

GOOD FAITH – AN IDEA PAST ITS TIME

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This paper examines the arguments for and against the imposition of an overarching standard of good faith in Australia. The Australian Government has recently decided to reject calls for an overarching standard of Good Faith to attend commercial contracts in a franchising context. In line with traditional arguments in favour of certainty in commercial contracting, the government has opted to provide for more specific legislation in dealing with specific problems that may arise in commercial dealings.

Introduction

Since 2006 there have been no less than four government inquiries into the regulation of the franchise sector: *Review of the Disclosure Provisions of the Franchising Code of Conduct*, October 2006 (The Matthews Report); *Inquiry Into the Operation of Franchise Businesses in Western Australia* – Report to the Western Australian Minister for Small Business, April 2008 (The Western Australia Report); *Franchises: Final Report of the Sixty-Fifth Economic and Finance Committee of the Parliament of South Australia*, May 2008 (The South Australia Report); *Opportunity Not Opportunism: Improving Conduct in Australian Franchising*, (Parliamentary Joint Committee on Corporations and Financial Services), December 2008 (The Federal Report). Three of these four inquiries recommended the introduction of a good faith obligation attend franchise contracts.

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The Matthews Report of October 2006 noted that ‘interdependency between franchisors and franchisees is fundamental to the franchise sector’ and considered that recognition in the *Code* of a concept of good faith and fair dealing would provide positive reinforcement to the development of improved relationships and dealings between franchisors, franchisees and prospective franchisees. The report recommended that ‘[a] statement obligating franchisors and prospective franchisees to act towards each other fairly and in good faith be developed for inclusion in the code’. The Government’s response (February 2007) was parsimonious. It agreed with the “intention” that franchise participants act towards each other fairly and in good faith but simply noted that s 51AC of the *Trade Practices Act* 1974 (Cth) – the business unconscionability provision – includes “good faith” as a factor that can be taken into account when determining unconscionability.

The South Australian Report was of the opinion that ‘there currently exist unacceptable limits on the ability of the franchisees to seek redress in cases where franchisors abuse their contractual discretions and powers’. The Committee recommended amending the *Franchising Code of Conduct* by inserting a provision imposing ‘a duty to act in accordance with good faith and fair dealing by each party of the franchise relationship’.

The latest and most influential report – *Opportunity not opportunism: Improving conduct in Australian Franchising* – by the Federal Parliamentary Joint Committee on Corporations and Financial Services (December 2008) concluded that while the *Code*’s prior disclosure obligations are ‘for the most part adequately addressed’ there remain concerns because of the ‘continuing absence of an explicit overarching standard of conduct for parties entering a franchise agreement’. The Report noted that:

[T]he interdependent nature of the franchise relationship leaves the parties to the agreement vulnerable to opportunistic conduct by either franchisors or franchisees. Franchisee opportunism may take the form of free riding, unauthorised use of franchisors’ intellectual property rights, under-performance, or failure to accurately disclose income. However, the franchisor’s control over the provisions in the contract enables franchisors to

address opportunistic behaviour of this kind by enforcing the terms of the franchise agreements.

Franchisor opportunism has been described as 'predatory conduct and strong arm tactics by franchisors' involving the exploitation of a pre-existing power relationship between the franchising parties, which makes the franchisee 'vulnerable or economically captive to the demands of the franchisor'. There is an inherent and necessary imbalance of power in franchise agreements in favour of the franchisor, but abuse of this power can lead to opportunistic practices including encroachment, kickbacks, churning, non-renewal, transfer, termination at will, and unreasonable unilateral variations to the agreement.

The Committee's conclusion was that the optimal way to provide a deterrent against opportunistic conduct in the franchising sector was 'to explicitly incorporate, in its simplest form, the existing and widely accepted implied duty of parties to a franchise agreement to act in good faith'. The Committee recommended that a clause stating "Franchisors, franchisees and prospective franchisees shall act in good faith in relation to all aspects of a franchise agreement" should be included in the *Code*.

Motivations behind calls for good faith

The reasons motivating calls for a good faith obligation are diverse. Generally, the exercise of contractual provisions agreed to at the outset of commercial relations which come to be exercised unfairly, harshly or without due regard for the interests of the other party is enough to draw the concept of good faith into the debate. The common element underlying such calls in a franchising context is what is usually seen as both a power and information imbalance in commercial contracts when a more experienced contractor becomes involved with a novice or amateur in the area. This is usually found in the context of a long-term standard-form contract where the need for cooperation is high and extends over time, and where there is little room if any for negotiation of central terms of the contract. Importantly, contractual provisions need to be drafted widely to enable the stronger party to control the operations of the newcomer and mitigate against the risk of taking on an inexperienced contractor. While the obligation has been argued to arise in contracts

generally, outside of cooperative or even long term contractual arrangements, the stronger claim to its operation arises in the presence of such circumstances, where it is said that the position of the weaker party needs to be supported by the chance of recourse to an obligation of fair dealing in order to prevent the stronger party from using their undoubted power to force the weaker party to agree to terms or actions which are unfair for the stronger party to insist upon.

While a familiar concept in Civil Law jurisdictions, the idea of good faith was shunned early in Common Law jurisdictions in favour of commercial certainty. The conflict between the traditional contractual freedom paradigm in common law jurisdictions and ideas of cooperation and fair use of contractual provisions has come into sharp relief in recent years as contractual time horizons have expanded and business forms making greater and greater use of cooperation have raised the question as to the role of any such concept of good faith in addressing frustrated expectations of commercial contractors in situations where terms agreed to at one point in time have come to be used in ways not envisioned at agreement.

While those pursuing reform and the introduction of an overarching standard of good faith may believe it to be the solution to problems of this nature, the actual application of any concept of good faith in Australia may well have disappointed. Recent cases in an Australian context have demonstrated that the concept of good faith does not fit well into the Australian legal landscape. While those alleging unfair use of contractual terms or in Australian vernacular, not being given a “fair go” may hope that standards of fairness might attend the exercise of contractual terms, in making such arguments they invariably come up against the sheer weight of the traditional concepts of certainty and freedom of contract developed over centuries of legal disputation in the UK. In the face of this construct, the idea of good faith is too abstract to offer any real assistance to those arguing they have been wronged by their contractual counterparty.

Recognition of Good Faith

Good faith can arise in three main ways – either as an express term of any given contract, as a term implied on an ad hoc basis to give business efficacy to a particular contract, or as a term implied in law as a necessary feature of a particular class of contracts. It has been argued that franchise contracts, due to their relational nature and long term existence, should be one such class of contracts. Such contracts pose a challenge to the adversarial model of contractual relations established in the common law, which cannot stomach the idea of requiring one party to attend to anything but their own interests.

A major factor working against the recognition of good faith in this context is the lack of a clear definition of what acting in good faith might actually involve. While lower courts have been somewhat amenable to the concept, the High Court is yet to deal with the issue. Nevertheless, the comments of Kirby J in *Royal Botanic Gardens and Domain Trust v South Sydney City Council* [2002] HCA 5 illustrate the forces the concept is up against:

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

The difficulty in defining good faith is in delineating its scope, which remains underdeveloped. While, as noted above, several lower court decisions have acceded to its existence, most judgments advocating recognition of the concept ‘appear incoherent and contain little legal principle’ (Peden, 2003). Paterson argues that ‘Australian case law has relied on synonyms or isolated examples to explain the duty, an approach which leaves much unanswered’ (Paterson, 2001). The problem with this is that contractual counterparties face difficulties in understanding whether or not certain behaviour, while contractually consistent, may offend any obligation to act in good faith.

Defining Good Faith

Perhaps the best known approach to understanding the potential content of a good faith obligation is Summers' excluder doctrine advanced in his seminal 1968 Virginia Law Review article. Professor Summers saw good faith as a phrase which 'has no general meaning or meanings of its own, but which serves to exclude many heterogeneous forms of bad faith'. However, this approach fails to provide a clear idea of what observance of the standard would actually require:

[I]t seems tantamount to saying that the good faith duty is breached whenever a judge decides that it has been breached... [which] hardly advances the cause of intellectual inquiry and provides absolutely no guide as to the disposition of future cases except to the extent that they may be on all fours with a decided case (Bridge, 1984).

The excluder approach does not appear able to provide any real guidance to courts or contracting parties as to whether the supposed duty might be breached by particular actions. This leads to an undesirable lack of certainty in commercial arrangements.

Two more comprehensive formulations which have some support are provided by two distinguished judges writing extra-judicially. Lord Steyn incorporates a subjective element, a 'threshold requirement ... that the party must act honestly', as well as an objective element requiring the 'observance of reasonable commercial standards of fair dealing in the conclusion and performance of the transaction concerned' (Steyn, 1997). Sir Anthony Mason (2000) states that

...the concept embraces no less than three related notions: (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.

The duty to cooperate to achieve contractual objects is an accepted legal duty for all contracts under the common law. In the words of Griffith CJ in *Butt v M'Donald* (1896) 7 QJLJ 68, '[i]t is a general rule applicable to every contract that each party agrees, by implication, to do all such things as are necessary on his part to enable the other to have the benefit of the contract'. The idea

that good faith requires parties to act honestly, and therefore that acting dishonestly connotes bad faith conduct, is uncontroversial. A standard of “honesty” nevertheless poses an evidentiary challenge to a franchisee and will not catch many forms of behaviour which although characterised by honest conduct will impact negatively and significantly upon the interests of the contractual counterparty.

Lord Steyn’s objective element, and Sir Anthony Mason’s third requirement, relating to reasonable commercial standards pose more serious difficulties. In relation to the exercise of a termination clause by a franchisor there is judicial support in Australia for the proposition that ‘provide the party exercising the power acts reasonably in all the circumstances, the duty to act fairly and in good faith will ordinarily be satisfied’ (see *Garry Rogers Motors (Aust) Pty Ltd v Subaru (Aust) Pty Ltd* (1999)). While reasonableness provides a platform from which to explore the content of the supposed good faith obligation, this approach has been criticised as being ‘more confusing than instructive’:

There is no precise meaning given, but rather a repetition of well-worn phrases and quotes, without explanation of how and why they fit together. There is, furthermore, no explanation of why “reasonableness” is a justified inclusion in the meaning of good faith, and why it is considered identical to “good faith” (Peden, 2003).

In *Renard Constructions (ME) Pty Ltd v Minister for Public Works* (1992) 26 NSWLR 234 at 265 it was noted that ‘in ordinary English usage there has been constant association between the words fair and reasonable. Similarly there is a close association of ideas between the terms unreasonableness, lack of good faith and unconscionability’. This is of great import to any definition of good faith involving reasonableness, for it can be argued that ‘a requirement to satisfy a standard of reasonable behaviour is more demanding than the requirement of good faith’ (Stapleton, 1999). In any event as Bowen LJ cautioned over a century ago in *Mogul Steamship Co. v McGregor, Gow & Co.* (1889) 23 Q.B.D. 5:

I should deem it to be a misfortune to attempt to adopt some standard of judicial “reasonableness” to which commercial adventurers were bound to conform.

The caution of Bowen LJ still retains much of its original force.

The quest for a more specific formulation to accommodate the underlying need for certainty amongst franchising contractors has led to the idea that good faith should preclude opportunistic conduct or the use of contractual terms for purposes antithetical to the contract. In *Far Horizons Pty Ltd v McDonald's Australia Ltd* [2000] VSC 310 at 120, Byrne J stated that good faith would oblige 'each party to exercise the powers conferred upon it by the agreement in good faith and reasonably, and not capriciously or for some extraneous purpose'. In fleshing out such a conception however, as stated by Barrett J in *Overlook v Foxtel* (2002) 'it becomes necessary to enquire about the extent to which selflessness is required'. While franchise contracts do not embody any sort of fiduciary relationship, Barrett J stated that good faith requires a party to 'recognise and to have due regard to the legitimate interests of both the parties in the enjoyment of the fruits of the contract as delineated by its terms', although the interests of the other party are not paramount (see *Mason v. Freedman* [1958], cited in *Shelanu Inc. v. Print Three Franchising Corp.* (2003)). If this be the case, the logical question which follows concerns the divining of "legitimate interests". Would such interests be inferred from the contract alone or would exogenous sources of information such as extra-contractual norms developed as part of the ongoing relationship play a role in determining whether legitimate interests had been controverted?

Should the former approach be taken, the weight of the standard form contract drafted in the interests of the stronger franchisor would not assist the franchisee except in cases of obvious abuse, such as in *Australian Competition and Consumer Commission v Simply No-Knead (Franchising) Pty Ltd* [2000] FCA 1365, where the statutory unconscionability provisions provided relief. Hadfield (1990) argues that consideration should be given to the continuing relationship and the expectations engendered therein. This suggests another approach to good faith which is to consider the "reasonable expectations" of parties to a contract. Under this approach a court may be able to take a more balanced approach to franchising disputes by allowing franchisees, who might have had their legitimate expectations of contractual

performance frustrated and are not otherwise able to make a case in situations where they do not possess formal “legitimate interests” as specified in a written contract, a valid avenue for redress they otherwise would not have had. However, as noted by Professor Summers (1968), ‘[i]n most cases the party acting in bad faith frustrates the justified expectations of another [and] the ways in which he may do this are numerous and radically diverse’. Possibly for this reason, the reasonable expectations approach has received little judicial attention.

An important consideration in the use of the reasonable expectations approach as noted by Iglesias (2004) is that ‘what a party can reasonably expect must be determined not on subjective hopes, but on economic reality’. Even the good faith sceptic, Professor Michael Bridge (1984), suggests that the reasonable expectations approach might just fit the necessary requirements for a standard of good faith stating that reference to justified expectations ‘is much more satisfactory than good faith as a guide to the resolution of practical problems’. An important concern is the evidentiary burden of proving the reasonable existence of such expectations and ensuring franchisees actual and potential do not get swept up in any false expectations of the power of “good faith”, and all that term connotes. Any approach cloaked in the language of ‘good faith’ may give serve to disappoint franchisees by providing false hope that unsupported subjective hopes may trump hard contractual terms and unforgiving economic reality.

Conclusions

The underlying problem with good faith is that it appears to be ‘an imperfect translation of an ethical standard into legal ideology and legal rules’ (Bridge, 1984). The enduring and common issue for any system that embraces good faith as a guiding proposition is ultimately to determine its meaning, its scope, its limitations. A workable definition of good faith is elusive, but without it a stand-alone obligation of good faith would thrust the franchise sector into an era of uncertainty, disputation and litigation with breaches of good faith being sought to be applied to an indeterminate range of grievances, both fair and

contrived. As the authors have written elsewhere, '[i]f franchisor opportunism is a problem warranting legislative intervention this should be addressed by carefully crafted legislative responses rather than by defaulting to an undefined and overreaching standard of indeterminate scope and application' (Terry and Di Lernia, 2009). This was the preferred option of the Australian Government which has determined that the imperative that franchisors and franchisees act in good faith is better addressed by measures which will address specific behavioural concerns.

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