the notion of globalisation and contractual good faith are strongly correlated:

Such now are the dimensions of international trade, international capital flows, and of globalisation more generally, that the processes of transnationalisation and internationalisation of contract law seem to me to be inexorable and irreversible. The harmonisation of contract laws is a central endeavour in this. Good faith and fair dealing are emerging as foundation concepts in the developments that have occurred so far.¹⁶

A corollary to the phenomenon of globalisation is the advent of more political and economic unions amongst states. These unions inevitably create pressure for harmonisation of laws. The European Union (“EU”) is perhaps the best example in respect of the good faith issue.

The European Community has its origins in the European Coal and Steel Community, the European Atomic Energy Community and the European Economic Community. A Merger Treaty adopted in 1965 vested control of these communities in a single council, commission and Court.¹⁷ The subsequent signing of the Maastricht Treaty by Member States in 1993 was a significant step towards promoting economic, monetary and political union. The document propounded, inter alia, the concept of European citizenship, free movement of persons, free movement of capital, economic integration and common rules on competition, taxation and commercial policy.

ensures conditions such as equal protection of intellectual property rights or globally reliable enforcement of foreign judgments is one of many steps necessary to disburden cross-border business interaction. A reliable contractual fixation of the relationship between two or more parties doing business with each other poses a crucial condition for the success of any such transaction.’: Lars Meyer, ‘Soft Law for Solid Contracts? A Comparative Analysis of the Value of the UNIDROIT Principles of International Commercial Contracts and the Principles of European Contract Law to the Process of Contract Law Harmonization’ (2006) 34 *Denver Journal of International Law and Policy* 119, at 120.

¹⁶ Finn, above n 2, at 388.

¹⁷ See Justice Michael Kirby and Philip A Joseph, ‘Trans-Tasman Relations – Towards 2000 and Beyond’ in Philip A Joseph (ed), *Essays on the Constitution* (1995), at 145.

The EU has taken steps towards achieving harmonisation of contract laws. It was noted in Chapter 1 that experts from Member States have drafted the Principles of European Contract Law (“PECL”) under the sanction of the European Commission (“EC”). It is intended that the PECL might form a uniform code amongst Member States. The PECL contain duties of contractual good faith. This is consistent with the fact that the majority of the Continental European countries employ good faith obligations within their domestic civil law.

In light of the potential for implementation of the PECL, there is a greater likelihood that the United Kingdom will, as a member of the EU, soon need to recognise universal good faith obligations within contract. Indeed, moves towards legal harmonisation within the EU have already led the United Kingdom to incorporate aspects of good faith into its domestic contract law. For example, this has occurred as a result of the EC Directive on Unfair Terms in Consumer Contracts (“the Directive”).¹⁸ A directive is issued by the EC and sets out a binding result to be achieved by Member States and the EU. However, each Member State is left to choose the form and method to give effect to a directive.¹⁹

The purpose of the Directive is to provide a minimum level of consumer protection in consumer contracts.²⁰ The Directive incorporates good faith within the definition of unfairness. The United Kingdom initially implemented the Directive through the Unfair Terms in Consumer Contracts Regulations 1994 which came into force on 1 July 1995. The 1994 Regulations were subsequently revoked and replaced by the Unfair Terms in Consumer Contracts Regulations 1999 (“UTCCR”) from 1 October 1999. The test for unfairness is set out in reg 5(1) which states:

A contractual term which has not been individually negotiated shall be regarded as unfair if, contrary to the requirement of good faith, it causes a significant imbalance in the parties' rights and obligations arising under the contract, to the detriment of the consumer.

¹⁸ Council Directive 93/13/EEC of 5 April 1993, OJEC L95/29.

¹⁹ See Fisher, above n 15, at 52.

²⁰ See Andrew Grubb and Michael Furmston (eds), *The Law of Contract* (1999), at 536.

The pressure for harmonisation of laws arising from the EU has therefore required the United Kingdom to directly confront notions of good faith in contract. The House of Lords considered the good faith concept under the UTCCR in *Director General of Fair Trading v First National Bank plc*.²¹ Lord Bingham appeared to adopt a positive outlook towards contractual good faith:

The member states have no common concept of fairness or good faith, and the directive does not purport to state the law of any single member state. It lays down a test to be applied, whatever their pre-existing law, by all member states...The requirement of good faith in this context is one of fair and open dealing. Openness requires that the terms should be expressed fully, clearly and legibly, containing no concealed pitfalls or traps. Appropriate prominence should be given to terms which might operate disadvantageously to the customer...Good faith in this context is not an artificial or technical concept; nor, since Lord Mansfield was its champion, is it a concept wholly unfamiliar to British lawyers. It looks to good standards of commercial morality and practice.²²

EC interventions involving contractual good faith have been largely confined to consumer contracts to date.²³ However, it has been asserted that the logic of harmonisation could equally apply to business contracts and especially standard form

²¹ [2002] 1 All ER 97. See also *The Office of Fair Trading v Foxtons Limited* [2008] EWHC 1662; *The Governors of the Peabody Trust v Reeve* [2008] EWHC 1432; *Heifer International Inc v Christiansen* [2007] EWHC 3015; *Picardi v Cuniberti* [2002] EWHC 2923.

²² *Ibid*, at 107 and 108.

²³ Within the United Kingdom, and in addition to the Unfair Terms in Consumer Contracts Regulations 1999, the Consumer Protection (Distance Selling) Regulations 2000 (which give effect to the EC Directive on Distance Contracts (Council Directive 97/7/EC of 20 May 1997, OJEC L144)) requires a supplier under a qualifying contract to provide information to a consumer 'with due regard in particular to the principles of good faith in commercial transactions.' Notions of good faith do however have some commercial application outside of consumer contracts. For example, the Commercial Agents (Council Directive) Regulations 1993 (which give effect to the EC Directive on Commercial Agency (Council Directive 86/653/EEC of 18 December 1986, OJEC L382)) requires commercial agents engaged in selling goods and their principals to act towards each other 'dutifully and in good faith.' Notwithstanding, it has been recognised that whilst 'there have been important developments over the last several decades in terms of what may be called EU contract law, few of these developments have catered for the business community.': Ole Lando, 'Principles of European Contract Law and UNDRIT Principles: Moving From Harmonisation to Unification' (2003) 8 *Uniform Law Review* 123, at 127.

business contracts.²⁴ Accordingly, lawyers and scholars within the United Kingdom are well aware of the pressures for harmonisation and the implications it may have for good faith. McKendrick opines:

Resistance to good faith and to the creation of an international or European contract law are likely to march hand in hand. But our ability to resist the incursion of good faith into English law is likely to be limited as a result of our membership with the European Union...In a global economy the pressure for an international or a European contract law is likely to increase and, in such a context, the traditional resistance of English law to the doctrine of good faith is unlikely to be able to withstand this onslaught. Sooner or later domestic objections are likely to give way to these international, largely economic, pressures.²⁵

Like the United Kingdom, New Zealand is also subject to pressure to harmonise its laws with foreign jurisdictions. Political and economic union is not presently a significant factor for New Zealand. However, New Zealand is involved in economic integration measures such as free trade areas. For example, the Australia-New Zealand Closer Economic Relations Trade Agreement (“CER”), which took effect retrospectively on 1 January 1983, has the objective of realising a single market concept in relation to trade between Australia and New Zealand.²⁶ CER embodies a commitment to harmonising Australian and New Zealand business laws. In *Dominion Rent A Car Ltd v Budget Rent A Car Systems (1970) Ltd* Cooke P emphasised the impact of such trade deals on the necessity for commonality of law between Australia and New Zealand:

With regard to [] the European Economic Community, while similar legally-enforceable rules are not in force between New Zealand and Australia, I think that the Courts of the two countries should be prepared as far as reasonably possible to recognise the progress that has been made towards a common market. From 1966 there was a very substantial increase in two-way trade under the New Zealand-Australia Free Trade Agreement (NAFTA) and this has been accelerated by the

²⁴ See Collins, above n 4, at 253.

²⁵ McKendrick, above n 3, at 53 and 54.

²⁶ See Kirby and Joseph, above n 17, at 136.

CER...[T]hese Agreements [] are part of a background which should influence the development of the common law in Australasia.²⁷

It might be reasoned that the case for good faith within Australasia is not strong because neither the final appellate courts of New Zealand or Australia have recognised a universal good faith doctrine. New Zealand and Australia could therefore harmonise their contract laws without good faith. However, New Zealand subscribes to wider trade agreements whose signatories include states expressly acknowledging good faith. The concept of Asia Pacific Economic Cooperation (“APEC”) is an example. APEC was established in 1989. Its purpose is to reduce barriers to international trade and move towards an integrated regional market.²⁸ Certain of the 21 members overtly employ good faith in contract law. The two most significant are the United States and China.²⁹

It is notable that many of the major trading partners of New Zealand recognise good faith as an element of their contract law. For example, the United States and the European Union comprised approximately 12 per cent and 16 per cent respectively of all of the merchandise exports and imports of New Zealand in 2007.³⁰ China is also a rapidly expanding market for New Zealand. It was the fourth largest export destination for New Zealand in 2007. Imports from China rose by 18.7 per cent in the same year.

Accordingly, it is arguable that there is a *prima facie* case for good faith in New Zealand based on the desire for harmonisation. As was noted above, the primary goal of coordinating laws is to facilitate trade. It is fundamental that the New Zealand economy is heavily dependent on international exchange. Thus, in *Attorney-General v Mobil Oil*

²⁷ [1987] 2 NZLR 395, at 407.

²⁸ See Kirby and Joseph, above n 17, at 144.

²⁹ Contractual good faith in the United States is discussed below. Article 6 of the new Contract Law of the People’s Republic of China (promulgated in the Second Session of the Ninth National People’s Congress on 15 March 1999) states that the ‘parties shall abide by the principle of honesty and good faith in exercising their rights and performing their obligations.’

³⁰ Statistics available from <<http://www.stats.govt.nz/products-and-services/ext-trade-stats/key-points-december-2007.htm?print=Y>>, at 28 August 2008.

NZ Ltd Heron J recognised that international trade and associated commercial relationships are of critical importance within a small country such as New Zealand.³¹ New Zealand should therefore strive to develop contract laws which promote foreign trade. Seemingly, this may now entail adoption of the subject doctrine.

It appears that the New Zealand courts are well aware of the need to achieve consistency with foreign domestic law. For example, in *Attorney-General v Dreux Holdings Ltd*³² the Court of Appeal considered whether evidence of the conduct of parties after the making of a contract should be admissible to construe it. The Court cited the approach in the United States and Canada which both permit such evidence to be adduced. Notwithstanding that the issue was left open, the Court recognised that New Zealand domestic contract law should generally remain consistent with best international practice.³³ The matter again arose in *Gibbons Holdings Ltd v Wholesale Distributors Ltd*³⁴ where the Supreme Court determined that the subsequent joint conduct of the parties could be admissible in order to ascertain the mutual intention of the parties.³⁵ Tipping J repeated the views of the Court of Appeal in *Dreux*, noting that the finding accorded ‘with general international trade practice.’³⁶

It is also likely that the fate of good faith within New Zealand contract law will be strongly linked to the English approach. The pressures felt by England from the EU may well reverberate to Australasia. The law of contract within New Zealand has generally remained consistent with English law with the exception of certain legislative enactments. Undoubtedly there is a greater willingness for New Zealand courts to depart

³¹ [1989] 2 NZLR 649, at 668.

³² (1996) 7 TCLR 617.

³³ *Ibid*, at 627 per Blanchard J. See also David McLauchlan, ‘Subsequent Conduct and Contract Interpretation: An Update’ (1997) 3 *New Zealand Business Law Quarterly* 147.

³⁴ [2008] 1 NZLR 277.

³⁵ Blanchard J reserved his Honour’s position on the issue.

³⁶ [2008] 1 NZLR 277, at 295.

from English authority which is regarded as unsound.³⁷ Differences in local conditions have also been regarded as reason to part ways from English law.³⁸ Notwithstanding, such divergences have not frequently been seen in New Zealand within the realm of contract law. Thus, in *Yoshimoto v Canterbury Golf International Ltd* Thomas J recognised that, being realistic, the law of contract in New Zealand is likely to remain the law of England.³⁹ Accordingly, if England was to incorporate a common law doctrine of contractual good faith there would be a strong argument for the New Zealand courts to follow suit. It would be an odd result for the Antipodean Commonwealth countries to take a position inconsistent with the other legal jurisdictions of the developed world.

However, it should be noted that good faith is more likely to be incorporated into English law by the legislature under EU influence rather than the courts. Were this to occur then seemingly the issue of whether New Zealand would also adopt good faith might properly be a matter for Parliament rather than the judiciary.

Despite the identified influences tending towards harmonisation of law, it is arguable that such synchronisation may not necessarily entail importing an express doctrine of good faith within New Zealand law. Harmonisation of laws may assume differing degrees of intensity.⁴⁰ Absolute replication of foreign law would constitute the most extreme form of harmonisation. However, it has been suggested that a degree of harmonisation can be achieved by less exacting means. Thus, harmonisation may entail achieving only ‘approximation’ with foreign law.⁴¹ Accordingly, harmonisation of New Zealand law with Continental Europe and the United States may be attained by less drastic measures

³⁷ See Sir Robin Cooke, ‘The New Zealand National Legal Identity’ (1987) 3 *Canterbury Law Review* 171; John Farrar, ‘Closer Economic Relations and Harmonisation of Law Between Australia and New Zealand’ in Joseph (ed), above n 17, at 158.

³⁸ See for example *Invercargill City Council v Hamlin* [1996] 1 NZLR 513.

³⁹ [2001] 1 NZLR 523, at 548.

⁴⁰ Farrar, above n 37, at 168. See also Andrzej Calus, ‘Modernisation and Harmonisation of Contract Law: Focus on Selected Issues’ (2003) 8 *Uniform Law Review* 155.

⁴¹ Ibid. See also Louis F Del Duca, ‘Teachings Of The European Community Experience For Developing Regional Organizations’ (1993) 11 *Dick Journal of International Law* 485, at 505.

than overtly recognising a doctrine of contractual good faith. Provided New Zealand law produces substantially the same outcomes which are achieved in jurisdictions recognising good faith, then this may be sufficient. The ends rather than the means is arguably the more critical factor. After all, the goal of harmonisation is not to achieve absolute uniformity but instead to reduce or eliminate identified impediments to international trade and investment. Ultimately however, it is unclear whether the anticipated benefits of harmonisation could be achieved without openly adopting a good faith doctrine in New Zealand.

6.2.3 Précis:

It is generally accepted that harmonisation of law between states is a desirable goal. New Zealand is particularly dependent on foreign trade and therefore needs to ensure that its domestic laws are such as to eliminate impediments to foreign exchange and investment. The phenomenon of globalisation and the advent of more political and economic unions and free trade arrangements have significantly increased the case for harmonisation of laws. Accordingly, England and the Commonwealth common law countries are now faced with strong pressures to endorse contractual good faith in order to achieve consistency with the majority of the legal jurisdictions in the developed world.

6.3 Choice of Law in International Commercial Contracts:

Despite the Anglo-Antipodean common law countries not yet adopting a general good faith obligation, it is possible that parties engaged in international contracting from those jurisdictions may be subject to the laws of a state recognising good faith. Contracting parties might be favouring legal forums which endorse contractual good faith. The case for the adoption of the subject doctrine in domestic New Zealand law is conceivably enhanced if this occurs in practice. The following section will therefore discuss the ability of contracting parties to select jurisdictions recognising contractual good faith as the governing law of their contract.

6.3.1 Choice of Law Rules:

Choice of law rules and conflict of laws is a complex and specialist field. It is not the function of this thesis to consider these matters in depth. The intention of the following analysis is to identify the extent to which contracting parties can elect to have their contract governed by a jurisdiction incorporating good faith and the circumstances in which foreign law will be deemed to apply by the courts.

As a general rule, the common law courts allow contracting parties to choose an unrelated jurisdiction as the governing law of their contract. The principle was illustrated in *Vita Food Products Inc v Unus Shipping Co Ltd (in Liquidation)*.⁴² Vita Food carried on business in New York. It was the consignee of a cargo of herrings to be carried from Newfoundland. The ship was owned by Unus and was registered in Nova Scotia. It ran ashore on route due to the negligence of the captain. The cargo was salvaged but delivered in a damaged condition to Vita Food which thereupon sued Unus for the loss. The bills of lading were expressed to be governed by English law. The Privy Council held that the words of the bills were to be given effect such that English law would apply. Lord Wright recognised that a court must look to the intention of the parties to determine the governing law. That intention could be ascertained from the words of the agreement and the surrounding circumstances.⁴³ Their Lordships did however qualify this view by recognising that the choice of law must be *bona fide*, legal and there must be no reason to avoid the choice on the grounds of public policy.⁴⁴ The fact that the parties had no apparent connection with English law was no reason to override the intention of the parties. It was recognised that contracting parties may reasonably desire that the familiar principles of English law apply. Indeed, their Lordships recognised that such an election

⁴² [1939] 1 All ER 513. The principles emanating from the decision have since been altered by legislation in a number of countries. However, the case still stands for the proposition that an express choice of law within a contract is fundamental in determining the appropriate governing law. See William Tetley, 'Vita Food Products Revisited (Which Parts of the Decision are Good Law Today?)' (1992) 37 *McGill Law Journal* 291, at 315.

⁴³ *Ibid*, at 521.

⁴⁴ *Ibid*.

is commonplace.⁴⁵ As a result, it was held that *Unus* was entitled to rely on the words of the bills which exempted it from liability due to loss from negligence. English law permitted such an exclusion.

A similar approach to that taken in *Vita Food* has been adopted in New Zealand.⁴⁶ The test that has traditionally been applied in New Zealand to identify the governing law of a contract is that outlined by Dicey and Morris:

The term proper law of a contract means the system of law by which the parties intended the contract to be governed, or, where their intention is neither expressed nor to be inferred from the circumstances, the system of law with which the transaction has its closest and most real connection.⁴⁷

This approach accords closely with the 1980 Rome Convention which applies to Member States of the EU.⁴⁸ Article 3(1) contemplates that contracting parties can chose a governing law. There is no qualification that the chosen law must be related to the contract. Article 4(1) requires application of the law of the country with which the contract is most closely connected in the event that the parties have not made a choice.

⁴⁵ Ibid.

⁴⁶ *Advanced Cardiovascular Systems Inc v Universal Specialties Ltd* [1997] 1 NZLR 186; *Apple Computer Inc v Apple Corps SA* [1990] 2 NZLR 598. For the corresponding Australian approach see *Oceanic Sun Line Special Shipping Co Inc v Fay* (1988) 79 ALR 9, at 28 per Brennan J. For a comprehensive discussion of choice of law rules see Laurete Barnard, 'Choice of Law in International Contracts – The Objective Proper Law Reconsidered' (1996) 2 *New Zealand Business Law Quarterly* 27; Kelvin F K Low, 'Choice of Law in Formation of Contracts' (2004) 20 *Journal of Contract Law* 167.

⁴⁷ A V Dicey and J H C Morris, *Dicey and Morris on the Conflict of Laws* (10th ed, 1980), at 747. Subsequent editions refer to the 1980 Rome Convention (discussed below) to which New Zealand cannot be a signatory. See also Richard J Howarth, 'Lex Mercatoria: Can General Principles of Law Govern International Commercial Contracts?' (2004) 10 *Canterbury Law Review* 36, at 37.

⁴⁸ The Convention on the Law Applicable to Contractual Obligations opened for signature in Rome on 19 June 1980. It was enacted by the United Kingdom under the Contracts (Applicable Law) Act 1990. For a discussion of choice of law under the Rome Convention see Jonathan Hill, 'Choice of Law Under the Rome Convention: The Approach of the UK Courts' (2004) 53 *International and Comparative Law Quarterly* 325; Murat Metin Hakki, 'Choice of Law, Contracts and the EC's 1980 Rome Convention – A Re-Evaluation in the 21st Century' [2003] *Australian International Law Journal* 156.

6.3.2 Choice of Law and Good Faith:

The choice of law rules within New Zealand therefore permit parties to an international contract to choose a governing legal system which employs the concept of good faith. Indeed, it is possible that contracting parties may select the foreign law for that particular reason.⁴⁹ In consequence, a New Zealand court may potentially be required to apply foreign concepts of contractual good faith in order to give effect to the governing law which the contracting parties nominate.

Apparently this situation has not yet arisen in New Zealand. It did however occur in an English court in *The Eleftheria*.⁵⁰ The Greek defendants were the owners of the vessel. They entered into bills of lading with the plaintiffs, whose offices were stated to be in Hull, Newcastle upon Tyne and Liverpool. The defendants discharged the cargo of the plaintiffs in Rotterdam instead of the agreed destination of Hull. The defendants cited labour troubles at the Hull docks as the reason for its actions. The bills of lading permitted the defendants to unload at an alternative port if there were labour obstructions at the specified port. The plaintiffs were dissatisfied with the election made by the defendants and sued in an English court to recover the cost of on-carriage from Rotterdam to Hull. The defendants refused to pay and asserted that they had validly discharged the contract. The bills of lading expressly stated that the law of the country in which the carrier had its principal place of business would apply. This was Greece. Consequently, an issue arose as to whether the defendants had exercised their contractual right in accordance with art 281 of the Greek Civil Code, *Astikos Kodix*. This precludes the exercise of a contractual right if the exercise of that right would manifestly exceed the limits which are imposed by, inter alia, good faith. Brandon J accepted that an English court would be competent to resolve issues relating to good faith:

⁴⁹ See Elsabe Schoeman, 'Good Faith in Conflict(s): The International Commercial Contract Dimension' (2005) 11 *New Zealand Business Law Quarterly* 446, at 450.

⁵⁰ [1969] 1 Lloyd's Rep 237. For a discussion of the case see Lawrence Collins, 'Arbitration Clauses and Forum Selecting Clauses in the Conflict of Laws: Some Recent Developments in England' (1971) 2 *Journal of Maritime Law and Commerce* 363, at 370-376.

I recognize that an English Court can, and often does, decide questions of foreign law on the basis of expert evidence from foreign lawyers. Nor do I regard such legal concepts as contractual good faith and morality as being so strange as to be beyond the capacity of an English Court to grasp and apply.⁵¹

Despite making these observations, Brandon J granted a stay of proceedings in England recognising that the issue should be resolved by a Greek court. In support of this decision, his Honour took cognisance of the advantage which a foreign court has in determining and applying its own law. Moreover, a question of foreign law decided by an English court on expert evidence is a question of fact. Thus, any appeal relating to such issues would be on the basis of an error of fact rather than an error of law. Appellate courts are more reluctant to displace the factual findings of trial judges. Accordingly, it was most appropriate that the legal issues be determined in Greece in order to ensure that justice was done. Notwithstanding, the case evidences that common law courts may be required to apply general obligations of contractual good faith in certain circumstances.

The New Zealand approach relating to proof of foreign law is similar to that outlined by Brandon J. In the event that contracting parties are to rely on a foreign concept of good faith within a New Zealand forum, that foreign law must be proved as a fact by way of expert evidence to the satisfaction of the judge.⁵² Where the foreign law is not adequately proved, a New Zealand court will generally resort to applying New Zealand law.⁵³

As a result of the prevailing choice of law rules within New Zealand, a domestic party to an international contract may elect to be bound by foreign jurisdictions imposing good faith obligations. Conceivably, the case for harmonisation and the adoption of contractual good faith within domestic law in Anglo-Antipodean countries is stronger if parties to international contracts favour jurisdictions with good faith over jurisdictions without good faith. If contracting parties are voluntarily choosing good faith then arguably its

⁵¹ Ibid, at 246.

⁵² *Mount Cook (Northland) Ltd v Swedish Motors Ltd* [1986] 1 NZLR 720.

⁵³ Ibid. See also *Koops v Den Blanken* [1998] NZFLR 891.

express recognition is more warranted. It is outside the bounds of this thesis to undertake empirical analysis relating to this issue. Indeed, it would be difficult to isolate any trend to demonstrate that certain jurisdictions are favoured over others by contracting parties on account of the recognition or non-recognition of contractual good faith.

It is however notable that parties engaged in cross-border exchange do continue to select jurisdictions which do not expressly recognise good faith. A glance at the English law reports reveals that many parties who have no connection with England select it as the governing law of their contract.⁵⁴ A recent survey of 175 firms in eight Member States of the EU reveals that English law is likely to be chosen as the governing law of a contract approximately two and a half times more frequently than any other law.⁵⁵ The fact that international trading parties continue to voluntarily select England as the governing jurisdiction may imply that the existence of contractual good faith is not a necessity for foreign exchange. Indeed, it has been suggested that London is a well-established commercial centre and the fact that commercial parties choose English law is evidence that it is suited to the regulation of commercial relationships.⁵⁶

Maintenance of the status quo, and therefore rejection of the subject doctrine, may be justified if contracting parties continue to opt for the English jurisdiction because of the quality of its substantive law. Commercial parties may favour England precisely because it does not give wide discretionary powers to courts and arbitrators via a good faith

⁵⁴ See McKendrick, above n 3, at 52; Roy Goode, 'The Concept of Good Faith in English Law' *Centro di Studi e Ricerche di Diritto Comparato e Straniero* (1992), at 6 <<http://w3.uniroma1.it/idc/centro/publications/02goode.pdf>>, at 14 September 2008. The authors do not produce any empirical evidence to support the contention.

⁵⁵ Stefan Vogenauer and Stephen Weatherill, 'The European Community's Competence to Pursue the Harmonisation of Contract Law – an Empirical Contribution to the Debate' in Stefan Vogenauer and Stephen Weatherill (eds), *The Harmonisation of European Contract Law* (2006), at 121.

⁵⁶ McKendrick, above n 3, at 53. For example, it has been noted that 'parties to a dispute may choose English Maritime Law based on its completeness and sophistication.': Vitek Danilowicz, 'The Choice of Applicable Law in International Arbitration' (1986) 9 *Hastings International and Comparative Law Review* 235, at 242.

principle.⁵⁷ Indeed, it has been reasoned that predictability of legal outcome is more important than absolute justice in a commercial context.⁵⁸ It is necessary that businessmen and businesswomen know where they stand. This is particularly so in international exchange transactions which inherently involve large sums of money and significant risk.⁵⁹ Goode therefore opines:

The last thing that we want to do is to drive business away by vague concepts of fairness which make judicial decisions unpredictable, and if that means that the outcome of disputes is sometimes hard on a party we regard that as an acceptable price to pay in the interest of the great majority of business litigants.⁶⁰

Accordingly, it might be reasoned that there is no justification for New Zealand or her larger Commonwealth counterparts to adopt good faith solely on the basis of achieving comity. The common law jurisdictions which do not subscribe to good faith have been perfectly able to compete in the international marketplace. Certainly, there is no proven statistical evidence to suggest that the common law countries would gain any significant benefit by adopting good faith. On the contrary, there are indications that English law continues to be regarded as a suitable forum for the regulation of commercial contracts.

⁵⁷ Ibid. It has been argued that the 'Commercial Court works on something of a chicken-and-egg principle: if it gives its clientele what they want, they will come in goodly numbers...[B]usinesses from France, The Netherlands, Germany, Egypt, Russia and practically every other jurisdiction under the sun [are] flocking to London...[O]ne can be confident that they wouldn't continue to come unless English contract law, as administered by the Commercial Court and the professional arbitrators, was to their liking. Quite often all the parties to a dispute are foreign; and sometimes we even have a buyer and seller or a shipowner and charterer who are based in the same country overseas, litigating in London...[I]n every case they have voted with their choice of law clauses to contract under the mantle of English law. I believe that it is no coincidence that this is a law which, more than any other, puts the autonomy of the parties and the qualities of certainty and predictability ahead of any other consideration, and allows its Judges minimal scope for discretionary intervention in the name of equity, good faith, fairness, unconscionability or anything similar.' Len Sealy, 'Ties That Bind: Security of Contract in England at the End of the 20th Century' (2000) 6 *New Zealand Business Law Quarterly* 134, at 136-137 (citations omitted).

⁵⁸ See Goode, above n 54, at 6.

⁵⁹ Schoeman, above n 49, at 452.

⁶⁰ Goode, above n 54, at 7.

England may lose this ostensible comparative advantage if it were to adopt contractual good faith. Commercial parties would have less incentive to select English law as the governing law of their contracts.

6.3.3 Précis:

Choice of law rules imply that New Zealand courts may be required to apply foreign concepts of contractual good faith. Parties may also voluntarily elect to have their contract governed by foreign principles of good faith. The argument for harmonisation becomes stronger if this were to frequently occur in New Zealand. There is however no demonstrable evidence to establish that jurisdictions recognising contractual good faith are favoured by contracting parties. If anything, England is a preferred jurisdiction for commercial parties and it might be inferred that this is because it does not endorse general discretionary principles such as good faith.

6.4 Good Faith and the United Nations Convention on Contracts for the International Sale of Goods:

Some meaningful guidance for the good faith debate may conceivably be derived from international instruments in place recognising good faith and which parties can elect to govern their international contracts or which may govern their contracts by default. The treatment of such instruments by New Zealand parties may give an indication of the necessity for good faith in international trade and the likely response to contractual good faith within domestic law. This section will evaluate one of those instruments, namely the United Nations Convention on Contracts for the International Sale of Goods (“CISG”).

6.4.1 Background to the CISG:

Steps taken towards a unification of the law of international sales dates back to 1929.⁶¹ In that year, the International Institute for the Unification of Private Law (“UNIDROIT”) appointed a committee to undertake preparatory studies. The work was subsequently interrupted by the Second World War. However, after numerous drafts, two conventions were eventually adopted at a conference at the Hague in 1964. The first was the Uniform Law of International Sale (“ULIS”). The second was the Uniform Law on the Formation of Contracts for the International Sale of Goods (“ULFC”). Both entered into force in 1972.

The United Nations Commission on International Trade Law (“UNCITRAL”) was established in 1966.⁶² It was tasked with promoting the progressive harmonisation and unification of law in international trade. This required the coordination of the work of organisations active in the field. UNCITRAL soon discovered that the ULIS and ULFC did not have widespread support. In particular, the ULIS was perceived to be too long and too complicated.⁶³ Although the United Kingdom ratified ULIS, the enabling mechanism required contracting parties to adopt ULIS as the governing law of their contract. There were no reported British cases where the parties had elected to do so.⁶⁴ Consequently, UNCITRAL tasked a working group to ascertain whether modifications might enhance the likelihood of the conventions being adopted. It submitted revised drafts in 1976 and the conventions were amalgamated in 1977.

⁶¹ See Michael Joachim Bonell, ‘Introduction to the Convention’ in Cesare Massimo Bianca and Michael Joachim Bonell (eds), *Commentary on the International Sales Law: The 1980 Vienna Sales Convention* (1987), at 3.

⁶² Ibid, at 5.

⁶³ There were forewarnings of these problems. See John Honnold, ‘The Uniform Law for the International Sale of Goods: The Hague Convention of 1964’ (1965) 30 *Law and Contemporary Problems* 326.

⁶⁴ See Jacob S Ziegel, ‘The Future of the International Sales Convention from a Common Law Perspective’ (2000) 6 *New Zealand Business Law Quarterly* 336, at 337.

The United Nations Conference on Contracts for the International Sale of Goods was held in Vienna in April and March of 1980. It was attended by representatives of 62 states and eight international organisations. The Convention on Contracts for the International Sale of Goods was signed at the conference. The CISG is otherwise known as the Vienna Convention. It received the requisite 10 ratifications by 11 December 1986⁶⁵ and came into force in 1988.

The purpose of the CISG is to implement a universal regime for international sales contracts. Its objective is to offer rules which are more suited to international trade rather than domestic trade.⁶⁶ Accordingly, the CISG is intended to overcome divergences in domestic law that might otherwise act as an obstacle in the development of exchange between states.⁶⁷

The CISG has been adopted by approximately 70 countries.⁶⁸ This figure includes most of the countries of the EU and a number of Eastern European countries. The North American Free Trade Area (“NAFTA”) states have implemented it, as have some South American countries. China, Singapore and Australia have also given effect to the CISG.

New Zealand has followed the trend and has adopted the CISG through the Sale of Goods (United Nations) Convention Act 1994 (“SOGUNCA”). The SOGUNCA came into force on 1 October 1995 and gives the articles of the CISG the force of law in New Zealand.⁶⁹

⁶⁵ See Bonell, above n 61, at 7.

⁶⁶ Ibid, at 9.

⁶⁷ See Alexander S Komarov, ‘Internationality, Uniformity and Observance of Good Faith as Criteria in Interpretation of CISG: Some Remarks on Article 7(1)’ (2005) 25 *Journal of Law and Commerce* 75.

⁶⁸ See Michael Bridge, *The International Sale of Goods: Law and Practice* (2nd ed, 2007), at 505.

⁶⁹ Section 4 Sale of Goods (United Nations Convention) Act 1994. For a commentary advocating the adoption of the United Nations Convention on Contracts for the International Sale of Goods within New Zealand see C C Nicoll, ‘The United Nations Convention on Contracts for the International Sale of Goods: The Vienna Sales Convention 1980’ [1993] *New Zealand Law Journal* 305.

Further, the articles of the CISG effectively override domestic New Zealand law in relation to contracts to which the articles apply.⁷⁰

Article 1 provides that the provisions of the CISG will apply to a contract for the sale of goods where the parties have places of business in different states and those states have adopted the CISG or the rules of private international law lead to the application of the law of a state which has adopted the CISG.

The CISG contains preliminary general provisions and articles relating to: the formation of the contract; obligations of the seller; obligations of the buyer; matters common to the obligations of the seller and the buyer and; preservation of goods. There are also concluding provisions. Article 2 precludes the application of the CISG to consumer contracts and contracts involving the sale of securities, ships, vessels, hovercraft, aircraft and electricity.

Court decisions and arbitral awards relating to CISG are now being collected and disseminated as part of the case law on UNCITRAL texts (“CLOUT”). This phenomenon is reflective of the growth in infrastructure supporting the CISG since the late 1990s.⁷¹ The decisions collated in CLOUT are intended to enable judges, arbitrators, lawyers and contracting parties to reach a common understanding of the interpretation and application of the CISG. The system therefore serves to facilitate international uniformity in the implementation of the CISG. There are now over 1000 abstracts of decisions and awards on CLOUT.⁷² Several hundred of these relate to the interpretation of the CISG.⁷³ Alternative case databases have also been developed. Arguably the most comprehensive and up to date is that database operated by the Pace University Law School.⁷⁴

⁷⁰ Section 5 Sale of Goods (United Nations Convention) Act 1994.

⁷¹ See Luke Nottage, ‘Who’s Afraid of the Vienna Sales Convention (CISG)? A New Zealander’s View from Australia and Japan’ (2005) 36 *Victoria University of Wellington Law Review* 815, at 837.

⁷² *Ibid*, at 827.

⁷³ See Komarov, above n 67, at 80.

⁷⁴ See Henning Lutz, ‘The CISG and the Common Law Courts: Is there Really a Problem?’ (2004) 35 *Victoria University of Wellington Law Review* 711, at 714.

6.4.2 Good Faith and Interpretation of the CISG:

Good faith appears within art 7 of the CISG which is part of the general provisions. This is the only reference to the concept within all of the CISG. Nonetheless, art 7 is of fundamental importance. The relevant part provides:

- (1) In the interpretation of this Convention, regard is to be had to its international character and to the need to promote uniformity in its application and the observance of good faith in international trade.

The inclusion of a reference to good faith was one of the most challenging problems faced by the drafters of the CISG.⁷⁵ The issue created a division of opinion largely between the civil law delegates and the common law delegates. The former apparently would have preferred a provision directly imposing an obligation on the parties to act in good faith.⁷⁶ The latter were generally opposed to any explicit reference to good faith.⁷⁷ The finalised version of art 7(1) represents the compromise that was ultimately reached.

Ironically, the interpretation provision has itself become the subject of debate as to its meaning. This is no surprise in light of its ambiguity. It seems relatively clear that reference to the international character of the CISG is intended to indicate that the articles should not be interpreted with reference to domestic law.⁷⁸ Courts should avoid domestic preoccupations and must examine the manner in which courts in other jurisdictions interpret the articles.⁷⁹ The ambiguity relating to art 7(1) is therefore centered primarily around the reference to good faith. There are essentially two competing schools of thought relating to the interpretation of the good faith provision.

⁷⁵ See Elena Christine Zaccaria, 'The Dilemma of Good Faith in International Commercial Trade' (2004) 1 *Macquarie Journal of Business Law* 101, at 104.

⁷⁶ See Michael Joachim Bonell, 'Interpretation of the Convention' in Bianca and Bonell (eds), above n 61, at 83.

⁷⁷ *Ibid*, at 84.

⁷⁸ See Bruno Zeller, 'Good Faith – The Scarlet Pimpernel of the CISG' (2001) 6 *International Trade and Business Law* 227.

⁷⁹ See Bridge, above n 68, at 505.

One theory propounds that good faith should be narrowly construed. Good faith is a mere instrument for the interpretation of the CISG.⁸⁰ To allow a duty of good faith in through the back door would be a pervasion of the compromise that was reached between the drafters.⁸¹ Thus, art 7(1) does not impose an obligation on the parties to act in good faith. This view was endorsed in the International Chamber of Commerce Arbitral Award No 8611 of 1997 where it was recognised that because art 7(1) concerns only the interpretation of the CISG, ‘no collateral obligation may be derived from the promotion of good faith.’⁸²

The converse school of thought is that the principle of good faith must have a strong impact on the behaviour of the parties. It is not possible to interpret the articles of the CISG without affecting the manner in which the contracting parties are required to carry out their contract. Thus, the principle of good faith is not only directed towards judges and arbiters but also the parties to each individual contract of sale.⁸³ Because good faith cannot exist in a vacuum, it must impose a standard of behaviour to be maintained throughout the life of the agreement.⁸⁴ This approach is more synonymous with the attitude of civilian lawyers rather than lawyers practicing in common law jurisdictions. Whereas the common law draws a distinction between implied terms and interpretation, some Continental lawyers tend to treat these issues as one.⁸⁵

⁸⁰ E Allan Farnsworth, ‘Duties of Good Faith and Fair Dealing Under the UNIDROIT Principles, Relevant International Conventions, and National Laws’ (1995) 3 *Tulane Journal of International and Comparative Law* 47, at 56.

⁸¹ Ibid,

⁸² <<http://cisgw3.law.pace.edu/cases/978611i1.html>>, at 16 September 2008. See also Bridge, above n 68, at 534.

⁸³ See Bonell, above n 76, at 84.

⁸⁴ See Phanesh Koneru, ‘The International Interpretation of the UN Convention on Contracts for the International Sale of Goods: An Approach Based on General Principles’ (1997) 6 *Minnesota Journal of Global Trade* 105, at 140.

⁸⁵ See Bridge, above n 68, at 531. It has been recognised that the style of drafting is more akin to the civilian approach than a common law approach. See Duncan Webb, ‘A New Set of Rules for International Sales’ [1995] *New Zealand Law Journal* 85, at 87.

The more expansive approach was adopted in *Dulces Luisi SA de CV v Seoul International Co Ltd* where it was said that the effect of art 7(1) is that ‘parties must act in good faith and deal fairly throughout their contractual relations.’⁸⁶ However, the fact that parties must act in good faith cannot logically be perceived as a completely independent duty. No remedies flow from the good faith principle.⁸⁷ Accordingly, a failure to act in good faith will only have practical significance if it leads to a conclusion that the specific articles of the CISG have been contravened.

The competing schools of thought evidence the difficulty presented by universal law aimed at satisfying the conflicting requirements of different legal systems. In some instances the compromises required to redress divergences in domestic law between countries cannot realistically be codified.⁸⁸ Article 7(1) is perhaps the paradigm example of this phenomenon. The drafters have sought refuge in vague and obfuscatory language.⁸⁹

Notably, a pragmatic solution was adopted by the drafters to resolve the conflict between the common law and civil law jurisdictions with respect to the availability of specific performance as a primary remedy for breach. Whereas the right to specific performance is endorsed in many civil law systems, the common law generally regards specific performance in the context of sale contracts as an exceptional remedy. Article 28 resolves this discrepancy by stating that a court is not obliged to award specific performance unless the Court would do so under its own law. The willingness of the drafters to resort to such a pragmatic article is understandable. Nonetheless, art 28 appears to completely undermine the tenet of uniformity which the CISG is designed to promote. A

⁸⁶ < <http://cisgw3.law.pace.edu/cases/981130m1.html>>, at 16 September 2008.

⁸⁷ Zeller, above n 78, at 238.

⁸⁸ Howarth, above n 47, at 52.

⁸⁹ Ziegel, above n 64, at 339. See also Gyula Eörsi, ‘Problems of Unifying Law on the Formation of Contracts for the International Sale of Goods’ (1979) 27 *American Journal of Comparative Law* 311, at 323.

corresponding provision whereby contracting parties would only be required to observe standards good faith if domestic law expressly required such an obligation would no doubt give rise to anomalous results.

Ultimately, it appears that the more expansive approach to good faith will inevitably dominate. Even common law lawyers and opponents of good faith are willing to concede this point. Bridge notes:

It can fairly be predicted that some national courts will interpret this provision more broadly than others. Some courts might be prepared to spell out a general duty of good faith from the remaining provisions of the CISG...There are difficulties of interpretation here. Given that an explicit standard of good faith and fair dealing was rejected by the conference delegates, does this mean that the standard itself was rejected as a general principle or only that express mention of the standard was rejected? The latter approach is likely to gain the ascendancy.⁹⁰

That conclusion is also enhanced by the relationship between the CISG and the UNIDROIT Principles of International Commercial Contracts (“UNIDROIT Principles”). The UNIDROIT Principles were first published in May 1994. They set out relevant principles relating to the formation, validity, interpretation and performance of international contracts.⁹¹ The UNIDROIT Principles are proffered for use by contracting parties and arbitrators⁹² and apply to all categories of contract unlike the CISG which is confined to sales. Article 1.7 of the UNIDROIT Principles contains an express reference to a duty of good faith and fair dealing. Thus, an obligation of good faith may be imported into the CISG to the extent that the UNIDROIT principles may have a part to play in filling any gaps in the CISG. The UNIDROIT Principles may supplement the CISG due to the silence of the latter as to an express duty of good faith. This outcome is ostensibly supported by the recognition of good faith within art 7(1).

⁹⁰ Bridge, above n 68, at 535.

⁹¹ See generally Hans van Houtte, ‘The UNIDROIT Principles of International Commercial Contracts’ (1996) 2 *International Trade and Business Law Journal* 1; David A R Williams, ‘The Further Development of International Commercial Arbitration through Unidroit Principles of International Commercial Contracts’ (1996) 2 *New Zealand Business Law Quarterly* 7.

⁹² See Bridge, above n 68, at 15.

In addition to the uncertainty surrounding the effect of art 7(1), there is also significant disagreement as to the meaning of good faith. This ambiguity of meaning is a natural corollary of the fact that the principle of good faith differs greatly in content within different jurisdictions.⁹³ It has been opined that the notion of good faith may not be applied according to standards adopted within different legal systems.⁹⁴ Thus, in *Dulces Luisi* the deciding Mexican body recognised that ‘good faith must be interpreted internationally without resorting to its meaning under Mexican law.’⁹⁵

Alternatively, it has been argued that standards and meanings of good faith in domestic law may be taken into account but only ‘to the extent that they prove to be commonly accepted at a comparative level.’⁹⁶ Accordingly, it is suggested that a litigant relying on good faith might have to establish that good faith would compel certain behaviour in his or her own country but also in the country where the counterparty has his or her place of business.⁹⁷ This argument lacks persuasive force. Some states, such as New Zealand, have no general obligation of good faith in contracts. Therefore, the envisaged comparative investigation could not be undertaken and would be meaningless.

Ultimately, it is not apparent where the drafters of the CISG intended the content of the good faith principle to be derived from. Some have resorted to construing good faith in light of the many references to reasonableness within the CISG.⁹⁸ Conceivably a definition should have been included in the articles if the drafters were resolute that domestic law should not be used to derive a meaning. Accordingly, it has been recognised that if ‘it was the drafters’ belief that the concept of good faith should be

⁹³ See Zaccaria, above n 75, at 102.

⁹⁴ Bonell, above n 76, at 86.

⁹⁵ <<http://cisgw3.law.pace.edu/cases/981130m1.html>>, at 16 September 2008.

⁹⁶ Bonell, above n 76, at 86.

⁹⁷ Ibid, at 86-87.

⁹⁸ For a discussion of the argument see John Honnold, *Uniform Law for International Sales* (3rd ed, 1999), at 101.

interpreted without resorting to domestic definitions, then they fell far short of achieving their intended aim.’⁹⁹

The overwhelming conclusion is that arbitrators are resorting to domestic understandings of good faith due to the lack of guidance under the CISG. It is certainly evident that the numerous international CISG decisions do not reveal a common underlying meaning and application of good faith.¹⁰⁰ Consequently, the uniformity which the CISG seeks to achieve is compromised by the unclear reference to good faith.

There is further debate as to whether the application of good faith standards can be contractually excluded. Article 6 of the CISG provides:

The parties may exclude the application of this Convention or, subject to article 12, derogate from or vary the effect of any of its provisions.

Some have suggested that art 6 clearly permits the parties to contractually exclude any recourse to good faith when interpreting the CISG or any potential application of good faith in the performance of the contract.¹⁰¹ This is indicative that the dominant motif of the CISG is freedom of contract.¹⁰² Article 6 therefore permits businessmen and businesswomen to take appropriate contractual measures to counter the liberal approach to the interpretation of the CISG.¹⁰³

However, others contend that art 6 cannot be read literally.¹⁰⁴ It is not competent for contracting parties to direct how art 7(1) is to be interpreted by courts and tribunals.

⁹⁹ Zaccaria, above n 75, at 109 (citation omitted).

¹⁰⁰ See generally Paul J Powers, ‘Defining the Undefinable: Good Faith and the United Nations Convention on the Contracts for the International Sale of Goods’ (1999) 18 *Journal of Law and Commerce* 333, at 342-349.

¹⁰¹ Farnsworth, above n 80, at 62.

¹⁰² Ziegel, above n 64, at 338-339.

¹⁰³ See Bonell, above n 76, at 93.

¹⁰⁴ See Bridge, above n 68, at 535.

Consequently, art 7(1) should not be open to variation by the parties. Thus, the parties are bound to the interpretation in art 7 if the CISG applies to their contract. This affirms that the CISG is an autonomous body of law. To permit the parties to derogate from this law by deferring to domestic rules of interpretation would be inconsistent with the international character of the CISG.¹⁰⁵

Regardless of which approach is preferable, it is evident that there is no consensus as to the application of good faith under the CISG and its effect on contractual autonomy.

6.4.3 The New Zealand Experience of the CISG and Implications for a Universal Doctrine of Good Faith:

The CISG and the SOGUNCA have barely featured in any judicial decisions within New Zealand to date.¹⁰⁶ Similarly, there are few cases recorded within CLOUT involving New Zealand parties.¹⁰⁷ The degree of reference to international uniform law is pitiful by civil law standards.¹⁰⁸

There are certain inferences that can be drawn from the hitherto limited application of the CISG within New Zealand.¹⁰⁹ Contracting parties and legal advisors may not be familiar with the CISG and therefore do not rely on it in litigation. Alternatively, New Zealand

¹⁰⁵ Bonell, above n 76, at 94.

¹⁰⁶ A search of the Lexis Nexis New Zealand database as at 1 August 2008 produces only seven separate cases citing the Sale of Goods (United Nations Convention) Act 1994 or the United Nations Convention on Contracts for the International Sale of Goods. See *International Housewares (NZ) Ltd v SEB SA* (High Court, Hamilton, CP 395-SD01, 31 March 2003, Master Lang); *KA (Newmarket) Ltd v Hart* (High Court, Auckland, CP 467-SD01, 4 July 2002, Heath J); *Thompson v Cameron* (High Court, Auckland, AP 117-SW99, 27 March 2002, Chambers J); *Bobux Marketing Ltd v Raynor Marketing Ltd* [2002] 1 NZLR 506; *Yoshimoto v Canterbury Golf International Ltd* [2001] 1 NZLR 523; *Tri-Star Customs and Forwarding Ltd v Denning* [1999] 1 NZLR 33; *Attorney-General v Dreux Holdings Ltd* (1996) 7 TCLR 617.

¹⁰⁷ See Nottage, above n 71.

¹⁰⁸ Howarth, above n 47, at 69.

¹⁰⁹ It has been recognised that unfortunately ‘we have no empirical data, but only a great deal of hearsay and subjective impressions, to tell us about CISG’s role in practice.’: Ziegel, above n 64, at 340.

parties may be deliberately excluding the application of the CISG, as is expressly permitted under art 6.¹¹⁰ It has also been suggested that New Zealand parties engaged in the international sale and purchase of goods are likely to have weaker bargaining power and are therefore more prone to acceding to the choice of the domestic law of the foreign counterparty rather than the uniform law under the CISG.¹¹¹

A lack of case law and apparent skepticism regarding the CISG is not confined to New Zealand. Distrust for the CISG is evident in many common law jurisdictions. The United Kingdom has not elected to adopt the CISG to date. Further, a number of large English bodies have anticipated the effects of the CISG and have excluded its application in their standard trading forms. Those excluding the application of the CISG include major oil companies and significant trade organisations.¹¹² It has also been asserted that lawyers within the United States are frequently advising their clients to opt out of the application of the CISG.¹¹³ Approximately 10 years ago, there were relatively few instances where the CISG had been applied in contracts between United States and Canadian parties.¹¹⁴ This was despite the fact that both states subscribe to the CISG and each is a significant trading partner to the other within a common trade area. Australia fares no better. There were fewer cases attributable to Australia than New Zealand listed on the Pace University Law School database as at May 2004.¹¹⁵

Numerous reasons have been advanced for the ostensible declinature of contracting parties within the common law jurisdictions to embrace the CISG. Whilst systematic exclusion of the CISG is antithetical to the development of uniform international law,

¹¹⁰ See Nottage, above n 71, at 835.

¹¹¹ Ibid, at 836.

¹¹² Bridge, above n 68, at 509.

¹¹³ Monica Kilian, 'CISG and the Problem with Common Law Jurisdictions' (2001) 10 *Journal of Transnational Law and Policy* 217, at 227.

¹¹⁴ Harry M Flechtner, 'Another CISG Case in the U.S. Courts: Pitfalls for the Practitioner and the Potential for Regionalized Interpretations' (1996) 15 *Journal of Law and Commerce* 127, at 134.

¹¹⁵ See Lutz, above n 74, at 714.

commercial parties may have convincing justifications for the exclusion.¹¹⁶ For example, the cost of familiarisation with the CISG may exceed any benefit that will be derived over selecting a specific and known national law.¹¹⁷ Similarly, the CISG does not govern the validity of the contract or the property effects of the contract. For example, the CISG cannot be utilised to determine the validity of a limitation of liability clause. This significantly restricts the utility of the CISG given that exclusion clauses are common in sales contracts.¹¹⁸ The CISG is more likely to be excluded altogether if it is of only piecemeal application. Moreover, there is no international tribunal to resolve conflicting interpretations of the provisions. This is likely to be a significant deterrent to those from a common law background who generally take a more restricted approach to statutory and contractual interpretation than civil law counterparts. As a result, the difficulties of interpreting principles such as good faith cannot be resolved in a uniform manner nor definitively adjudicated upon. Ziegel concludes:

Given these weaknesses, the contracting parties may often find it more attractive to choose a municipal law with a well developed and balanced sales law to govern their contract, because it will provide greater certainty and because they hope the chosen law will be able to resolve all future disputes arising between the parties, procedural as well as substantive.¹¹⁹

The lack of enthusiasm for the CISG apparent in New Zealand and other Commonwealth common law jurisdictions does not bode well for a doctrine of contractual good faith. The approach within New Zealand to date in relation to the CISG arguably indicates the reluctance of New Zealand contracting parties and legal advisors to accept unfamiliar and demonstrably uncertain contractual laws. Similar conclusions can be drawn in relation to the other Anglo-Antipodean common law countries. In particular, the declinature of the United Kingdom to adopt the CISG is said to be evidence of the hostility of members of the legal profession and the judiciary who are concerned that ratification may jeopardise

¹¹⁶ See generally Ziegel, above n 64, at 345-346.

¹¹⁷ Ibid, at 345.

¹¹⁸ Ibid.

¹¹⁹ Ibid, at 346.

the role of London as a preeminent arbitration and litigation centre.¹²⁰ The lack of clarity inherent in the CISG contrasts markedly with the perceived certainty associated with domestic English contract law.

Accordingly, the hitherto unwelcoming approach to the CISG may be indicative of the likely reaction to the subject doctrine of good faith if it were to be introduced into domestic New Zealand law. If the lack of case law relating to the CISG is indeed explained by the fact that commercial parties are contracting out of the CISG due to its unfamiliarity, it seems reasonable to conclude that similar results might arise in respect of the subject doctrine of good faith which, as determined in Chapter 2, contracting parties would be at liberty to exclude.

Further, the New Zealand courts have not previously been compelled to bring domestic law into line with the CISG. As was noted above, the courts are aware that domestic law should generally remain consistent with best international practice. Notwithstanding, uniformity with the CISG has not always been sought. For example, in *Yoshimoto*¹²¹ an issue arose in the Court of Appeal as to whether evidence of pre-contractual negotiations might be admitted to show that the words in the contract should bear a particular meaning. Thomas J expressly recognised the UNIDROIT Principles and art 8(3) of the CISG which provides:

- (3) In determining the intent of a party or the understanding a reasonable person would have had, due consideration is to be given to all relevant circumstances of the case including the negotiations, any practices which

¹²⁰ Ibid, at 343.

¹²¹ [2001] 1 NZLR 523. In a European context, it has been suggested that the extent to which the United Nations Convention on Contracts for the International Sale of Goods may influence 'concrete rules of general contract law' is not clear: Thomas Wilhelmsson, 'European Contract Law Harmonization: Aims and Tools' (1993) 1 *Tulane Journal of International and Comparative Law* 23, at 34. However, some have advocated adoption of the Convention, including the good faith element, as part of the domestic law of sales within New Zealand. See Nicholas Whittington, 'Reconsidering Domestic Sale of Goods Remedies in Light of the CISG' (2006) 37 *Victoria University of Wellington Law Review* 421.

the parties have established between themselves, usages and any subsequent conduct of the parties.

However, his Honour declined to bring New Zealand domestic law into line with the CISG. It was reasoned that the Court of Appeal would not be permitted to do so by the Privy Council. Thus, New Zealand would continue to follow the English approach which demonstrated little readiness to permit latitude for the admission of evidence of negotiations as an aid to the interpretation of a contract.¹²² Although there has been some suggestion that this rule may be revisited in the future or has been relaxed¹²³, the case demonstrates that the New Zealand judiciary does not regard the provisions of the CISG as a definitive standard for domestic law.

It is therefore submitted that the existence of good faith within the CISG and related international instruments should not be perceived as a compelling reason to incorporate a doctrine of good faith within domestic law in New Zealand. In light of the evidence from the common law jurisdictions, it is still premature to consider good faith a meaningful and universal principle in international trade contracts.¹²⁴ Accordingly, arguments for a universal doctrine of good faith based on the desire to achieve comity with international trade practice presently lack definitive force. Seemingly the province of good faith in international contract law should be settled and established before New Zealand seeks to compare it to domestic law. At present, good faith under the CISG is an unhelpful and

¹²² Ibid, at 547-548. On appeal to the Privy Council, their Lordships declined to reconsider the law relating to the admissibility of pre-contractual negotiations as an aid to contractual interpretation because the evidence in the particular case was thought to be unhelpful. Ultimately however, the decision of the Court of Appeal as to the appropriate interpretation of the contract was overturned: [2004] 1 NZLR 1.

¹²³ See Shy Jackson, 'Pre-Contractual Negotiations: Recent Trends in the Interpretation of Contracts' (2007) 23 *Construction Law Journal* 268; John Burrows, Jeremy Finn and Stephen Todd, *Law of Contract in New Zealand* (3rd ed, 2007), at 166-167; Gerard McMeel, *The Construction of Contracts* (2007), at 128-155; Lord Nicholls, 'My Kingdom for a Horse: The Meaning of Words' (2005) 121 *Law Quarterly Review* 577; Lord Steyn, 'The Intractable Problem of the Interpretation of Legal Texts' (2003) 25 *Sydney Law Review* 5, at 10; Gerard McMeel, 'Prior Negotiations and Subsequent Conduct - The Next Step Forward for Contractual Interpretation' (2003) 119 *Law Quarterly Review* 272.

¹²⁴ See Zaccaria, above n 75, at 112.

undesirable precedent on which to base or justify the subject doctrine of contractual good faith.

6.4.4 Précis:

The application and meaning of good faith within the CISG is inherently uncertain. Despite now having had legislative recognition for some 13 years, the CISG does not appear to have been embraced by commercial parties in New Zealand engaged in foreign exchange. This experience may portend the likely approach to good faith in domestic law should the subject doctrine be introduced. Because of the uncertainty surrounding the CISG and, in particular, the good faith element, it does not present a convincing case for a universal doctrine of contractual good faith in domestic New Zealand law.

The CISG provides evidence of the extent of the acceptance of good faith within international commercial law. However, it is also necessary to consider how good faith operates in a domestic forum. Conceivably, the experience within the United States might act as a useful exemplar for the debate within New Zealand. Thus, the application of good faith within America is discussed in the following section.

6.5 The United States Experience:

The province of contractual good faith within the United States was briefly identified in Chapter 1. The following analysis considers whether the experience within America is of utility in evaluating the good faith debate within New Zealand. This requires a consideration of the suitability of comparing American contract law with New Zealand contract law.

This section also highlights some of the current issues pertaining to good faith within the United States. The discussion is necessarily brief. The contentious matters are identified but prospective resolutions of the outstanding issues are not explored as such matters are not necessarily relevant to the conclusion of this thesis. The analysis is therefore

descriptive. Indeed, the literature engaging in an extensive appraisal of contractual good faith within the United States is voluminous.¹²⁵ For present purposes it is sufficient to

¹²⁵ For example see John E Murray and Timothy Murray, *Corbin on Contracts* (revised ed, 2008 Spring Cumulative Supplement) vol 8, at 56-94; Todd D Rakoff, 'Good Faith in Contract Performance: *Market Street Associates Ltd Partnership v Frey*' (2007) 120 *Harvard Law Review* 1187; Harold Dubroff, 'The Implied Covenant of Good Faith in Contract Interpretation and Gap Filling: Reviving a Revered Relic' (2006) 80 *St John's Law Review* 559; Daniel C Peterson, 'All the King's Horses and All the King's Men: Are the Oregon Courts Putting the Good Faith Obligation Back Together Again?' (2005) 84 *Oregon Law Review* 907; Teri J Dobbins, 'Losing Faith: Extracting the Implied Covenant of Good Faith from (Some) Contracts' (2005) 84 *Oregon Law Review* 227; Howard O Hunter, 'The Growing Uncertainty about Good Faith in American Contract Law' (2004) 20 *Journal of Contract Law* 50; Emily Houh, 'Critical Interventions: Towards an Expansive Equality Approach to the Doctrine of Good Faith in Contract Law' (2003) 88 *Cornell Law Review* 1025; Seth William Goren, 'Looking for Law in All the Wrong Places: Problems in Applying the Covenant of Good Faith Performance' (2002) 37 *University of San Francisco Law Review* 257; James J White, 'Good Faith and the Cooperative Antagonist' (2001) 54 *Southern Methodist University Law Review* 679; Judge Howard L Fink, 'The Splintering of the Implied Covenant of Good Faith and Fair Dealing in Illinois Courts' (1999) 30 *Loyola University Chicago Law Journal* 247; Michael P van Alstine, 'Of Textualism, Party Autonomy, and Good Faith' (1999) 40 *William and Mary Law Review* 1223; Saul Litvinoff, 'Good Faith' (1997) 71 *Tulane Law Review* 1645; Thomas A Diamond and Howard Foss, 'Proposed Standards for Evaluating When the Covenant of Good Faith and Fair Dealing Has Been Violated: A Framework for Resolving the Mystery' (1996) 47 *Hastings Law Journal* 585; Kevin C Braley, 'What is Good Faith and Fair Dealing? A Lost Chance to Create a Useable Standard Results in an Erroneous Outcome: *High Plains Genetics Research Inc v J K Mill-Iron Ranch*' (1996) 41 *South Dakota Law Review* 195; James A Webster, 'A Pound of Flesh: The Oregon Supreme Court Virtually Eliminates the Duty to Perform and Enforce Contracts in Good Faith' (1996) 75 *Oregon Law Review* 493; Richard E Speidel, 'The "Duty" of Good Faith in Contract Performance and Enforcement' (1996) 46 *Journal of Legal Education* 537; Jason Randal Erb, 'The Implied Covenant of Good Faith and Fair Dealing in Alaska: One Court's Licence to Override Contractual Expectations' (1994) 11 *Alaska Law Review* 35; Robert S Adler and Richard A Mann, 'Good Faith: A New Look at an Old Doctrine' (1994) 28 *Akron Law Review* 31; Steven Burton, 'Good Faith in Articles 1 and 2 of the U.C.C.: The Practice View' (1994) 35 *William and Mary Law Review* 1533; Denise R Boklach, 'Commercial Transactions: U.C.C. Section 1-201(19) Good Faith – Is Now the Time to Abandon the Pure Heart/Empty Head Test?' (1992) 45 *Oklahoma Law Review* 647; Dennis M Patterson, 'A Fable from the Seventh Circuit: Frank Easterbrook on Good Faith' (1990) 76 *Iowa Law Review* 503; Steven Burton, 'More on Good Faith Performance of a Contract: A Reply to Professor Summers' (1984) 69 *Iowa Law Review* 497; Robert S Summers, 'The General Duty of Good Faith – Its Recognition and Conceptualization' (1982) 67 *Cornell Law Review* 810; Steven Burton, 'Breach

ascertain the problems within America. These problems should reveal important lessons for those examining the merits of the subject doctrine within New Zealand.

6.5.1 Is Contractual Good Faith in the United States an Appropriate Exemplar?

Prima facie, contractual good faith within the United States may serve as a useful exemplar for New Zealand. The New Zealand system of law is more analogous to American law than Continental European law. America appears to occupy an intermediate position between the Anglo-Commonwealth common law countries and the Continental civilians.¹²⁶ Certainly, America possesses by far the most developed good faith jurisprudence out of all the jurisdictions with common law origins. In the last several decades there have been over 10,000 cases mentioning the concept of contractual good faith within America.¹²⁷

The principle of good faith has also been in existence in the United States for a significant period of time. Obligations of contractual good faith were recognised by American common law jurists well before the first enactment of the Uniform Commercial Code (“UCC”) in 1954.¹²⁸ For example, in the 1933 case of *Kirke La Shelle Co v Paul Armstrong Co* the New York Court of Appeals recognised that ‘in every contract there

of Contract and the Common Law Duty to Perform in Good Faith’ (1980) 94 *Harvard Law Review* 369; Robert S Summers, “‘Good faith’ in General Contract Law and the Sales Provisions of the Uniform Commercial Code’ (1968) 54 *Virginia Law Review* 195; E Allan Farnsworth, ‘Good Faith Performance and Commercial Reasonableness Under the Uniform Commercial Code’ (1962) 30 *University of Chicago Law Review* 666.

¹²⁶ See Farnsworth, above n 80, at 54.

¹²⁷ See Dubroff, above n 125, at 561. It has further been noted that the ‘recognition and expansion of a pervasive duty of good faith has been possibly the single most significant doctrinal development in American contract law over the past fifty years.’: John A Sebert, ‘Rejection, Revocation, and Cure Under Article 2 of the Uniform Commercial Code: Some Modest Proposals’ (1990) 84 *Northwestern University Law Review* 375, at 383.

¹²⁸ Pennsylvania adopted the Uniform Commercial Code in 1954. It subsequently underwent some revisions and, by 1961, 13 states had adopted it. See E Allan Farnsworth, *Farnsworth on Contracts* (2nd ed, 1998) vol 1, at 41-42.

exists an implied covenant of good faith and fair dealing.¹²⁹ Indeed, it has been pointed out that the essentials of the modern doctrine of contractual good faith were established in a number of 19th century cases.¹³⁰ Thus, it can be said that good faith jurisprudence has been in existence in America for in excess of 100 years.

Undoubtedly, the express recognition and widespread application of the doctrine of good faith was secured by the introduction of the UCC. The UCC was the product of a collaborative effort by the National Conference of Commissioners on Uniform State Laws and the American Law Institute. The underlying purpose and policy of the UCC is to create uniform law amongst the various state jurisdictions.¹³¹ It has now been fully enacted in every state except Louisiana, which has extensively modified the provisions on sales.¹³²

The UCC is divided into 11 substantive sections or articles including: general provisions; sales; leases; negotiable instruments; bank deposits and collections; funds transfers; letters of credit; bulk transfers; warehouse receipts (including bills of lading and other documents of title); investment securities and; secured transactions. The general provisions expressly recognise that every contract governed by the UCC contains ‘an obligation of good faith in its performance and enforcement.’¹³³ Specific duties of good faith are also recognised throughout the UCC.

The other principal instrument under which contractual good faith is recognised in America is the Restatement (2d) of Contracts 1981 (“the Restatement”). The Restatement

¹²⁹ 188 NE 163, at 167 per Hubbs J (NY, 1933). See also *Brassil v Maryland Casualty Co*, 210 NY 235 (NY, 1914).

¹³⁰ *Market Street Associates Ltd Partnership Ltd v Frey*, 941 F2d 588, at 595 per Judge Posner (1991, US App).

¹³¹ Section 1-102 Uniform Commercial Code.

¹³² See Farnsworth, above n 128, at 42. Consequently it has been recognised that ‘[m]ost state laws impose a duty of good faith performance of contracts.’: *re Ocwen Loan Servicing*, 491 F3d 638, at 645 per Judge Posner (2007, US App).

¹³³ Section 1-203 Uniform Commercial Code.

is a document produced by the American Law Institute which seeks to reduce the mass of case law in America into a body of readily accessible rules.¹³⁴ The first Restatement of Contracts was completed in 1932. This underwent revision commencing in 1952 and ultimately resulted in the publication of the Restatement in 1981.

Like the UCC, the Restatement imposes a duty of good faith in performance and enforcement upon each contracting party. However, the Restatement does not have the force of legislation. It is distinct from the UCC in this respect. Nonetheless, the Restatement is likely to be highly persuasive in the state courts. A judge who declines to follow the Restatement will do so in the knowledge that it is written by those who are eminent specialists in the field of contract law and whose conclusions have been discussed and defended before able critics.¹³⁵

Thus, the doctrine of contractual good faith is widely recognised throughout the United States as a result of its common law, statutory and scholarly underpinnings. There are however certain caveats which must be recognised before accepting that the good faith doctrine in America is an appropriate exemplar for the New Zealand debate.

The federal system of law in the United States is quite distinct from the system of law in New Zealand. In America certain powers to enact statute are vested in the state legislatures. Indeed, contract law is generally considered to be a matter for the individual states rather than the federal legislature.¹³⁶ Accordingly, each of the states has the power to enact or vary the UCC. Uniformity is not guaranteed with 50 legislatures at work. Some states have been slow to enact revisions of the UCC and others have refused to

¹³⁴ See Farnsworth, above n 128, at 31.

¹³⁵ See Herbert F Goodrich, 'Restatement and Codification' in Alison Reppy (ed), *David Dudley Field Centenary Essays* (1949), at 244.

¹³⁶ See Justice L J Priestley, 'A Guide to a Comparison of Australian and United States Contract Law' (1989) 12 *University of New South Wales Law Journal* 4, at 5.

enact the revisions at all.¹³⁷ Critically, state legislatures have differed on the appropriate general definition of good faith. This issue is discussed further below.

New Zealand is not subject to this legislative division. Parliament has the power to enact contract statute applicable to all of New Zealand. Thus, contractual good faith might conceivably be of more consistent and uniform application than in America if it were to be introduced within New Zealand via statute. Equally however, the potential lack of legislative uniformity in America may inhibit the ability to formulate a definitive good faith obligation that might be imported into New Zealand law.

The judicial system also differs between America and New Zealand. The jurisdiction of the United States Supreme Court is limited to cases where a substantial federal question is involved. This generally precludes the Supreme Court from hearing cases concerning contract law specific to a particular state. As a result, the United States Supreme Court plays a much smaller role in creating final rules of contract law than the New Zealand Supreme Court.¹³⁸ In America there are effectively 50 courts of appeal dealing with issues pertaining to contractual good faith. This means that there is a significant propensity for conflicting common law contract rules and statutory interpretation within the United States. This phenomenon should not arise in New Zealand. The hierarchical court structure minimises and rectifies legal inconsistency.

¹³⁷ See generally Robyn L Meadows, Russell A Hakes and Stephen L Sepinuck, '2006 Uniform Commercial Code Survey: Introduction' (2007) 62 *The Business Lawyer* 1555.

¹³⁸ For similar observations in respect of the comparison between the United States and Australia see Priestley, above n 136, at 6. See also Justice G L Davies and M P Cowen, 'The Persuasive Force of the Decisions of United States Courts in Australia' (1996) 15 *Australian Bar Review* 51. Some Australian commentators have been highly critical of a comparison between United States and Australian case law. It has been noted that American case law is 'a trackless jungle in which only the most intrepid and discerning Australian lawyers should venture. It is possible to find American authority to support almost any conceivable proposition of law. Frequently one finds that there are competing and conflicting propositions, some commanding acceptance in particular jurisdictions, others commanding acceptance in other jurisdictions.': Sir Anthony Mason, 'The Use and Abuse of Precedent' (1988) 4 *Australian Bar Review* 93, at 108.

Having regard to the identified constitutional characteristics of the United States, it would be dangerous to view contractual good faith as a uniform doctrine. Whilst the doctrine may be recognised throughout America, it certainly has not been applied consistently. This lack of uniformity may diminish the utility of drawing on the experience of contractual good faith within the United States in the debate for a general doctrine in New Zealand. In this respect, the constitutional differences may render America an imperfect exemplar for New Zealand. It is evident that there are a number of unresolved issues surrounding good faith in America which arise as a result of the unique system of contract law in the United States. Cognisance of these issues must be taken when appraising the good faith issue in New Zealand and they are therefore discussed below.

6.5.2 Unresolved Good Faith Issues in the United States:

(a) *Is Good Faith a Subjective or Objective Standard?*

It was recognised within Chapter 3 that there is significant academic debate as to whether contractual good faith embodies a subjective or an objective standard of conduct. The American experience evidences that this issue is not a trivial matter of academic conjecture. The dilemma is real. The United States courts have frequently been perplexed as to whether good faith is to be judged solely by a subjective concept of honesty or also by some objective standard of reasonableness.¹³⁹ The common law doctrine splinters when the courts discuss whether a guilty mind is a prerequisite for a breach of good faith claim.¹⁴⁰

Some courts have held that good faith only requires that a contracting party honestly believe that he or she is acting properly. The test has been referred to as that of 'the pure

¹³⁹ See Farnsworth, above n 128, vol 2, at 378-379.

¹⁴⁰ See Emily Houh, 'The Doctrine of Good Faith in Contract Law: A (Nearly) Empty Vessel?' [2005] *Utah Law Review* 1, at 50.

heart and the empty head.’¹⁴¹ This approach was applied in *Daniels v Army National Bank*.¹⁴² The plaintiffs engaged a contractor to build their home and obtained a loan from the defendant bank to do so. The plaintiffs were living abroad and were unable to supervise the construction of the home. The defendant was aware of this. The plaintiffs discovered that there were a number of construction defects in the house when they returned. However, the defendant distributed the balance of the loan to the contractor notwithstanding that the defendant was appraised of the defects. The contractor subsequently filed for bankruptcy. The plaintiffs sued the defendant on the basis of, inter alia, breach of the covenant of good faith within the lending contract. The defendant counterclaimed for default on the loan. The Supreme Court of Kansas recognised that Kansas courts imply a duty of good faith into every contract.¹⁴³ However, it was noted that ‘the test of good faith is subjective and requires only honesty in fact.’¹⁴⁴ The duty only meant that a contracting party could not intentionally or purposely prevent the other party from receiving the fruits of the contract. The defendant did not breach its duty of good faith by failing to inspect the house. Nor had it intentionally or purposely prevented the contractor from properly constructing the house. Accordingly, it was held that the defendant had not contravened the standard of good faith. Conceivably, the conduct of the defendant might have been subject to more stringent scrutiny if good faith required an element of reasonable conduct. A bank acting reasonably may have inspected the property before distributing the funds.

Other American courts have insisted that good faith comprises an objective component. In *Reid v Key Bank of Southern Maine Inc* Judge Bownes recognised that the Maine courts would be likely to include an objective element within the concept of good faith.¹⁴⁵ Likewise, in *Best v United States National Bank of Oregon* the Oregon Supreme Court

¹⁴¹ Robert Braucher, ‘The Legislative History of the Uniform Commercial Code’ (1958) 58 *Columbia Law Review* 798, at 812.

¹⁴² 249 Kan 654 (Kan, 1991).

¹⁴³ *Ibid*, at 658 per Lockett J.

¹⁴⁴ *Ibid*. See also *United States National Bank v Boge*, 814 P2d 1082 (Or, 1991); *Karner v Willis*, 238 Kan 246 (Kan, 1985).

¹⁴⁵ 821 F2d 9, at 15 (1987, US App).

observed that the purpose of the good faith doctrine is to prohibit improper behavior in the performance and enforcement of contracts.¹⁴⁶ Whilst a party to a contract expects that the other will act honestly, the reasonable expectations of the parties need not be so limited.¹⁴⁷ Accordingly, in *Luedtke v Nabors Alaska Drilling Inc* the Supreme Court of Alaska commented that good faith requires a focus on conduct which a reasonable person would regard as fair rather than the intent of the defendant.¹⁴⁸

The meaning of good faith under the UCC appears to be as confused as what it is under American common law. The original promulgation of the UCC defines the general obligation of good faith as ‘honesty in fact in the conduct or transaction concerned.’¹⁴⁹ This appears to suggest that good faith is confined only to a subjective analysis. However, that result has been criticised. It is argued that this leaves the duty of good faith so enfeebled that it can scarcely qualify as an overriding or super-eminent principle.¹⁵⁰

There are more specific definitions of good faith within the UCC which appear to incorporate an objective standard. For example, the UCC imposes a duty of good faith on a merchant which requires ‘honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade.’¹⁵¹ Similarly, the obligation of good faith applying to bank deposits and collections includes ‘the observance of reasonable commercial standards of fair dealing.’¹⁵² These definitions have found favour with a number of commentators who argue that the general definition under the UCC is too limited.¹⁵³ They contend that the more specific definitions properly import some objective standard

¹⁴⁶ 303 Ore 557, at 562 per Lent J (Ore, 1987).

¹⁴⁷ Ibid, at 564.

¹⁴⁸ 834 P2d 1220, at 1224 per Compton J (Alas, 1992).

¹⁴⁹ Section 1-201(19) Uniform Commercial Code (1958).

¹⁵⁰ See Farnsworth, above n 125, at 674.

¹⁵¹ Section 2-103(1)(b) Uniform Commercial Code.

¹⁵² Sections 3-103(a)(4) and 4-104(c) Uniform Commercial Code.

¹⁵³ See Peterson, above n 125; Farnsworth, above n 125.

tied to commercial reasonableness.¹⁵⁴ Without such a standard, no more than knowing and deliberate maliciousness, trickery and deceit would be forbidden.¹⁵⁵

In light of these criticisms, the UCC has subsequently been amended. The drafting committee charged with revising the general definitions decided that it was appropriate to adopt a broader definition of good faith.¹⁵⁶ Thus, the revised general definition requires honesty in fact and the observance of reasonable commercial standards of fair dealing.¹⁵⁷ Now both the revised UCC and the Restatement (2d) of Contracts 1981 contain a definition of good faith which incorporates both subjective and objective elements.

Notwithstanding, some state legislatures have declined to adopt the broader definition of good faith.¹⁵⁸ Accordingly, the differences in the definition of good faith within the UCC are retained in certain states. It is therefore apparent that there remains little consensus as to the meaning of good faith between different states. Further, the definition of good faith differs between statutory and common law contexts. There is no uniformity.

(b) *Does Good Faith Create Independent Rights?*

In addition to the debate over meaning in America, it is unclear whether a claim for breach of good faith gives rise to a cause of action separate from an ordinary breach of contract claim.¹⁵⁹ The narrower approach is that good faith merely serves as a means of interpreting the contract. Thus, good faith does not create independent rights separate from those created by the provisions of the contract.

¹⁵⁴ See Farnsworth, above n 125, at 671.

¹⁵⁵ Ibid, at 672.

¹⁵⁶ See Peterson, above n 125, at 914.

¹⁵⁷ Section 1-201(20) Uniform Commercial Code.

¹⁵⁸ Arizona, Indiana and Utah had elected to retain the original promulgation as at 2006. California, Iowa, Kansas, Louisiana, Nevada, North Carolina and North Dakota have adopted the broader definition. See Meadows, Hakes and Sepinuck, above n 137.

¹⁵⁹ Goren, above n 125, at 302.

The case law again reveals significant inconsistencies. Some courts have adopted a restrictive approach to the application of good faith. In *Duquesne Light Co v Westinghouse Electric Co* the Court suggested that the good faith duty should be used as an interpretive tool.¹⁶⁰ The courts should not enforce an independent duty divorced from the specific clauses of the contract. Thus, the implied covenant of good faith is derivative in nature. It does not create new contract terms but ‘grows out of existing ones.’¹⁶¹ This approach was adopted in *Northview Motors Inc v Chrysler Motors Corp* where it was recognised that the duty of good faith cannot override the express terms of the contract because the duty cannot be separated from the existing terms.¹⁶²

Other courts appear to adopt a more liberal approach to the application of good faith. In *Twentieth Century Fox Film Corp v Marvel Enters Inc* the Court said that a claim for breach of good faith might be made where conduct by a defendant separate from a breach of the express terms frustrates the right of the plaintiff to the benefits due under the contract.¹⁶³

Indeed, in some cases the duty appears to give rise to obligations which are not directly referable to the contractual terms. The case of *Vylene Enterprises Inc v Naugles Inc*¹⁶⁴ is a prime example. Vylene was a franchisee of Naugles. The parties entered into a 10 year contract under which Vylene assumed the operation of a restaurant, previously run by Naugles. One of the issues in the case concerned whether Naugles had breached the implied covenant of good faith by opening a competing franchise within the immediate

¹⁶⁰ 66 F3d 604, at 617 per Judge Greenberg (1995, US App).

¹⁶¹ *Pizza Management Inv v Pizza Hut Inc*, 737 F Supp 1154, at 1179 per Crow J (D Kan, 1990).

¹⁶² 227 F3d 78, at 91 per Judge Greenberg (2000, US App). See also *John B Conomos Inc v Sun Co*, 831 A2d 696 (Pa Super Ct, 2003); *Swedish Civil Aviation Admin v Project Mgmt Enters Inc*, 190 F Supp 2d 785 (D Md, 2002); *Designers N Carpet Inc v Mohawk Indus Inc*, 153 F Supp 2d 193 (EDNY, 2001); *Clark Bros Sales Co v Dana Corp*, 77 F Supp 2d 837 (ED Mich, 1999); *Echo Inc v Whitson Co*, 121 F3d 1099 (1997, US App); *Baxter Healthcare Corp v OR Concepts Inc*, 69 F3d 785 (1995, US App); *Medtronic Inc v ConvaCare Inc*, 17 F3d 252 (1994, US App).

¹⁶³ 155 F Supp 2d 1, at 16 per Schwartz J (SDNY, 2001).

¹⁶⁴ 90 F3d 1472 (1996, US App).

vicinity of the restaurant operated by Vylene. It was clear that the franchise agreement did not permit Vylene an exclusive territory. The Court observed that where there is no grant of an exclusive territory within a contract, none will be impliedly read into the contract.¹⁶⁵ Notwithstanding, the Court was prepared to rule that Naugles had breached the covenant of good faith and fair dealing.¹⁶⁶ It did not trouble the Court that it could not link the breach of good faith to an existing express or implied contractual provision.

There is no agreement as to which is the preferable approach, although the case law appears to tend towards precluding good faith from acting as an independent cause of action.¹⁶⁷ It has been suggested that good faith should not create independent rights because the duty of good faith is ‘simply a rechristening of fundamental principles of contract law.’¹⁶⁸ Notwithstanding, many of the uses to which good faith is put today in America appear to extend past traditional techniques of interpretation and gap filling.¹⁶⁹

Others vehemently oppose a restricted application of good faith. It is argued that if good faith is used merely as an aid to interpretation without creating free-standing rights, then it is stripped of its potency and its equitable elements.¹⁷⁰ Good faith is reduced to a rhetorical device utilised to bolster judicial findings in underlying breach of contract claims. Thus, it serves only as an ‘analytical proxy’ for simple breach of contract.¹⁷¹

(c) *Is Good Faith an Issue of Fact or an Issue of Law?*

It has been observed that the American courts have reached different conclusions on whether and when the issue of good faith is one of fact for the jury or an issue of law to

¹⁶⁵ The Court relied on *Eichman v Fotomat Corp*, 880 F2d 149 (1989, US App) for this proposition.

¹⁶⁶ 90 F3d 1472, at 1477 per Judge Nelson (1996, US App).

¹⁶⁷ See Goren, above n 125, at 311.

¹⁶⁸ *Tymshare v Covell*, 727 F2d 1145, at 1152 per Scalia J (DC Cir, 1984).

¹⁶⁹ Farnsworth, above n 128, vol 2, at 376.

¹⁷⁰ See Houh, above n 140, at 52.

¹⁷¹ *Ibid*, at 14.

be determined by the judge.¹⁷² The uncertainty is a corollary of the inability of the courts to agree on whether good faith is merely a device used to interpret express terms of an agreement or whether it has more wide ranging application.

In *Highmark Inc v Hospital Service Association of Northeastern Pennsylvania* the Superior Court of Pennsylvania recognised that the proper interpretation of a contract is a question of law.¹⁷³ Therefore, if good faith is a device for contractual interpretation it is properly a question to be resolved by the presiding judge.¹⁷⁴ Thus, in *Questar Pipeline Co v Grynberg* the Court opined that an issue as to good faith should not be submitted to the jury where it arises in relation to contractual interpretation.¹⁷⁵ The Court went further in *Richard Short Oil Co Inc v Taxaco Inc* appearing to hold that the issue of good faith is solely one of law for the judge:

With regard to the standard for a directed verdict for a claim of violation of the covenant of good faith and fair dealing, questions about what amounts to good faith or bad faith are questions of law for the court to decide.¹⁷⁶

Other cases evidence a greater willingness to refer good faith to the jury. Indeed, questions of intent and whether there has been a contractual breach have been regarded as questions of fact appropriate for a jury.¹⁷⁷ Accordingly, in *Guardian Alarm Co of Michigan v May* the Court said that the question of whether a defendant has adhered to the duty of good faith should necessarily be appraised by a jury.¹⁷⁸

¹⁷² See Farnsworth, above n 128, vol 2, at 380.

¹⁷³ 785 A2d 93, at 98 per Cavanaugh J (Pa Super Ct, 2001).

¹⁷⁴ See Goren, above n 125, at 302.

¹⁷⁵ 201 F3d 1277, at 1291 per Judge Kelly (2000, US App).

¹⁷⁶ 799 F2d 415, at 422 per Hanson J (1986, US App).

¹⁷⁷ *GMH Associates Inc v The Prudential Realty Group*, 752 A2d 889, at 898 per Cavanaugh J (Pa Super Ct, 2000). See also Goren, above n 125, at 302.

¹⁷⁸ 24 Fed Appx 464, at 470 per Judge Cole (2001, US App). See also *Cotran v Rollins Hudig Hall International Inc*, 948 P2d 412 (Cal, 1998); *Fort Knox National Bank v Gustafson*, 385 SW2d 196 (Ky App, 1964).

The debate as to when good faith is an issue of law or an issue of fact would be relevant to New Zealand notwithstanding that jury trials are rare, if not non-existent, in contractual claims in the New Zealand High Court.¹⁷⁹ The issue would still affect New Zealand litigants. For example, a right of appeal may be confined solely to issues of law.¹⁸⁰ Similarly, appellate courts are generally less amenable to displacing findings of fact as compared to findings of law.¹⁸¹ Accordingly, it would be desirable to resolve the issue before adopting the doctrine within New Zealand. However, it appears that no clear answer can be derived from the United States. Indeed, the failure of the American courts to reconcile whether good faith is a legal or factual issue or a combination of both serves to illustrate the uncertainty surrounding the jurisprudential basis of the doctrine.

(d) *Is it Possible to Contract out of Good Faith?*

The American courts have again divided on the issue of whether and the extent to which obligations of good faith may be excluded. In *Carmichael v Adirondack Bottled Gas Corporation of Vermont* the Supreme Court of Vermont held that the covenant of good faith is imposed by law and is not a contractual term that the parties are free to bargain in

¹⁷⁹ Section 19A Judicature Act 1908 permits a party to have a case tried before a jury if the only relief claimed is payment of a debt, pecuniary damages, or the recovery of chattels. Section 19A(5) permits the judge to try a case without a jury on the application of either party where the case involves complex issues of law. The Court retains a residual discretion under s 19B to try the case before a jury if it deems convenient.

¹⁸⁰ For example, if contracting parties include an arbitration clause within their contract then a right of appeal from an arbitral award generally only exists in respect of an issue of law. See cl 5 of Schedule 2 of the Arbitration Act 1996. For a discussion of the right to appeal an issue of law in the context of the Arbitration Act 1996 see *Downer Construction (New Zealand) Ltd v Silverfield Developments Ltd* [2008] 2 NZLR 591.

¹⁸¹ See generally *Owners of the "P Caland" and Freight v Glamorgan Steamship Co* [1893] AC 207, at 216 per Lord Wright. Thus, it has been noted that 'an appellate court will recognise the limitations on its capacity to make factual judgments where they depend in part upon the observation of witnesses who have been seen only by the trial judge.': *Graham Barclay Oysters Pty Ltd v Ryan* (2002) 194 ALR 337, at 353 per Gleeson CJ

and out as they see fit.¹⁸² This reasoning suggests that the common law doctrine represents a significant departure from the principle of freedom of contract. In order to support the view that the duty cannot be disclaimed, some jurists have asserted that the obligation of good faith is constructive rather than implied.¹⁸³ This may reflect attempts to overcome the difficulty that a term will not ordinarily be implied if the parties have purported to exclude it. However, the distinction is not entirely clear. If contracting parties express an intention that the doctrine should not apply it is difficult to see how the contract can be construed to require good faith.

Indeed, other courts have been less willing to undermine contractual autonomy. For example, in *Eis v Meyer* the Supreme Court of Connecticut declined to imply a covenant of good faith and fair dealing.¹⁸⁴ The Court said that the imposition of a duty of good faith would be contrary to the express wording of the legal document. Accordingly, the doctrine was inapplicable.

The position under the UCC was briefly explored in Chapter 2. Section 1-102(3) provides that the parties are not able to disclaim obligations of good faith under the UCC by agreement. Nonetheless, the parties may contractually stipulate the standards required to observe good faith provided such obligations are not manifestly unreasonable.

The restriction on contracting out of UCC good faith obligations appears to contradict the demonstrable willingness of some American courts to defer to the intention of the contracting parties. Farnsworth notes:

It is sometimes no simple matter to reconcile the mandatory character of the duty of good faith with the principle, often repeated by the courts, that there is no such duty if it would conflict with an express provision of the contract.¹⁸⁵

¹⁸² 635 A2d 1211, at 1216 per Morse J (Vt, 1993).

¹⁸³ *Olympus Hills Shopping Center Ltd v Smith's Food & Drug Centers Ltd*, 889 P2d 445, at 450 per Judge Jackson (Utah App, 1994).

¹⁸⁴ 566 A2d 422, at 426 per Hull J (Conn, 1989).

¹⁸⁵ Farnsworth, above n 128, vol 2, at 341.

For example, in *Kahm & Nate's Shoes No 2 Inc v First Bank of Whiting* Judge Easterbrook said that principles of good faith 'do not block the use of terms that actually appear in the contract.'¹⁸⁶ Arguably this statement is incompatible with the provisions of the UCC. The mandatory application of good faith will indeed serve to 'block' any terms purporting to exclude the doctrine.

Ultimately, one commentator has suggested that the UCC 'waffles on the question of how much control parties have over the duty of good faith.'¹⁸⁷ Others argue that good faith clearly has the effect of restricting party autonomy. Chivers contends:

One notion of the doctrine is that it is a set of peremptory norms of appropriate behaviour...That is, instead of forming a part of the "background law", the covenant stands at the "foreground" trumping even explicitly bargained-for terms in the same way doctrines of illegality or unconscionability stand in the foreground placing substantive limits on contractual freedom. This notion is conveyed, at least superficially, by the Code provision making good faith obligations non-disclaimable.¹⁸⁸

Thus, in some cases courts are prepared to impose obligations of good faith without reference to the actual intent of the parties. In others the courts appear to defer to the express words of the agreement. Ultimately, the extent to which the doctrine of contractual good faith can be used to override the intention of the parties is inherently unclear within the United States.

6.5.3 Précis:

The foregoing analysis has identified the limitations of drawing on the experience of the United States when appraising the good faith debate in New Zealand. The differences in

¹⁸⁶ 908 F2d 1351, at 1357 (1990, US App).

¹⁸⁷ Mark P Gergen, 'A Defense of Judicial Reconstruction of Contracts' (1995) 71 *Indiana Law Journal* 45, at 50.

¹⁸⁸ Corey R Chivers, "'Contracting Around" the Good Faith Covenant to Avoid Lender Liability' [1991] *Columbia Business Law Review* 359, at 365 (citation omitted).

legal systems must be factored into account. In particular, the lack of completely uniform legislation or a universal final court to determine contractual issues within America inhibits comparisons of American and New Zealand contract law.

The heavy reliance on codification under the UCC within America is also significant. New Zealand contract law is primarily common law based.¹⁸⁹ There are fundamental difficulties in comparing the American doctrine under the UCC with the subject common law doctrine. For example, state legislatures in America have been able to preclude contracting parties from excluding the doctrine. It was recognised in Chapter 2 that New Zealand courts might not be able to impose such a restriction should a common law doctrine of contractual good faith be introduced.

Critically, it can be seen from the experience within the United States that the application of the covenant of good faith is often laced with inconsistencies.¹⁹⁰ The doctrine has provided work for many American lawyers who endeavour to untangle the case law.¹⁹¹ The fact that America has been unable to resolve fundamental issues relating to the doctrine despite over a 100 years of good faith jurisprudence must be of concern to those engaged in the debate within New Zealand. It warrants close scrutiny of good faith. In *Service Station Association Ltd v Berg Bennett & Associates Pty Ltd* Gummow J emphasised the point:

In the United States [] it has been said that the good faith performance doctrine may appear as a licence for the exercise of judicial or juror intuition in unpredictable and inconsistent applications, requiring repeated adjudication before an “operational standard” may be “articulated and evaluated”...[This]

¹⁸⁹ Although New Zealand arguably has enough statute law to divorce itself from the mainstream of Anglo-Antipodean contract law. See John Burrows, ‘Contract Statutes: The New Zealand Experience’ [1983] *Statute Law Review* 76. See also B H Giles, ‘The Further Development of International Commercial Arbitration through the Unidroit Principles of International Commercial Contracts – A Commentary’ (1996) 2 *New Zealand Business Law Quarterly* 22, at 26.

¹⁹⁰ See Goren, above n 125, at 258.

¹⁹¹ See E Allan Farnsworth, ‘Good Faith in Contract Performance’ in Jack Beatson and Daniel Friedman (eds), *Good Faith and Fault in Contract Law* (1995), at 169.

serves to illustrate the caution necessary in accepting foreign importations, without prior scrutiny and comparison with the development of the law here.¹⁹²

It is recognised that the foregoing analysis has not extensively examined the perceived and actual benefits of the good faith doctrine in America. Nonetheless, the identified problems are alarming. Ultimately, it is submitted that the experience within the United States does not present a strong argument for the introduction of good faith within New Zealand. Certainly, American law might serve as a useful guide or caveat should the subject doctrine be incorporated within New Zealand law. However, the American experience does not advance any compelling evidence to support the introduction of the doctrine. It is perhaps apt that words of caution to Anglo-Commonwealth countries have emanated from American academics, including Hunter:

[B]efore one suggests a wholesale adoption of the American version of good faith, one must understand that, at present, there remains considerable uncertainty about the full meaning of the concept. The American cases may provide useful examples and guides to the development of the concept of 'good faith' during the past century, but an observer must be aware of the shifting currents and the absence of a common understanding of the scope and content of the implied covenant.¹⁹³

Thus, extreme caution is warranted both in propounding the American experience as an argument for adopting good faith in New Zealand and utilising it to develop good faith jurisprudence.

¹⁹² (1993) 117 ALR 393, at 402 and 406 (citations omitted). Accordingly, it has been recognised that it would be 'rather bold for Australian courts to rely heavily upon the American experience in relation to good faith. There is no clear definition or law concerning good faith in America, and there are precedents available for most propositions.' Elizabeth Peden, 'Contractual Good Faith: Can Australia Benefit from the American Experience?' (2003) 15 *Bond Law Review* 187, at 203.

¹⁹³ Hunter, above n 125, at 56.

6.6 Summary:

The majority of developed legal jurisdictions expressly recognise a doctrine of contractual good faith. New Zealand is fundamentally dependent on international trade such that it is subject to constant pressure to achieve harmonisation with the laws of its major trading partners in order to minimise impediments to international exchange. The phenomenon of globalisation and worldwide recognition of the need for economic cooperation contributes to the need for harmonisation of domestic laws. The EU is a significant factor in England which is pushing it towards the recognition of contractual good faith. The likelihood of New Zealand adopting contractual good faith may be strongly correlated to whether England, its historical source of contract law, and Australia, its largest trading partner, embrace good faith.

However, there are certain international considerations which militate against recognition of a doctrine of good faith in domestic New Zealand law. In particular, there is no demonstrable evidence to suggest that New Zealand and its larger Commonwealth counterparts have been prejudiced in the international trade arena by not recognising contractual good faith. Further, parties engaged in international trade are free to choose a jurisdiction to govern their contract which endorses good faith. Again, there is no proof to suggest that parties are rejecting jurisdictions which endorse the libertarian tradition and leave it up to the parties to embrace good faith. Indeed, there is evidence to the contrary. Certainly, good faith has had an unsettled application within international trade laws such as those embodied in the CISG. This does not bode well for a doctrine of good faith within New Zealand domestic law. Similar results can be seen in America. There are still unresolved issues and numerous contradictions within the case law despite the United States having recognised good faith for over a century. There is even legislative divergence between states with respect to good faith. Thus, it would be wrong to regard the experience within the United States as presenting a compelling argument for good faith. Ultimately, these factors do not inspire confidence for the subject doctrine of good faith within New Zealand.

Conclusion

Good faith has been associated with contract law since Ancient Roman times. From its classical origins, the principle has developed through a range of legal sources including canon law, civil law, common law and equity. The majority of developed legal systems now overtly acknowledge a general principle of good faith in contract law. However, New Zealand and the Anglo-Antipodean common law countries have hitherto declined to expressly recognise an overarching doctrine of good faith in contract. Notwithstanding, the pressure for harmonisation of contract law brought about by the phenomenon of globalisation will inevitably require a reassessment of this position. An appraisal of whether there is a requirement for a universal doctrine of good faith in New Zealand contractual relationships is therefore a current and significant issue.

This thesis has focused predominantly on a common law doctrine of good faith. The preferred methodology through which the doctrine could be incorporated into contract law is by way of a rule of construction. Contracts could be construed to require good faith conduct. However, there are inherent limits to the subject doctrine. Parties would inevitably be able to contractually exclude it. Further, it is unlikely to apply to pre-contractual and non-contractual conduct. A claim for breach of good faith would necessarily have to be pleaded as a breach of contract. Although this thesis has not focused on a statutory rule, these factors suggest that a legislative doctrine rather than a judicial doctrine might be preferred if good faith is to have the wide ranging effect proponents desire.

It was noted in the introduction that determination of the thesis is necessarily a balancing exercise. The competing arguments for and against good faith have been weighed up. It will have become readily apparent throughout this manuscript that the negative arguments have been found to displace the views of proponents of good faith.

It is anticipated that a good faith doctrine would be of uncertain application in New Zealand. Whilst good faith may embody obligations of cooperation, honesty and

reasonable behaviour, determining the conduct required in the particular circumstances of each case to meet the good faith standard would be inherently uncertain. There is no apparent justification to introduce this unpredictability into the law of contract. Proponents of good faith fail to establish that existing contract law within New Zealand does not adequately give effect to the reasonable expectations of contracting parties. On the contrary, it is clear that much of the prevailing law of contract embodies unexpressed notions of good faith. Further, there is a strong likelihood that the courts would not allow good faith to undermine the certitude of existing contract law. In consequence, the doctrine might not produce any different substantive legal outcomes and would only confuse the administration of the law.

Good faith obligations may enhance economic efficiency through transactions cost savings. However, there is a trade-off in terms of certainty. A doctrine of good faith is therefore unlikely to be efficient in all circumstances, particularly where it is used as a mandate for the courts to rewrite a contract. The preferable approach is to impose obligations consonant with good faith in those classes of contractual relationship in which efficiency is likely to be enhanced. This is already achieved to some extent through legislative and judicial intervention and is best progressed through incremental and specific development rather than a blanket rule of good faith.

Finally, the need to accord with widespread international practice does not present a compelling argument for good faith within domestic law. The principle is of vague application in the international trade arena. There is no meaningful evidence to suggest that New Zealand foreign trade is impaired due to the declinature of the New Zealand courts to embrace a universal obligation of good faith. Quite the opposite, England may be preferred as a litigation centre by international commercial parties precisely because it does not recognise discretionary principles such as good faith. It may therefore be desirable for New Zealand to continue to follow the Commonwealth approach. The American experience also confirms the skepticism towards the general doctrine. Constitutional and legal differences between the United States and New Zealand render it

an imperfect exemplar. Nonetheless, the fundamental unresolved issues pertaining to good faith within America does not inspire confidence in the utility of the doctrine.

These conclusions should not be construed as suggesting that obligations of good faith do not have a place in contractual relationships within New Zealand. It has been recognised throughout this thesis that good faith is a valuable principle whether it is embedded in certain contractual rules or implied as a term in particular categories of contract. It has also been noted that there is potential for development. For example, good faith may serve a useful future role in areas such as agreements to negotiate, process contracts, regulating the exercise of contractual discretions, contractual variations and distinguishing between liquidated damages and penalty clauses. There is scope for further research to ascertain those areas of contract law in which good faith may be appropriately deployed in the future.

Ultimately however, the ‘piecemeal’ approach to contract law which is synonymous with Anglo-Commonwealth common law countries is preferred to a general, unfamiliar and uncertain doctrine of good faith. Where necessary, incremental development of the common law, equitable and statutory rules regulating contractual dealings should be advocated over a reformulation of the law of contract in New Zealand based on a general principle of good faith. Thus, it is concluded that there is no requirement for a universal doctrine of good faith in New Zealand contractual relationships.

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