Overview: The Implied Duty of Good Faith

CRISP LAW

Newsletter

June 2024: Issue 1

This newsletter provides a succinct overview of the differing views regarding the degree of adoption of the implied duty of good faith.

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Introduction

A common part of modern standard form construction contracts, is a term which permits the principal to have recourse to the builder's security or bank guarantee. Typically, a principal's recourse to security will be limited in situations where a party remains unpaid (like in the AS 4000 Contract), or where a party has a claim against a contractor (as is the case with the AS 2124 Contract). Unfortunately, despite the limitations placed on this recourse right, at times the security clauses have been worded in broad terms, leaving open to a wide unfettered ability for principals to claim this bank guarantee. To avoid situations where principles unfairly recall securities, some parties have amended these standard terms to only allow recourse if "the [p]rincipal has a bona fide claim".[1] Notwithstanding, there may be recourse for aggrieved parties even in situations where principals are not limited to bona fide claims due to the possible implied term of good faith.

Implied Terms

Differing views regarding the varying degrees of adoption on this implied term have often obscured a clear definition of 'good faith'. At times, the concept has eluded definition entirely, settling for anything short of 'bad faith'.[2] The judgement in *Paciocco v Australia and New Zealand Banking Group Pty Ltd*,[3] however, has relevantly summarised much of Australia's jurisprudence on this point, forming a definition that encompasses:

> *an obligation to act honestly and with a fidelity to the bargain; an obligation not to act dishonestly and not to act to undermine the bargain entered or the substance of the contractual benefit bargained for; and an obligation to act reasonably and with fair dealing having regard to the interests of the parties (which will, inevitably, at times conflict) and to the provisions, aims and purposes of the contract, objectively ascertained.*[4]

The originating source of jurisprudence on the possibility of an implied term of good faith stems from the Court of Appeal judgement in *Renard Constructions Pty Ltd v Minister for Public Works* (*Renard*).[5] Part of this decision turned upon the construction of a clause, which permitted the developer to cancel the contract or take over the work, unless the contractor was able to show cause to the contrary.[6] Ultimately, Priestly JA's Judgement turned upon the implication in fact, and by law, of a duty for the developer to exercise this power 'reasonably'. This concept of reasonableness, however, was considered in *obiter dicta,* and likened to notions of 'good faith'

[1] *Total Construction Pty Ltd v Catholic Healthcare Limited* [2023] NSWSC 585, [3].
[2] *Renard Constructions Pty Ltd v minister for Public Works* (1992) 26 NSWLR 234.
[3] (2015) 321 ALR 584.
[4] *Paciocco v Australia and New Zealand Banking Group Pty Ltd* (2015) 321 ALR 584, [288].
[5] *Renard Constructions Pty Ltd v minister for Public Works* (1992) 26 NSWLR 234.
[6] Ibid, 238.

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that have been applied in America and England.[7] His Honour noted the possibility of a "fast approaching" future where concepts of good faith would become part of explicit law in a similar means to foreign jurisdictions.[8] These comments have formed the basis of judicial debate surrounding the adoption of an implied term of good faith in Australian commercial contracts.

Despite Priestly JA's comments in 1988, this implied term of good faith has remained in a similar unresolved form, presently far short from the generalised implication that was foreshadowed by his Honour.[9] The Queensland Court of Appeal Case *QNI Resources Pty Ltd v North Queensland Pipeline No 1 Pty Ltd* (*QNI*),[10] aptly reviewed much of the historical jurisprudence on this point. In summary, despite the reluctance from Judges to imply a duty to act with good faith in a general context, it remains open for parties to argue whether the implied term should apply to a specific contract, or class of contract.[11] For an implied term of good faith to be implied into a particular type of contract at law, an applicant is not merely required to demonstrate an implied term is reasonable, but must establish that such term satisfies broad concepts of 'necessity'.[12] On this matter, courts have considered necessity to mean "what is needed for the effective working of contracts of that class,"[13] and have at times adopted a but for test which questions whether the contract "would or could be rendered nugatory…or, perhaps, be seriously undermined"[14] but for the implication of a duty to act in good faith.

Although the implied term of good faith has not reached uniform assent in commercial contracts, case law has supported a proposition that this term will be implied where a "contract confers [a] power on a contracting party in terms wider than necessary for the protection of legitimate interests".[15] Further specificity of this class was provided in *Eastbound Estate,*[16] where the plaintiff argued that a duty to act in good faith should be implied in contracts where a "discretion were so absolute as to permit the [party] to act unreasonably or in bad faith". Although it was ultimately left undecided whether the implied term would apply in this contract, Croft J accepted that on the proper construction of the contract as a whole, the unfettered discretion was subject to limitations.

In a similar vein, clauses that permit principals to have recourse to security without the need for a bona fide claim may be both 'wider than necessary' and permitting a party to act unreasonably or in bad faith. This issue was specifically addressed in *Clough Engineering Ltd v Oil and Natural*

[7] Ibid, 275.
[8] Ibid, 264.
[9] *QNI Resources Pty Ltd v North Queensland Pipeline No 1 Pty Ltd* [2022] QCA 169, [127].
[10] [2022] QCA 169.
[11] *Commonwealth Bank of Australia v Barker* (2014) 253 CLR 169, 187 [25]-[29].
[12] *QNI* [2022] QCA 169, [138], citing *Commonwealth Bank of Australia v Barker* (2014) 253 CLR 169, [28] and *Renard* (1992) 26 NSWLR 234, 255.
[13] *Commonwealth Bank of Australia v Barker* (2014) 253 CLR 169, [113].
[14] *Byrne v Australian Airlines Ltd* (1995); 185 CLR 410, [73].
[15] *Alcatel Australia Ltd v Scarcella* (1998) 44 NSWLR 349 ('*Alcatel*'), 367.
[16] *Pty Ltd v DC Consolidated Investments Pty Ltd* [2024] VSC 40, [62].

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Gas Corporation Ltd,[17] which stated that there were three recognised exceptions when a court will not enforce an unconditional recourse to security:[18]

1. Where the party in whose favour the performance guarantee has been given acts fraudulently;
2. Where the party in whose favour the performance guarantee has been given has acted unconscionably (in breach of the *Australian Consumer Law*); and
3. Where the party in whose favour the performance guarantee has been given has made a contractual promise not to call upon the bond.

In *Clough*, it was discussed how this prohibition on acting 'fraudulently' can be likened to a duty to act in good faith.[19] Despite the lack of clarity in this area, and the Australian Court's reluctance to imply a term of good faith broadly, jurisprudence has recognised a need for limitations to be placed on recourse to security clauses. This, however, is not to suggest that recourse to security clauses will automatically be subject to restrictions. Analysis of the contract's proper construction is still required, regarding the agreement as a whole. Rather, these principles elucidate that although courts may not necessarily always imply a duty to act in good faith for these clauses, the judiciary will *generally* prohibit a claiming party's ability to have recourse to the security in circumstances where they have acted unconscionably or in bad faith.

[17] [2008] FCAFC 136; 249 ALR 458 ('*Clough*').
[18] Ibid, [77] citing *Reed Construction Services Pty Ltd v Kheng Seng (Aust) Pty Ltd* (1999) 15 BCL 158 at 164-165.
[19] Ibid, [80] citing *Fletcher Construction Australia Ltd v Varnsdorf Pty Ltd* [1998] 3 VR 812, 827.

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