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# **How Discretionary are Contractual Discretions?**

A Critical Analysis of the Judicial Approach to Discretionary Powers in Commercial  
Contracts

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A dissertation submitted in partial fulfilment of the degree of Bachelor of Laws (with Honours) at the  
University of Otago, Dunedin, New Zealand

October 2017

## **ACKNOWLEDGEMENTS**

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I would like to sincerely thank Barry Allan, for your insightful ideas, feedback and support throughout the year that gave me the confidence to challenge the status quo.

I would also like to thank my friends, particularly Phoebe Clifford and Mitchell East, for providing much appreciated support, intellect and comic relief.

Finally, thank you to my family for the endless support and encouragement that has led me here.

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“A discretion is a very valuable asset.”

Shahid Khan – Business Tycoon

# INTRODUCTION

When parties engage in contractual agreements, they will generally agree on the dispersion of various powers within the arrangement. A contractual discretion is a legally constituted power of decision, vested in one of the contracting parties, which they alone may exercise.<sup>1</sup> A discretion will arise when the rights and obligations of the parties are not fixed within the four corners of the contract. Instead, it is stipulated that one or both parties should have a power of choice to make decisions after the contract is formed.

Discretionary powers are an increasingly common feature of commercial contracts, as they are a valuable asset to exchange when negotiating the agreement, an efficient way to provide flexibility for unforeseeable future events and a way to achieve *consensus ad idem* at contract formation while circumventing permanent agreement on all matters. Basic examples of such discretionary powers include:

- a) A discretion allowing one party to alter the interest rate part way through a finance or mortgage contract;
- b) A power to vary the charging or payment scheme in a contract of service;
- c) A discretion to choose a port or place of delivery for goods in a charter party;
- d) A power to vary operating rules for contractors or franchisees;
- e) A discretion to approve assignment or subcontracting by the other party, or to consent to a transfer of ownership.

When these powers are expressed in terms unconstrained by extrinsic advice, consent or input, their remit and potential effects can be very broad and powerful.<sup>2</sup> Hence, while the parties have bargained for these unilateral powers, they may substantially alter the relative benefits and burdens of the contract for each party – making them a very valuable asset. The rights affected by the exercise of a discretion do not pre-exist the legal source of the discretion; they are derived from the same bargain and instrument as the discretion itself.<sup>3</sup> Thus, as contract law governs voluntary, self-imposed obligations, the orthodox understanding is that any protections or limitations to the exercise of the discretionary power can be expressly provided for by the parties in their contract.

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<sup>1</sup> Terrence Daintith “Contractual Discretion and Administrative Discretion: A Unified Analysis” (2005) 68(4) MLR 554 at 555.

<sup>2</sup> Shane Campbell “Fetters upon the exercise of contractual discretion” [2017] NZLJ 141 at 141.

<sup>3</sup> Daintith, above n 1, at 565.

However, while New Zealand and the United Kingdom do not endorse a general duty of good faith in the performance of commercial contracts, a growing body of case law suggests that similar obligations will be imposed in the limited context of contractual discretions.<sup>4</sup> Increasingly, where a contract confers a discretionary power on one party, the courts are applying a minimum standard of decision-making, limited by concepts of honesty, good faith, and genuineness, and the need for absence of arbitrariness, capriciousness, perversity and irrationality.<sup>5</sup> This has been called the common law “mechanism to ensure good faith exercise of contractual discretions”.<sup>6</sup> Due to the increasing frequency of this limitation on the exercise of contractual discretions, it has come to be considered a ‘default rule’.<sup>7</sup> Therefore, throughout this dissertation, this formulation is what is meant when reference is made to the ‘default rule’, the ‘rule’ or the ‘limitation’.

A default rule is a consistent approach that will, in the absence of express exclusion or modification, govern parties’ contractual relationships, instead of the courts proceeding on a strictly case-by-case basis.<sup>8</sup> However, the courts insist that this term will not automatically be implied, as the limitation arises out of the individual contract itself.<sup>9</sup> Therefore, the courts have been imposing the rule through two legal mechanisms – contract construction and implication in fact – on the basis of the limit being the reasonable expectation of the parties.<sup>10</sup>

However, recent authority shows that such implication will ordinarily be made, due to the default rule not being displaced. This creates an issue as the courts are not consistently undergoing the orthodox interpretation and implication process to ensure the limitation is actually consistent with the agreed bargain and the parties’ intentions. This threatens the parties’ autonomy and freedom of contract, particularly in contracts between sophisticated commercial parties. Therefore, the purpose of this dissertation is to provide a critical analysis of the judicial approach to discretionary powers in commercial contracts.

The main framework of the rule developed in the United Kingdom over recent decades – a time of quiet revolution in the courts’ construction of commercial contracts. The judiciary began to prioritise the objectively reasonable interpretation that accorded with ‘commercial common sense’ over the

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<sup>4</sup> Richard Hooley “Controlling Contractual Discretion” (2013) 72(1) CLJ 65 at 65.

<sup>5</sup> *Socimer International Bank Ltd v Standard Bank London Ltd* [2008] EWCA Civ 116 at [66].

<sup>6</sup> Stephen Kós “Constraints on the Exercise of Contractual Powers” (2011) 42 V.U.W.L.R. 17 at 26.

<sup>7</sup> Kós, above n 6, at 20.

<sup>8</sup> C. A. Riley “Designing Default Rules in Contract Law” (2000) 20 O.J.L.S 367 at 367; Ian Ayres “Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules” (1989) 99 Yale LJ 87 at 88; Randy E. Barnett “The Sound of Silence: Default Rules and Contractual Consent” (1992) 78 Va. L. Rev 821 at 823.

<sup>9</sup> *Gan Insurance Company Ltd v Tai Ping Insurance Company Ltd* (No 2) [2001] 2 All ER (Comm) 299 at [62].

<sup>10</sup> *Cantor Fitzgerald International v Horkulak* [2004] EWCA Civ 1287 at [30].

ordinary, natural meaning of the contract.<sup>11</sup> While there is currently no authoritative New Zealand position on the default rule, the courts have made dicta statements that the United Kingdom approach would likely be followed in an appropriate case.<sup>12</sup>

Chapter One will provide a jurisprudential analysis of the rule's development and application in United Kingdom and New Zealand case law – and how this reflects the interventionist judicial approach of the time. This will focus on contracts between commercial parties of relatively equal bargaining strength, in which a bare, unfettered contractual discretion is expressly provided.<sup>13</sup>

In Chapter Two, I will explore the judicial rejection of imposing similar good faith duties in relation to the general performance of commercial contracts, absolute contractual rights and termination for convenience clauses. Consequently, I will analyse the reasons behind this 'hands off' approach and seek to understand why these reasons do not justify a similar treatment of contractual discretions, which is currently an anomaly in New Zealand contract law.

In Chapter Three, I will illustrate the recent reversion in contract interpretation towards the primacy of the commercial parties' express language. As the clearest evidence of the parties' intentions, the judiciary is striving to give effect to the contract's express language, except in the most obvious and extreme cases.<sup>14</sup> Courts are recognising that it is "unprincipled to interpret a contract so as to avoid a bad outcome for one party" and commercial common sense is no longer being seen as a trump card.<sup>15</sup> In light of this judicial trend, I propose it is time to reconsider the way the courts have been 'constructing' contractual discretions. It is my argument that, when a contract provides a bare, unfettered discretion, the process of interpretation should give effect to the natural and ordinary meaning of the discretion, unless there is clear reason to displace this assumption.

Finally, in Chapter Four, I will consider the principles of implication that the courts should be applying when deciding to fill a 'gap' in the contract with the default rule. Despite the rule's frequent inclusion by the courts, it often may not meet the stringent test for implication.<sup>16</sup> The rule provides one party with additional protection, artificially derived from the parties' 'reasonable intentions'. This

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<sup>11</sup> Lord Sumption, House of Lords "A Question of Taste: The Supreme Court and the Interpretation of Contracts" (Harris Society Annual Lecture, Keble College, Oxford, 8 May 2017).

<sup>12</sup> See for example *Bos International (Australia) Ltd v Strategic Nominees Ltd (in receivership)* [2013] NZCA 643; *C & S Kelly Properties Ltd v Earthquake Commission* [2015] NZHC 1690.

<sup>13</sup> Thus, my focus is not terms qualified as "sole" or "absolute" discretions, nor those that must be exercised "reasonably," "genuinely" or in reference to an objective criteria. However, I will consider the effect of my findings on these terms in Chapter Four.

<sup>14</sup> *Firm PI 1 Ltd v Zurich Australian Insurance Ltd* [2014] NZSC 147 at [62].

<sup>15</sup> *Air New Zealand Ltd v New Zealand Air Line Pilots' Association Inc* [2016] NZCA 131 at [75].

<sup>16</sup> While somewhat artificial to undergo an implied in fact analysis in the abstract, due to discretions sharing sufficient qualities to create a default rule, this will provide some value to courts' analysis going forward.

intervention may undermine the negotiated allocation of risk between sophisticated parties. This is not legally justified in the commercial sphere, where parties are sufficiently well placed to expressly provide their own protections and limitations in the contractual bargain. Although contractual discretions ostensibly share sufficient qualities to create a 'default rule', I argue that undergoing an implied in fact analysis will provide more rigorous protection for the bargain struck between the contracting parties, and therefore is a worthwhile undertaking.

In essence, I seek to demonstrate why the plain meaning of contractual discretions should be upheld, and why the current 'default rule' extends too far to be applicable in the commercial sphere. While current literature accepts the rule's application without question, I have sought to provide an alternative account, by considering whether such a rule is a necessary, justified limitation on commercial contracts.



# CHAPTER ONE

## The Current Approach to Contractual Discretions

### 1.1 Development of the Default Rule – United Kingdom

#### 1.1.1 Origin of the Rule

The *locus classicus* definition and justification of the rule is articulated by Leggatt LJ in *Abu Dhabi National Tanker Co v Product Star Shipping Co* (“The Product Star”).<sup>17</sup> This case concerned a charter party, which conferred on the owner of the ship a power to determine whether the port from which the charterer ordered the vessel was dangerous. In determining the scope of this power, Leggatt LJ found:<sup>18</sup>

The essential question always is whether the relevant power has been abused. Where A and B contract with one another 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 must be conferred, it must not be exercised arbitrarily, capriciously, or unreasonably. That entails a proper consideration of the matter after making any necessary enquiries. To these principles, little is added by the concept of fairness: it does no more than describe the result achieved by their application.

The United Kingdom Court of Appeal derived this limitation through construction, emphasising that the limitation arises out of the provisions of the contract by which the power is conferred. However, in subsequent Court of Appeal decisions where the rule was affirmed and applied, implication in fact developed as the preferred mechanism to limit a discretions' remit.<sup>19</sup> Reference to the parties 'reasonable expectations' was the key force behind the imposition of the term. It is “presumed to be the reasonable expectation and therefore the common intention of the parties that there should be a genuine and rational, as opposed to an empty or irrational, exercise of that discretion”.<sup>20</sup>

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<sup>17</sup> *Abu Dhabi National Tanker Co v Product Star Shipping Ltd (No 2)* [1993] 1 Lloyd's Rep 397 [‘The Product Star’].

<sup>18</sup> At 404.

<sup>19</sup> See *Ludgate Insurance Co Ltd v Citybank NA* [1998] Lloyd's Rep IR 221 (CA); *Gan Insurance*, above n 9; *Paragon Finance Plc v Nash* [2002] 1 WLR 685; *Cantor Fitzgerald*, above n 10; *Mid Essex Hospital Services NHS Trust v Compass Group UK and Ireland Ltd (trading as Medirest)* [2013] EWCA Civ 200. For a thorough outline of the development of English Court of Appeal decisions, see Stephen Kós, above n 6.

<sup>20</sup> *Cantor Fitzgerald*, above n 10, at [30].

This approach is summarised by the influential judgment of Rix LJ in *Socimer International Bank Ltd v Standard Bank London Ltd*.<sup>21</sup> *Socimer* concerned the termination of a contract between two banks for the forward sale of securities, where the seller was obliged to value the securities and give credit to those belonging to the buyer. In rejecting the argument that this discretion was limited by a more onerous objective standard of reasonableness, Rix LJ found:<sup>22</sup>

It is plain from these authorities 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, but only in a sense analogous to *Wednesbury* unreasonableness, not in the sense in which that expression is used when speaking of the duty to take reasonable care, or when otherwise deploying entirely objective criteria... Pursuant to the *Wednesbury* rationality test, the decision remains that of the decision maker, whereas on entirely objective criteria of reasonableness the decision maker becomes the court itself.

In 2014, the United Kingdom Supreme Court in *Telefonica 02 UK v British Telecommunications*, considered whether British Telecommunications' power to, "from time to time vary the charge" for their service allowed them to introduce a new charging scheme based on different charging criteria.<sup>23</sup> The Court found that:<sup>24</sup>

As a general rule, the scope of a contractual discretion will depend on the nature of the discretion and the construction of the language conferring it. But it is well established that in the absence of very clear language to the contrary, a contractual discretion must be exercised in good faith and not arbitrarily or capriciously...

In 2015, in *Braganza*, the United Kingdom Supreme Court posited the limitation clearly as an implied term, reflecting the recent reversion to the separation of the concepts of interpretation and implication.<sup>25</sup> The Court found that, "the court will only imply a term that the decision-making process be lawful and rational in the public law sense, that the decision is made rationally (as well as in good faith) and consistently with its contractual purpose".<sup>26</sup> The Court found that the problem with discretions is that they involve a clear conflict of interest, thus courts have sought to ensure that they

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<sup>21</sup> *Socimer*, above n 5.

<sup>22</sup> At [66].

<sup>23</sup> *British Telecommunications plc v Telefonica 02 UK Ltd and Others* [2014] UKSC 42.

<sup>24</sup> At [37] – citing the line of authority from *The Product Star* (above n 17). On the facts, as the contract was made in the context of a regulated environment, it was held the intention of the parties must have been to comply with these regulations, so were held to direct the scope of the powers. Overall, it was held their decision was within this scope.

<sup>25</sup> *Braganza v BP Shipping Ltd & Anor* [2015] UKSC 17. In *Marks & Spencer plc v BNP Paribas Securities Services Trust Co (Jersey) Ltd* [2015] UKSC 72, the United Kingdom Supreme Court clearly outlined the concepts were separate. Discussed further in Chapter Three.

<sup>26</sup> At [30].

were not abused.<sup>27</sup>

Overall, in the United Kingdom, it is considered that the threshold for intervention must be a high one, with the circumstances in which a court will intervene being “extremely limited”.<sup>28</sup> Provided there was a genuine and rational exercise of the discretion, the party is not obliged to prefer the interests of the other contracting party to the detriment of its own.<sup>29</sup>

### 1.1.2 Importation of the *Wednesbury* Unreasonableness Standard

The case law above identifies that *Wednesbury* unreasonableness, an administrative law concept, has been imported into this contractual context as an objective standard to test the subjective considerations of whether the exercise of the discretion was in good faith and rational.<sup>30</sup>

In administrative law, Parliament has given discretionary power to particular delegates under statute. As a result, due to the fundamental separation of powers in the constitutional structure of the United Kingdom and New Zealand, the Courts are reluctant to interfere with the substance of a decision. Rather, their enquiry is usually limited to assessing the propriety of the decision-making process.<sup>31</sup> Courts have the jurisdiction to ensure the decision-making power is properly exercised, but not to decide whether the proper decision has been made.

Similarly, in respect of contractual discretions, the fundamental common law rule is that the court does not substitute its own decision for that of the holder of the contractual power. The courts are committed to giving effect to the intention of the parties, therefore have seen their role as ensuring a proper decision-making process, judged in light of the overall purpose and character of the contractual deal, rather than commenting on the substance or effect of the decision.<sup>32</sup> Hence, analogies have been made with the judicial review of administrative powers.

*Wednesbury* unreasonableness is a standard applied in the judicial review of administrative law decisions. In its original formulation, *Wednesbury* unreasonableness had two stages.<sup>33</sup> First, the court interprets the relevant statutory power and decides which matters must be taken into account by the public decision-maker, and which must not. Second, the court determines whether these have been considered. If the decision-maker has not “kept within the four corners of the matter which they ought

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<sup>27</sup> At [18].

<sup>28</sup> *Ludgate Insurance*, above n 19, at [35].

<sup>29</sup> *Socimer*, above n 5, at [112].

<sup>30</sup> *Associated Provincial Picture Houses Ltd v Wednesbury Corporation* [1948] 1 KB 223 at 234; Hooley, above n 4, at 72.

<sup>31</sup> Jonathan Morgan “Against judicial review of discretionary powers”(2008) L.M.C.L.Q 230 at 233.

<sup>32</sup> Daintith, above n 1, at 576.

<sup>33</sup> *Wednesbury Corporation*, above n 30, at 241

to consider”, the decision is ultra vires and invalid.<sup>34</sup> Secondly, even when the authority has taken into consideration all relevant factors, it is still possible to impugn the decision if, “they have nevertheless come to a conclusion so unreasonable that no reasonable authority could have ever come it”.<sup>35</sup> This later phrase is what is traditionally imported to mean *Wednesbury* unreasonableness.

However, recently the Supreme Court expanded the requirement of “rationality” or “*Wednesbury* unreasonableness” to include both limbs in *Braganza v BP Shipping Ltd & Anor*.<sup>36</sup> The case concerned whether an employer had properly made his decision that an employee had committed suicide, as opposed to being lost at sea, hence disentitling his widow to the death in service’ benefit. As *Braganza* involved an employment contract, it was noted that this potentially attracted a greater degree of scrutiny than ordinary commercial contracts, meaning that they likely afforded less deference to the party exercising the contractual discretion due to the relative unequal bargaining power.<sup>37</sup> Nevertheless, both minority and majority judges agreed that the application of *Wednesbury* unreasonableness to the exercise of contractual discretions was the correct approach.<sup>38</sup> Therefore, the opinion did not have to be objectively reasonable as measured against some external benchmark.

However, increasing the previous standard of decision from solely the second limb, the majority in *Braganza* found that the discretion was constrained by both limbs of the *Wednesbury* test. As previously applied in this context, the final determination could not be so unreasonable – so outrageous in the defiance of logic – that no reasonable person could have reached it.<sup>39</sup> However, secondly, the *process* of decision-making also had to be rational, taking into account relevant considerations and disregarding those that were irrelevant. Thus, the Court recognised that the *Wednesbury* unreasonableness obligations may include both obligations relating to *how* the decision is arrived at, as well as the content of the decision itself.<sup>40</sup> In the majority’s view, the employer’s decision failed on the latter limb.<sup>41</sup>

The appropriateness of importing administrative law concepts to the context of commercial contracts is still debated (and will be considered further in Chapter Four). Whether the second limb ought to be applied to commercial contracts is controversial. It may add significantly to the due diligence required to exercise a discretion, and is arguably a much lower standard for intervention. A decision may be

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<sup>34</sup> At 241.

<sup>35</sup> At 234.

<sup>36</sup> *Braganza*, above n 25.

<sup>37</sup> Due to the special nature of employment, there is an implied term of mutual trust and confidence. At [38]-[40], [54] and [104], it is suggested that the employer may be held to a higher standard.

<sup>38</sup> *Braganza*, above n 25, at [29] and [103].

<sup>39</sup> *Wellington v Woolworths* [1996] 2 NZLR 537.

<sup>40</sup> At [18].

<sup>41</sup> At [42] and [63].

held to be a breach of contract simply because the discretion holder did not consider what the Court perceives to be the relevant matters, particularly when the court is assessing the situation *ex post facto* with the benefit of hindsight. In the administrative law context, public bodies owe duties to the public, thus it is justified for the Court to hold them to a higher standard of decision. However, the court imposing a default requirement that parties consider all proper considerations would go much too far in the encroachment of expressly agreed commercial rights. This could significantly undermine the deal they have struck - decreasing the value of the discretion and making it considerably more burdensome to exercise.

While *The Product Star* doctrine is still not fully settled and evolving, it is now firmly established in English law that, in the absence of very clear language to the contrary, the exercise of a contractual discretion will be restricted and controlled.<sup>42</sup> In both recent Supreme Court decisions, this firm establishment has meant the courts have not undergone the traditional stringent test for implication on the circumstances of the case – instead the rule is applied, absent clear language to the contrary. While it is apparently possible to exclude the implication of the term by the use of clear words, there are still uncertainties about the extent to which the term can be defined, modified and excluded.<sup>43</sup> It will be later argued that the current default imposition does not adequately respect the parties’ autonomy and freedom of contract in the commercial sphere.

## **1.2 Application of the Rule in New Zealand**

New Zealand legislation does not impose any general unfair contract term restrictions or protections on commercial contracts. Thus, parties must look to the common law to discover if, and how, the courts will intervene in commercial contracts. When the existence of the rule has been considered by the courts, an article written extra-judicially by Kós J (as his Honour then was) in 2011 is cited as authority for the rule’s existence in New Zealand.<sup>44</sup> In this article, his Honour noted that this is an area that receives surprisingly little attention in contract law textbooks and the framework of the rule has taken hold more clearly in comparable common law jurisdictions, particularly the United Kingdom.<sup>45</sup> Overall, the article proposes the English approach of implying a term to limit the exercise of unilateral contractual powers in commercial contracts, unless otherwise excluded or altered, would likely be followed if the issue was considered by a New Zealand court.

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<sup>42</sup> *Monk v Largo Foods Ltd* [2016] EWHC 1837 (Comm) at [59]. This position is also stated in leading commentaries including HG Beale (gen ed) *Chitty on Contracts: Volume 1: General Principles* (31<sup>st</sup> ed, Sweet & Maxwell, London, 2010) at [14-029] and Andrew Burrows *A Restatement of the English Law of Contract* (1<sup>st</sup> ed, Oxford University Press, Oxford, 2016) at 93.

<sup>43</sup> *Mid Essex Hospital Services NHS Trust v Compass Group*, above n 19, at [83].

<sup>44</sup> Kós, above n 6.

<sup>45</sup> Kós, above n 6, at 18.

At the time of writing the article, Kós J could only identify one short obiter passage in New Zealand dealing directly with the default rule in similar terms to the United Kingdom case law.<sup>46</sup> The Court of Appeal decisions in the 1980s developed a subsidiary aspect of the rule, namely the permissible scope of the exercise of a unilateral power to change the terms of the contract. In *Black White & Grey Cabs Ltd v Reid*, the Court found that the power of amendment held by the taxi company in a contract to vary its operating rules for drivers “must be confined to such amendments as could reasonably be considered to have been in contemplation by the parties when the contract was made having regard to the nature and circumstances of the contract”.<sup>47</sup> The Court of Appeal then subsequently qualified this “reasonably in contemplation” limitation, noting that it depended on the implication of a term, thus would “not arise almost automatically”, but would depend on the individual contract terms and context, advancing an *ad hoc* approach to the implication of these terms in New Zealand.<sup>48</sup>

Interestingly, Kós J’s article did not mention the case of *Vero Insurance New Zealand Ltd v Fleet Insurance & Risk Management Ltd*.<sup>49</sup> This was a High Court interim injunction hearing, where Asher J considered whether an absolute discretion to refuse consent to an ownership transfer in a joint venture agreement was subject to the contract’s express general good faith obligation, and if so, was this breached. The contract provided that the good faith provisions were, “subject to and not intended to limit the effect of any contrary provisions in the agreement”.<sup>50</sup> While good faith was argued to be contrary to an “absolute discretion”, the judge considered that the words “absolute discretion” did not necessarily exclude the application of a duty of good faith. His Honour held it would be “surprising” if discretions in a relational contract (here, a joint venture agreement) were not subject to such a requirement.<sup>51</sup>

Citing *The Product Star*, Asher J found that a party’s refusal to consent, so that it can escape an unwelcome contract, may be an arbitrary and unreasonable action not connected to the object of the contract, and not in accordance with what would, on an objective test, be the reasonable expectations of parties.<sup>52</sup> Consequently, the discretion’s exercise may not have been “true to the ideal that lies behind the contract”, was disloyal to the contractual relationship and may have been in bad faith.<sup>53</sup> However, as this was an interim injunction hearing the Court was, “more cautious about finally

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<sup>46</sup> *Todd Pohokura Ltd v Shell Exploration NZ Ltd* HC Wellington CIV-2006-485-1600, 13 July 2010 at [213]-[221].

<sup>47</sup> *Black White & Grey Cabs Ltd v Reid* [1980] 1 NZLR 40 (CA) at 49.

<sup>48</sup> *New Zealand Stock Exchange v Listed Companies Association Inc* [1984] 1 NZLR 699 (CA) at 705.

<sup>49</sup> *Vero Insurance New Zealand Ltd v Fleet Insurance & Risk Management Ltd* HC Auckland CIV-2007-404-1428, 21 May 2007.

<sup>50</sup> At [35].

<sup>51</sup> At [42].

<sup>52</sup> At [48].

<sup>53</sup> At [47].

determining issues of law” and indeed, did not need to do so.<sup>54</sup> Nevertheless, the reliance on *The Product Star* precedent is indicative of the position a New Zealand court would likely take.

In 2011, the year of Kós J’s article, the High Court in *Olsen Consulting Ltd v Goodman Fielder* held that a unilateral power to revise contractor’s fees based on a “costing model” was constrained by limitations analogous to the default rule – although these obligations were not termed as such.<sup>55</sup> The company paid a commission fee fixed by their costing model to its 130 delivery contractors nationwide, and the Company retained a unilateral right to review and change the commission based on this costing model.<sup>56</sup> However, this power was not entirely unfettered, as the discretion to review the commission fee was expressly “based on the Company’s costing model”.<sup>57</sup> The Court found that while the unilateral powers were to be given express effect, their:<sup>58</sup>

...only duty is to exercise those powers within their scope and to avoid acting maliciously, capriciously or arbitrarily. Whether in this instance it has done so depends firstly and finally on the express and any implicit scope of its power.

Although the Court could not dictate the outcome of the review, the power of review was subject to an implied term constraining the process used to exercise the power.<sup>59</sup>

Despite the findings in *Olsen*, since 2011, Kós J’s article has been consistently cited as authority for the existence of the default rule in New Zealand.<sup>60</sup> However, it is yet to be applied directly on the facts to a commercial contract. In *Bos Internatonal (Australia) Ltd v Strategic Nominees Ltd*, the Court of Appeal in obiter observed that while the discretionary power in question, might appear unconstrained (whether to exercise an option to capitalise the post-default interest), the Court will imply a term requiring the power to be exercised reasonably, in good faith, and consistently with the purpose of the power – citing Kós J’s article as authority.<sup>61</sup>

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<sup>54</sup> At [28].

<sup>55</sup> *Olsen Consulting Ltd v Goodman Fielder New Zealand Ltd* HC Auckland CIV 2011-404-5622, 23 November 2011.

<sup>56</sup> For authority, the case cited English authority *Paragon Finance Plc v Nash*, above n 19, and *Gan Insurance*, above n 9,, as well as Australian authority *Esso Australia Resources Pty Ltd v Southern Pacific Petroleum NL* [2005] VSCA 228 and *Vodafone Pacific Ltd v Mobile Innovations Ltd* (2004) NSWCA 15.

<sup>57</sup> On the facts, it was found the review could not be exercised consistently with its purpose (to ensure the costing model calculation is accurate) without engaging the contractor (by giving notice and opportunity to respond), as a completely unilaterally review would always carry the risk of being inaccurate and indeed arbitrary.

<sup>58</sup> At [38].

<sup>59</sup> Amy Ryburn and Jeremy Purton "Exercising contractual discretions" [2013] NZLJ 420 at 426.

<sup>60</sup> For example, *Quay Park Arena Management Limited v Great Lakes Reinsurance (UK) Plc* [2014] NZHC 2204; *C & S Kelly Properties Ltd v Earthquake Commission*, above n 12.

<sup>61</sup> *Bos Internatonal*, above n 12, at [70]. Similarly, the line of authority arising from *The Product Star*, above n 17, citing Kós, above n 6, was acknowledged as an alternative available course of action in *Quay Park Arena*, above n 60, with the principle being described as the default

Furthermore, the default rule was applied to a quasi-contractual statutory discretionary power by the High Court in *C & S Kelly Properties Ltd v Earthquake Commission*.<sup>62</sup> The power arose from the Earthquake Commission (EQC) Act creating rights, “pursuant to a scheme of statutory insurance”.<sup>63</sup> The Court held that, while it was not a contractual dispute insofar as it related to EQC, the relationship between the two parties was, “nonetheless analogous to a contractual one”, and relevant assistance is thus provided from considering the approach taken for a contractual discretion.<sup>64</sup> Citing *Kós J and Bos International*, the High Court summarised:<sup>65</sup>

Commonwealth Courts are willing to intervene in the exercise of a prima facie unfettered discretion. Such intervention will ordinarily be premised on an implied term to constrain the exercise of the discretion so as to give effect to the reasonable expectations of the parties. The exercise of contractual discretion will be open to challenge where it can be established that it was not exercised honestly in good faith; or not exercised for the purpose(s) for which it was conferred; or when exercised in a capricious or arbitrary manner; or otherwise falls into the category of what would be considered *Wednesbury* unreasonableness.

The Court found that it did not matter whether the discretion was categorised as administrative or contractual, as a challenge under either head had to meet the same high threshold.<sup>66</sup> The plaintiff would need to prove that the decision to repair was an unreasonable decision in the sense that no insurer in EQC’s position could have reasonably settled other than by way of monetary payment, thus establishing “a finding of irrationality”.<sup>67</sup> The case was decided on another ground, thus no conclusion was made as to whether this standard was breached.

However, most recently, indicative of a potential trend away from intervention, the High Court in *Myall v Tower Insurance Limited* recognised that the basic common law rule is that the Court does not substitute its own decision for that of the holder of the contractual power, and the circumstances in which a Court will interfere are extremely limited.<sup>68</sup> The Court did not engage in discussion of what standard should be applied to the exercise of the discretion, however concluded that there was no

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rule that applies in the exercise of a discretionary power conferred by a contract. An engineer did not validly exercise his contractual discretion to issue a certificate in respect of defective works. However, the decision had already been determined as ultra vires based on the express terms of the contract (at [173]).

<sup>62</sup> *C & S Kelly Properties Ltd v Earthquake Commission*, above n 12.

<sup>63</sup> At [54].

<sup>64</sup> At [66].

<sup>65</sup> At [73].

<sup>66</sup> At [75].

<sup>67</sup> At [85].

<sup>68</sup> *Myall v Tower Insurance Limited* [2016] NZHC 251 at [94].



evidence that Tower exercised its discretion about how to deal with under insurance outside of its power.<sup>69</sup>

Accordingly, unlike England, in New Zealand there is currently no clear case where the default rule has formed the basis for the decision. However, if an appropriate case came before the courts there is a strong indication that limitation may be imposed as a default position, given Kós J's endorsement of the United Kingdom approach, alongside the recent line of English Appellate Court cases endorsing the implication.<sup>70</sup>

### **1.3 Summary**

Overall, the development of the default rule highlights how the express terms of a contractual discretion often do not explicitly specify the scope or the limits of how the power can be exercised, generally in order to give effect to a power of choice. This has led courts to impose constraints through a mixture of principles of construction and terms implied in fact. This line of cases is indicative of a period when construction and implication were largely conflated by the judiciary, and the notion of commercial common sense was something of a trump card.<sup>71</sup> The parties are assumed to have intended the scope of the powers to be limited in this way, as the courts perceive this to be a commercially reasonable way to prevent abuse in the self-interest.<sup>72</sup> It is the parties' duty to use express language to displace this presumption, rather than expressly provide for it.

The courts have posited the justification for the default rule as representing “the very essence of any business relationship”.<sup>73</sup> However, the question that arises is how does this align with the courts' general refusal to constrain sophisticated commercial parties with good faith duties in other areas of commercial contracts? An exploration of these areas provides an insightful background for considering if and why differential treatment of discretionary powers is necessary.

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<sup>69</sup> At [107].

<sup>70</sup> Kós, above n 10, at 26.

<sup>71</sup> Lord Sumption, above n 11.

<sup>72</sup> *Socimer*, above n 5, at [116].

<sup>73</sup> *Socimer*, above n 5, at [106].

## CHAPTER TWO

### Unrestrained Areas of Commercial Contracts

In this chapter I will explore three areas where the courts have refrained from imposing similar duties to the default rule in relation to commercial contracts. Firstly, the refusal to imply a general duty of good faith in the performance of commercial contracts. Secondly, the rejection of the application of the default rule, and good faith generally, to the exercise of absolute rights and termination for convenience clauses.

#### 2.1 General Duty of Good Faith in Contract Performance

New Zealand and English courts have thus far not recognised a general duty of good faith in the performance of commercial contracts. The general approach in English Law is to develop “piecemeal solutions in response to demonstrated problems of unfairness” rather than committing to an overriding principle.<sup>74</sup> The default rule is the mechanism to ensure good faith in the exercise of contractual discretions.<sup>75</sup> Consequently, this raises concerns as to whether discretions provided between sophisticated commercial parties gives rise to sufficient unfairness to justify introducing a subset of this general duty into commercial law. While inevitably opening a Pandora’s box of academic debate, it is necessary to broadly consider the reasoning behind the rejection of the general duty in order to understand why and how this subset could be justified.

##### 2.1.1 Meaning of Good Faith

Obligations of good faith have deep roots in long established common law doctrines of contract.<sup>76</sup> However, a clear meaning of the concept has been notoriously difficult to reach. There is still no consensus on the meaning and scope of the duty.<sup>77</sup> This is in part due to courts defining the duty in a context-specific way, depending on the type of contract and the express obligations placed on parties.<sup>78</sup> It is often argued that the inherent ambiguities render the duty too uncertain to be useful.

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<sup>74</sup> *Interfoto Picture Library Ltd v Stiletto Visual Programmes Ltd* [1988] 1 All ER 348 at 352.

<sup>75</sup> Stephen Kós, above n 6, at 26.

<sup>76</sup> Edward Elvin “*Good faith, or good fake? The role of good faith in the performance of commercial contracts*” (LLM, University of Otago, 2013) at 7; *Bhasin v Hrynew* [2014] 3 SCR 494 at [32].

<sup>77</sup> Elvin, above n 76, at 40.

<sup>78</sup> John Burrows, Jeremy Finn and Stephen Todd *Law of Contract in New Zealand* (5<sup>th</sup> ed, LexisNexis, Wellington, 2015) at 201.

While previously often described as requiring the absence of bad faith, New Zealand has recently shown movement towards a more substantive definition of good faith.<sup>79</sup> While still always being highly dependent on the factual matrix, Sir Anthony Mason’s definition embracing three common notions is frequently cited by the courts in relation to both implied and express obligations of good faith.<sup>80</sup> These notions are:<sup>81</sup>

- a) An obligation on the parties to cooperate in achieving the contractual objects (*loyalty to the promise itself*);
- b) Compliance with honest standards of conduct; and
- c) Compliance with standards of conduct which are reasonable having regard to the interests of the parties.

This creates three interrelated duties: co-operation, honesty and reasonableness, with cooperation of the parties tending to emerge as the key general principle.<sup>82</sup> As described in *Bobux Marketing Ltd*, “underlying the concept of [good faith] ... is a perception of loyalty to the promise”.<sup>83</sup> This is intended to ensure that both parties are able to gain the benefit of the contract, by preventing one party from taking advantage of any technicalities to the disadvantage of the other.<sup>84</sup>

### 2.1.2 Implying Good Faith into Commercial Contracts

English and New Zealand courts are currently “swimming against the tide” by rejecting a general duty of good faith implied in law into commercial contracts.<sup>85</sup> The general duty is gaining momentum internationally, as overseas courts are demonstrating a stronger acceptance of the duty.<sup>86</sup> However, given New Zealand’s general alignment with the English approach, these two jurisdictions’ general rejection will be the focus of the discussion.

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<sup>79</sup> Bad faith being considered behaviour such as acting capriciously, inconsistently with the terms of the contract or attempting to frustrate or undermine the agreement (J Cheyne and P Taylor “Commercial Good Faith” [2001] NZLJ 245 at 247).

<sup>80</sup> Anthony Mason “Contract, *Good Faith and Equitable Standards in Fair Dealing*” (2000) 116 LQR 66; cited in cases such as *Vero Insurance*, above n 49, at [45].

<sup>81</sup> Mason, above n 80.

<sup>82</sup> Elvin, above n 76, at 21.

<sup>83</sup> *Bobux Marketing Ltd v Raynor Marketing Ltd* [2002] 1 NZLR 506 (CA) at [41].

<sup>84</sup> L Hamilton and A Chote “Good faith in commercial contracts” [2013] NZLJ 209 at 209.

<sup>85</sup> *Yam Seng Pte Limited v International Trade Corp Limited* [2013] EWHC 111 (QB) at [124].

<sup>86</sup> Elvin, above n 76, at 6. Across the Pacific, Australian courts have shown a stronger acceptance of a duty. However, the approach has been inconsistent across States, and the High Court is yet to consider the issue (Jeffrey Goldberger “Fetters on the exercise of unilateral contractual powers and discretions” (2015) CLQ 16). Conversely, in 2014, Canada had a land mark decision of the Supreme Court, recognising a duty of good faith as an “organising principle” across contractual relations (*Bhasin v Hrynew* above n 76, at 385).

In New Zealand, there are currently only statutorily imposed duties and judicially imposed targeted interventions within specific commercial contexts. Generally, this involves close relationships where it is considered that the contract would lack commercial or practical coherence without a duty of good faith and where all other requirements for implication are met.<sup>87</sup>

Overall, duties of good faith have generally arisen out of ideas of fairness and protecting a vulnerable party. Thus, the requisite necessity has not arisen between arm's length, commercial parties with relatively equal bargaining power. The English approach is said to embody an ethos of individualism, as judges have tended to prefer to take a 'hands off' approach in the competitive commercial environment – favouring freedom of contract and the notion that contractual obligations are voluntarily assumed.<sup>88</sup> Particularly where there is a complete commercial agreement, courts often consider that a good faith requirement would not fit comfortably with the express terms of that agreement.<sup>89</sup> Courts operate on the assumption that sophisticated parties can and will negotiate for any protection they desire, and prefer that judges simply give effect to what is written in the contract.<sup>90</sup> Therefore, parties are free to pursue their own self-interest not only in negotiating, but also in performing contracts, provided they cooperate in the doing of things that are necessary to perform their obligations and do not act in breach of any terms in the contract.<sup>91</sup>

A general good faith obligation arguably also creates too much uncertainty.<sup>92</sup> The ideal of the rule of law, a fundamental pillar of the common law, is that parties can ascertain in advance with reasonable certainty the extent of their legal duties. There is concern that the ambiguity and open ended nature of an obligation of good faith is vague and subjective and could undermine the goal of contractual certainty to which English law has always attached great weight.

Furthermore, there is a fear of legal moralism, as enforcing good faith duties encourages judicial conscience to ameliorate the outcomes of harsh commercial dealing.<sup>93</sup> This arguably uses the legal system to enforce moral and ethical standards of the community, as opposed to merely enforcing rules that prohibit harmful behaviour. Judges are also already able to deal satisfactorily with much of what,

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<sup>87</sup> *Yam Seng*, above n 85. Statutes impose duties of good faith into employment and fiduciary relationships, insurance contracts and on company directors. In employment contracts, the duty is seen as a common-sense approach to mediating the key relationship in commercial endeavours. In the insurance context, it is implied due to the common market failure caused by asymmetrical information.

<sup>88</sup> *J.L. Stanley v Fuji Xerox New Zealand Ltd HC Auckland CP479/96*, 5 November 1997.

<sup>89</sup> See for example, *Walton Mountain Ltd v Apple New Zealand Ltd* (2004) 5 NZCPR 241.

<sup>90</sup> P.S. Atiyah and S. A. Smith *Atiyah's Introduction to the law of contract* (6<sup>th</sup> Ed, Oxford University Press, Oxford, 2005) at 155. This has led to parties increasingly including express obligations of good faith in their arrangements (Mary Arden *Common Law and Modern Society: Keeping Pace with Change* (Oxford University Press, Oxford, 2016) at 48).

<sup>91</sup> *Yam Seng*, above n 85, at [123]; Burrows, Finn and Todd, above n 78, at 200.

<sup>92</sup> *Yam Seng*, above n 85, at [123].

<sup>93</sup> Atiyah and Smith, above n 90, at 165.

in other legal systems, might be dealt with by the doctrine of good faith. Undue influence, misrepresentation and requirements of notice for unusually draconian terms all protect against certain instances of bad faith.

Given these concerns, a duty of good faith will only be implied when it is deemed necessary. The requisite level of necessity has been found to arise out of ‘relational contracts’ – which govern not merely an exchange but a longer term relationship between the parties.<sup>94</sup> This was recognised in *Yam Seng*, where Leggatt J, in a significant departure from the traditional position, implied a good faith obligation on contract performance in a commercial distribution contract due to the ‘relational’ nature of the contract.<sup>95</sup> Leggatt J found that the implication of good faith “necessarily arises”, as the contract is predicated on high expectations of loyalty, mutual trust and confidence.<sup>96</sup> His Honour emphasised that contracts, like all human communications, are made against a background of unstated, shared understandings consisting of shared values, norms of behaviour and expectations of honesty which inform their meaning.<sup>97</sup> These may not be legislated for in the express terms of the contract but can be implied as a matter of business efficacy. This reflects the wide-ranging approach to contract construction of the period, of which there has been a slight shift away from as referred to earlier. This will be considered in Chapter Three.

However, despite *Yam Seng*, it is still likely that any good faith term must satisfy the common implication law tests – particularly, it must sit comfortably with the express terms of an agreement – a hurdle that may not be easily overcome in a detailed, carefully constructed agreement.<sup>98</sup>

## **2.2 Duties in Relation to ‘Absolute’ Rights**

Secondly, the default rule (and good faith obligations generally) do not apply to the exercise of an absolute right of a binary nature – for example, an option to extend a contract, which simply can be positively exercised or not.<sup>99</sup> Such powers have frequently been distinguished from discretions, as it is

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<sup>94</sup> Such as in joint venture, franchise and distributorship agreements. This is in contrast to transactional contracts, such as sale and purchase agreements, where the ongoing maintenance of the relationship is not paramount to the contract’s completion (L Hamilton and A Chote, above n 84).

<sup>95</sup> *Yam Seng*, above n 85, at [142].

<sup>96</sup> At [133].

<sup>97</sup> At [134].

<sup>98</sup> J Cheyne and P Taylor, above n 79. For example, see *Dymocks Franchise Systems (NSW) Pty Ltd v Bilgola Enterprises Ltd* [2000] 3 NZLR 169 (CA) at [21].

<sup>99</sup> J Edward Bayley “A Doctrine of Good Faith In New Zealand Contractual Relationships” (LLM, University of Canterbury, 2009) at 199. The courts have also denied that any obligations apply to rights arising at law, such as to rescind or to claim damages. However, as these rights are not provided through express agreement, they are outside of these principles is outside of the scope of this dissertation.

argued that in a simple decision of whether or not to engage, there is no process which needs activation and no further need to give effect to the intention of the parties.<sup>100</sup>

This occurred in *Mid-Essex Hospital Services NHS Trust v Compass Group*, where it was noted that, “[a]n important feature of the...authorities is that in each case the discretion does not involve a simple decision whether or not to exercise an absolute contractual right. The discretion involved making an assessment or choosing from a range of options, taking into account the interests of both parties”.<sup>101</sup> The Court held that the default rule should not apply to a simple decision to engage an objective ‘points and deduction’ calculation mechanism to award service failure points specified in the contract.

Similarly, in the recent decision of *Monk v Largo Foods Ltd* it was noted that, “where a commercial contract gives one party an option to extend the contract, or as to the amount of goods to be supplied or acquired, or as to the ports to or from which cargo is to be shipped, that party will not ordinarily be under any duties of the kind recognised in *Braganza* in relation to the exercise of that option”.<sup>102</sup>

The lack of mutuality is considered the issue with discretions, as the default rule applies when a contract allocates one party a power to make decisions in the contract which may have an effect on *both* parties to the contract.<sup>103</sup> This apparently distinguishes it from an absolute right. A discretion puts one party at the mercy of the other’s discretion – which one can expect to be used by the party to advance its own interests, to the detriment of others.<sup>104</sup> The courts have constrained this freedom to ensure the conflict of interest does not lead to abuse.

However, the distinction between the two powers seems arbitrary. It seems that the exercise of an absolute right will also have an effect on *both* parties and involve a conflict of interest. While a simple decision of whether or not to exercise has less latitude for abuse, “in each case one party to the contract has a decision to make on a matter which affects the interests of the other party...whose interests are not the same. The same reason exists in each case to imply some constraint on the decision maker’s freedom to act purely in its own self-interest”.<sup>105</sup> The issue in the case concerned whether an innocent party’s right in law to elect to remain in a contract after a repudiatory breach was subject to an implied good faith restriction.

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<sup>100</sup> Elizabeth Peden *Good Faith in the Performance of Contracts* (LexisNexis Butterworths, 2003) at 167.

<sup>101</sup> *Mid Essex Hospital Services NHS Trust v Compass Group*, above n 19, at [83].

<sup>102</sup> *Monk v Largo Foods Ltd*, above n 42, at [57].

<sup>103</sup> *Braganza*, above n 25, at [18].

<sup>104</sup> *Gan Insurance*, above n 9, at [62].

<sup>105</sup> *MSC Mediterranean Shipping Co. SA v Cottonex Anstalt* [2015] EWHC 283 (Comm) per Leggatt J at [97].

The High Court of England in *MSC Mediterranean Shipping* held it should, as it should be treated analogously to contractual discretions. However, this was overruled by the Court of Appeal as a good faith duty in relation to termination rights was rejected.<sup>106</sup> This was on the grounds that a general duty may be invoked to undermine, as much as to support, the terms in which the parties have reached agreement, and that the danger of the duty is not dissimilar to that posed by too liberal an approach to construction, against which the Supreme Court warned in *Arnold v Britton*.<sup>107</sup> Consequently, it seems the Court's key reasons for rejecting the duty in relation to absolute rights should also apply to discretions. If the courts do not feel there is the necessary need for protection against abuse in the self-interest in relation to absolute rights, this reasoning should apply to contractual discretions. Therefore, the High Court's endorsement for analogous treatment and coherent standards of decision still has significance.

Furthermore, it is often difficult to distinguish between a right and discretion, and thus a discretion could be couched as a contractual right through small distinctions in drafting in order to avoid such obligations.<sup>108</sup>

### **2.3 Good Faith in Relation to Termination for Convenience Clauses**

Similarly, there has recently been an increase in discussion whether commonly encountered termination for convenience clauses - one of the most powerful, expansive forms of discretionary power - should be subject to a good faith obligation.<sup>109</sup> A termination for convenience clause is intended to permit the beneficiary to terminate a contract at any time with impunity, generally subject to a notice period.<sup>110</sup> Judges have been traditionally hostile towards pre-emptory termination clauses, as they are rarely invoked for the reasons they were originally included in the agreement.<sup>111</sup> A party with a right to terminate will only do so if it suits their commercial interest.<sup>112</sup>

However, while there are numerous indeterminate impediments to successful reliance upon a termination for convenience clause, this has not lead to an application of good faith obligations. Most

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<sup>106</sup> *MSC Mediterranean Shipping Co. SA v Cottonex Anstalt* [2016] EWCA Civ 789 at [45].

<sup>107</sup> *Arnold v Britton* [2015] UKSC 36.

<sup>108</sup> Ryburn and Purton, above n 59, at 7.

<sup>109</sup> William Dixon "Termination for Convenience or Not?" (2017) 45 ABLR 229 at 230: The origin of such clauses being the "contractualisation" of the accepted doctrine of executive necessity – to permit governments to unilaterally terminate a contract without impunity for policy or budgetary reasons. While the requirement to exercise such power properly was inherent where governments were concerned for a variety of reasons – particularly the obligation of answering to the voters at elections – such an obligation was not implied into contracts.

<sup>110</sup> Dixon, above n 109, at 229

<sup>111</sup> Lord Sumption, above n 11.

<sup>112</sup> Lord Sumption, above n 11.

recently, the New Zealand High Court in an interim injunction hearing found that the express contractual requirement of good faith in the agreement did not apply to the clearly defined right to terminate without cause.<sup>113</sup> Following the case of *TSG Building Services v South Anglia Housing*, a termination for convenience clause meant that a party could, for no good or bad reason, terminate at any time before the term of the contract concluded – that being the risk that each voluntarily undertook when it entered into the contract.<sup>114</sup> The Court found that the good faith clause requires:<sup>115</sup>

... the parties to act in good faith towards each other in respect of all dealings or matters under, or in connection with the agreement. The right to terminate is, however, unilateral. There are no dealings with the other party. Termination is not a matter under the agreement. It brings it to an end. Nor is termination connected with the agreement. It no longer exists.

Therefore, the entitled party could exercise this term solely by reference to his own interests.<sup>116</sup> The Court considered that even if the good faith obligation had been implied rather than expressed, it would not have extended to termination. According to the High Court, it simply would not make commercial sense to apply the good faith clause to a right of either party to terminate for convenience, as they were of clearly conflicting natures.

Aligned with this decision, and also demonstrating the recent shift in judicial approach, the English High Court in *Monde Petroleum SA v Western Zagros Ltd* refused to imply a term into a commercial contract which stated that a party would not terminate the contract in bad faith.<sup>117</sup> Such a term could not be implied because the contract had commercial and practical coherence without it, and a contractual right to terminate could be exercised irrespective of the exercising party's reason for doing so. Again, however, it was further justified that the suggested term was not concerned with the performance of the contract, but with its termination.

Despite commercial good faith obligations being more readily accepted in Australia, the Australian courts have followed the same approach to termination for convenience clauses.<sup>118</sup> The courts have

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<sup>113</sup> *Saturn Portfolio Management Limited v Camberlain & Ors* [2017] NZHC 1962 at [25].

<sup>114</sup> *TSG Building Services Plc v South Anglia Housing Ltd* [2013] EWHC 1151 at [51].

<sup>115</sup> *Saturn*, above n 113, at [29].

<sup>116</sup> *TSG Building Services*, above 114, at [51].

<sup>117</sup> *Monde Petroleum SA v WesternZagros Ltd* [2016] EWHC 1472 (Comm).

<sup>118</sup> For example, see *Carratti Holdings Co Pty Ltd v Coventry Group Ltd* [2014] WASC where it was held that good faith could not restrict the operation of a very broadly drafted clause. However, Dixon, above n 109, notes that there is still scope and some judicial support for an argument that a termination for convenience clause may be subject to a good faith obligation. Also of note, in relation to a more general, fettered termination right, requiring the party to show cause, the New South Wales Court of Appeal held this was subject to an implied duty for the principal to act reasonably in exercising its right to terminate (*Renard Constructions (ME) Pty Ltd v Minister for Public Works* (1992) 26 NSWLR 234). For further information, see William Dixon's recent article, above n 109.



considered good faith inconsistent with the unfettered right to terminate for convenience that the express terms provide.<sup>119</sup> It has been opined to be axiomatic as the parties will act “sometimes for a reason that may not present to others as a good reason”.<sup>120</sup>

Thus, the courts reject the duty for being inconsistent with the voluntarily given express right and because there is no future performance to be concerned with - the other party is no longer under the other party’s control. The recent *Monde* petroleum case also provides the additional reason that the contract had practical coherence without it, thus there is no justification for imposition.<sup>121</sup>

## 2.4 Summary

This discussion illuminates some important distinctions the courts in the United Kingdom and New Zealand are making. Overall, the court will not imply duties of good faith if the contract has commercial and practical coherence without such a duty. Generally, courts are only occasionally willing to impose good faith duties regarding future performance when there is an element of vulnerability or mutuality in order to keep the contract workable. Such a necessity does not arise when a party has a power to exercise a right to terminate the agreement at their convenience – which has fundamental impact on the other party, but does not leave any future performance to be concerned with. Nor does such a necessity arise when exercising absolute rights – as it is considered the interests of both parties do not need to be considered.

Generally, the mutuality and protectionist values underlying good faith are considered inappropriate between two sophisticated commercial parties. However, the courts have found the *default* position is that the exercise of discretionary powers are subject to good faith obligations. What gives rise to this significantly more interventionist position? Given the legal environment, the nature of a *discretionary* power must justify the necessity to imply this incremental, targeted duty of good faith. It is therefore necessary to consider whether this anomaly in default position is really justified.

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<sup>119</sup> See *Solution 1 Pty Ltd v Optus Network Pty Ltd* [2010] NSWSC 1060; *Starlink International Group Pty Ltd v Coles Supermarkets Australia Pty Ltd* [2011] NSWSC 1154; *Trans Petroleum (Australia) Pty Ltd v White Gum Petroleum Pty Ltd* (2012) 268 FLR 433.

<sup>120</sup> *Starlink*, above n 119, at [32].

<sup>121</sup> *Monde*, above n 117.

## CHAPTER THREE

### Interpretation of Contractual Discretions

It is at this stage that we reach the crux of the research, in considering whether the judicially imposed default rule is justified in the modern commercial law environment? The greatest strength of the common law lies in the fluidity of judge made law, as this provides versatility and responsiveness to new circumstances.<sup>122</sup> This means the default rule is in no way set in stone and the courts have the power to change their approach if it is unsettled in light of new principles.<sup>123</sup>

As the courts are favouring a contextual approach, legally each case is a discrete, contextual inquiry. The current law is applied to the individual circumstances of the case. While the courts have tended to prefer to frame the default rule as implied in fact, the principles of interpretation *and* implied terms have played complementary roles in how the courts have been controlling contractual discretionary powers in pre-existing case law:<sup>124</sup>

A discretionary power must be exercised within its proper scope and for its proper purpose. The scope and purpose of the power is to be identified through the process of construction of the contract. Once the limits of the power have been identified the court can then examine the manner of its exercise, which is usually controlled through the implication of terms.

This interpretation and implication of the contract is carried out through the lens of the courts, who are determining the parties' reasonable expectations. Thus, in this Chapter, I seek to demonstrate the evolution in judicial attitude towards commercial contracts and hypothesise how this should affect the judicial approach to interpreting discretionary powers going forward. Although it may seem somewhat artificial to 'interpret' a discretionary power in the abstract, I believe it will highlight important considerations for the courts going forward.

#### 3.1 The Role of the Judiciary in Enforcing Commercial Contracts

Contract law governs voluntary, self-imposed obligations, as opposed to legal duties imposed by the state. The state merely enforces the private agreement through the judiciary. As the core principles of

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<sup>122</sup> S. Wilken and T. Villiers *The law of waiver, variation and estoppel* (2<sup>nd</sup> ed, Oxford University Press, Oxford, 2002) at vii.

<sup>123</sup> JW Carter and W Courtney "Unexpressed Intention and Contract Construction" (2017) 37(2) OJLS 326 at 343.

<sup>124</sup> Hooley, above n 4, at 72.

contract law are almost entirely the product of judicial decisions, it is necessary to understand judges' conception of their own role in contract law, as this underlies their approach to enforcing a contract.

According to Atiyah, contract law can be justified on two grounds, referred to as the economic ground and the moral ground.<sup>125</sup> In brief, the economic ground is premised on the idea that parties freely enter agreements because both parties think they will be economically better off – which in turn helps society be better off by increasing social welfare and social wealth. However, as most exchanges cannot be performed simultaneously, the risk of non-performance would dissuade people from entering otherwise beneficial exchanges. Thus, to provide parties with confidence that the other party will perform, the court's role is to *secure performance* and *cooperation* in what the parties have agreed – instilling confidence in contracting and consequently facilitating mutually beneficial exchanges.

Comparatively, the foundation of the more individualist moral ground is that promises are considered one of humanity's greatest moral inventions, thus contracts are morally significant.<sup>126</sup> When individuals promise to do something, they place themselves under duties that did not previously exist. The court's primary purpose is to order contracts to be performed, as the parties owe duties to each other to do what they contract to do, rather than to society generally.<sup>127</sup> Any social benefits are merely side effects.

Under both views of contract law, the court's fundamental role is to impose the law that the parties have privately created and agreed upon. This is the fundamental principle of freedom of contract - individuals possess the liberty to make law for themselves and form contracts with whom and on what terms they choose in order to derive the benefit from co-operation and exchange.<sup>128</sup> However, while these intentions are expressed in the contract, the court will view the contract through the lens of the hypothetical reasonable person. As Lord Steyn explained:<sup>129</sup>

The function of the law of contract is to provide an *effective and fair* framework for contractual dealings. This function requires an adjudication based on the *reasonable expectations* of parties.

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<sup>125</sup> Atiyah and Smith, above n 90, at 3-9.

<sup>126</sup> Atiyah and Smith, above n 90, at 7.

<sup>127</sup> If the contract cannot be enforced, the court must ensure that *justice* is done between the individuals by requiring remedies for the injustice of parties breaking their promises.

<sup>128</sup> Daintith, above n 1, at 565.

<sup>129</sup> Johan Steyn "Contract Law: fulfilling the reasonable expectations of honest men" (1997) 113 LQR 433 at 433-434.

This is not a rule or principle of law, but “the objective which has been and still is the principal moulding force of our law of contract”.<sup>130</sup> This ‘lens’ of the hypothetical reasonable person regulates the interpretation of contracts. When it is given strong weight, it results in the judiciary limiting the parties’ freedom by ensuring a ‘reasonable’ contract is constructed. Conversely, when it is given less weight, contracts are strictly enforced, regardless of how fair the outcome. Over time, there has been a swinging pendulum of judicial weight between enforcing the values of the hypothetical reasonable person versus the contested ideal of freedom of contract. This evolution has significantly affected the organic development of the law and, of importance for this dissertation, the approach to interpreting commercial contracts.

### **3.2 The Revolution in Judicial Approach to Contract Interpretation**

#### **3.2.1 The Traditional Approach**

A court must *interpret* a contract in order to ascertain its meaning and how the parties intended it to apply to the given set of facts.<sup>131</sup> The clearest expression of the parties’ intention is the expressly agreed terms of the agreement. Consequently, the traditional understanding of contract interpretation prioritised a formalistic, textual approach. In exercising their judicial function, judges were bound by the ‘plain meaning rule’ – that the contract is to be interpreted using the ordinary meaning of the language - and the ‘parol evidence rule’ - requiring the exclusion of extrinsic evidence to ‘add to, vary or contradict’ a written document.<sup>132</sup> The court would seldom look beyond the ‘four corners’ of the contract in which they had chosen to enshrine their agreement and would follow the formal, literal expression of the parties’ intentions. The goal was to elucidate the meaning of the express words.<sup>133</sup>

This reflected the thinking of the Classical Period (1770 -1870), during which freedom of contract was left to flourish and state interference was kept to a minimum.<sup>134</sup> Courts took a laissez-faire approach and enforced contracts strictly to give effect to the intention of the parties. Judges denied any power to interfere with individuals’ inalienable rights to make contracts – even if this meant that one party suffered greatly. The law was not concerned with the justice or fairness of the outcome.

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<sup>130</sup> *First Energy (U.K.) Ltd v Hungarian International Bank Ltd* [1993] 2 Lloyd’s Rep 194 (emphasis added).

<sup>131</sup> JW Carter and W Courtney, above n 123, at 327.

<sup>132</sup> Burrows, Finn and Todd, above n 78 at 173.

<sup>133</sup> Lord Sumption, above n 11.

<sup>134</sup> P.S. Atiyah *The Rise and Fall of Freedom of Contract* (1<sup>st</sup> ed, Oxford University Press, Oxford, 1979) at 219-226, 398-448.

However, from 1870 -1980, the belief in freedom of contract declined due to a reversion to paternalistic traditions.<sup>135</sup> The lack of understanding of classical contract law was seen to provide no guarantee that contracts were meaningfully ‘free and voluntary’ – particularly when dealing with weaker parties like consumers. Therefore, the societal approach towards more general notions of fairness and justice resulted in a growth of consumer protection, rent and employment legislation. New contract law rules were invoked on the basis of advancing policy, rather than giving effect to the parties’ intention. However, when dealing with commercial contracts between parties of relatively equal bargaining power, this had little influence and the laissez-faire approach to interpretation remained the orthodoxy.

### 3.2.2 The Modern Approach

The default rule became readily applied during the ‘contemporary period’ (1980 - 2006). During this time, there was a revival in the freedom of contract approach due to a resurgence of support for the markets. However, this actually led to more judicial intervention, as the focus was facilitating contracting to achieve optimal market efficiency.<sup>136</sup> Forming default rules became a prominent way to provide parties with background support - making contracting easier, safer and saving time and expense in writing lengthy contracts.

Against this background, there was a ‘quiet revolution’, as the judicial role of ‘interpreting’ the contract prolifically expanded.<sup>137</sup> Led by Lord Hoffmann, adherence to the traditional rules of interpretation diminished and there was a “flight from language”.<sup>138</sup> The House of Lords began to “free the construction of contracts from the shackles of language” and replace them with some broader notion of intention by focusing on “surrounding circumstances” and “commercial common sense”.<sup>139</sup> There was a “shift from literal methods of interpretation to a more commercial approach”, resulting in the meaning of language being determined by the court striving to putting itself in the position in which the parties stood at the time the contract was made.<sup>140</sup>

Lord Diplock’s declaration in *Antaios Compania Naviera*, where the House of Lords refused to find that an express right of termination for any breach meant any breach, however minor, exemplifies this shift:<sup>141</sup>

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<sup>135</sup> Atiyah, above n 134, at 613 - 627.

<sup>136</sup> As opposed to reaching a fair outcome and protecting the weak.

<sup>137</sup> David McLauchlan “The New Law of Contract Interpretation” (2000) 19 NZULR 147 at 148.

<sup>138</sup> Lord Sumption, above n 11.

<sup>139</sup> Lord Sumption, above n 11.

<sup>140</sup> *Sirius International Insurance Co v FAI General Insurance* [2004] 1 WLR 3251 at 201 per Lord Steyn.

<sup>141</sup> *Antaios Compania Naviera v Salen Rederierna AB* [1985] AC 191 at 201.

If detailed semantic and syntactical analysis of words in a commercial contract is going to lead to a conclusion that flouts business common sense, it must be made to yield to business common sense.

Lord Hoffmann's five principles in *Investors Compensation Scheme Ltd v West Brunswick Building Society* ('ICS') were highly influential in securing this modern approach to contract interpretation.<sup>142</sup> The case is considered to have "changed the mood among judges dealing with commercial contracts".<sup>143</sup> The case established that interpretation is the ascertainment of not the literal meaning of the document but what the document would convey to a reasonable person having all background knowledge which would reasonably have been available to the parties at the time of the contract's formation.<sup>144</sup> The wider background and circumstances were to be considered even if there was no ambiguity in the language of the contract.

The first three principles adopted by Lord Hoffmann essentially allowed the court to consider "absolutely anything" which would have affected the way the contract would have been understood by a reasonable man, apart from pre-contractual negotiations and information unavailable to the parties.<sup>145</sup> The fourth principle distinguished between *language* and *meaning*; finding that language was merely dictionaries and grammar, while meaning was what the document would convey to a reasonable person against the relevant background. The fifth principle was that the 'natural and ordinary' meaning of the language is no more than a rebuttable presumption that people mean what they say in formal documents. If the background suggests something has gone wrong with the words, the law may find that the parties cannot, as reasonable people, have meant what they ostensibly said, so the court is entitled to substitute something else.<sup>146</sup> Hence, the objectively reasonable interpretation began to take priority over the plain language. These principles were adopted in New Zealand by the Supreme Court in *Vector Gas*.<sup>147</sup>

The plain meaning of an unfettered discretion provides no suggestion that a commercial party must exercise this power in good faith or that it must be exercised in accordance with the judicially construed purpose. If the discretion was abused or used absurdly, plainly this would be the suffering party's fault for agreeing to the term. However, under the modern approach, the injustice of "being subjected to the uninhabited whim" of the other party was perceived as a commercially unreasonable

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<sup>142</sup> *Investors Compensation Scheme Ltd v West Brunswick Building Society* [1998] 1 WLR 896 at 912-913 ['ICS'].

<sup>143</sup> Lord Sumption, above n 11.

<sup>144</sup> *ICS*, above n 142, at 912-913.

<sup>145</sup> At 912 - 913.

<sup>146</sup> At 912 - 913.

<sup>147</sup> *Vector Gas Ltd v Bay of Plenty Energy Ltd* [2010] NZSC 5 at [22].

result.<sup>148</sup> Therefore, the parties will be deemed to have not intended the scope of the power to be limitless and the courts intervened to reconstruct the power with ‘rational’ limits.

### 3.2.3 The ‘Post Modern’ Approach

Recently, there has been a shift back towards commercial parties being primarily governed by the voluntarily assumed obligations enshrined by their express agreement. Both United Kingdom and New Zealand appellate courts have begun to revert back to the primacy of express language in their interpretation of contracts.

In the United Kingdom Supreme Court case of *Arnold v Britton*, Lord Neuberger, delivering the leading judgement, asserted the danger of retrospectively applying a notion of commercial common sense influenced by what had gone wrong after the contract was made.<sup>149</sup> His Lordship stated that “a court should be very slow to reject the natural meaning of a provision as correct simply because it appeared to be a very imprudent term for one of the parties to have agreed”.<sup>150</sup> Similarly, in *Krys v KBC Partners*, a majority of the Privy Council declined to depart from the natural meaning of language simply because the result might be regarded as one sided or unfair, and suggested that in the face of sufficiently clear language even an absurd result may have to be accepted.<sup>151</sup>

Further a unanimous United Kingdom Supreme Court in *Wood v Capita Insurance Services* gave effect to the words of the contract, involving the sale of a company, despite this creating a very arbitrary distinction.<sup>152</sup> The Court noted the clear conflicting interests of the buyers and sellers involved, yet found:<sup>153</sup>

In the tug o’ war of commercial negotiation, business common sense can rarely assist the court in ascertaining on which side of the line the centre line marking the tug o’ war rope lay, when negotiations ended.

Thus, despite creating a harsh result, the plain meaning of the contract was followed, favouring the sellers, as there were reasons apparent in other provisions as to why the parties could have rationally intended it. While the United Kingdom Supreme Court is yet to overrule *ICS* and both decisions discussed above had powerful dissents arguing that the majority gave too much weight to the language

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<sup>148</sup> *The Product Star*, above n 17, at 404.

<sup>149</sup> *Arnold v Britton*, above n 107, at [17].

<sup>150</sup> At [20].

<sup>151</sup> *Krys v KBC Partners* [2015] UKPC 46 at [24].

<sup>152</sup> *Wood v Capita Insurance Services* [2017] UKSC 24.

<sup>153</sup> At [28].

and not enough to the reasonableness of the result, there is clearly evidence of a shift in judicial approach.

Similarly, in New Zealand, the Supreme Court in *Firm PI 1 Ltd v Zurich*, recognised the dangers of a purposive rather than strict construction in finding that:<sup>154</sup>

If the language at issue, construed in the context of the contract as a whole, has an ordinary and natural meaning, that will be a powerful, albeit not conclusive, indicator of what the parties meant.

The Court noted that where the contractual language, viewed in the context as a whole, has an ordinary and natural meaning, a conclusion that this ordinary meaning produces a commercially absurd result should be reached only in the most obvious and extreme of cases.<sup>155</sup> The Court held it should not be overlooked that:<sup>156</sup>

The language of many commercial contracts will have features that ordinary language (even a “serious utterance”) is unlikely to have, namely that it will result from a process of negotiation, will attempt to record in a formal way the consensus reached and will have the important purpose of creating certainty, both for the parties and for third parties...

Thus, while the context is still a necessary element of the interpretive process, the text is of central importance.<sup>157</sup> Courts must be careful departing from the natural meaning merely because it conflicts with commercial common sense, or what the parties *should* have intended. The New Zealand Court of Appeal in 2016 reiterated that the natural and ordinary meaning of the words is central to the interpretation task, concluding, “it is unprincipled to interpret a contract so as to avoid a bad outcome for one party”.<sup>158</sup> Similarly, this year the Supreme Court found there was no need to consider extrinsic evidence when interpreting the contract as the plain meaning of the language was “crystal clear”.<sup>159</sup>

While it is axiomatic that the law should reflect reasonable, moral views as to how citizens should act, in commercial contractual communications, the context is typically one in which it is known that

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<sup>154</sup> *Firm PI 1 v Zurich*, above n 14, at [63].

<sup>155</sup> At [93].

<sup>156</sup> At [62].

<sup>157</sup> At [63].

<sup>158</sup> *Air New Zealand Ltd v New Zealand Air Line Pilots' Association*, above n 15, at [75]-[76]. In this case, the Court overruled the Employment Court's finding as it could see no reasons arising from the context, background or business common sense for departing from the ordinary and natural meaning of the words “any agreement”.

<sup>159</sup> *Lakes International Golf Management Limited v Hartley Clendon Vincent* [2017] NZSC 99 at [29].



words are meant to be understood without resort to external evidence.<sup>160</sup> Drafters assume that they are producing a ‘self-interpreting’ document that can be understood without external aids or evidence, in accordance with the plain meaning. As the courts provide a public service and litigation is costly, with part of that cost being borne by the state, it is perfectly legitimate for courts to expect contracting parties to take care to ensure that their contractual documents accurately represent their agreement.<sup>161</sup> While not expected to draft perfectly self-interpreting documents, the parties can be expected to make reasonable efforts. The only way the judiciary can encourage such behaviour is by refusing to engage in a detailed examination of evidence designed to show that a contract does not mean what it appears to mean.

Therefore, it is argued this judicial retrenchment from the ‘modern approach’ is both necessary and appropriate. Interpretation is primarily about understanding the express words of the contract, and when dealing with commercial parties who are presumed to be well advised, the starting position should be that there is no reason to assume their ‘true intention’ was anything other than what they expressly agreed upon. Therefore, judges must give effect to what is written in the contracts, rather than deciding what the parties’ obligations ought to be on efficiency or fairness grounds.<sup>162</sup> If required at all, notions of fairness and commercial reasonableness are more appropriately invoked at the stage of implication, where a more stringent test is applied, as will be discussed in Chapter Four.

### **3.3 Application of the ‘Post Modern’ Approach to Contractual Discretions**

Lord Sumption persuasively argues *ICS* to be the commencement of using commercial common sense not as a means of understanding the language, but as a means of overriding it.<sup>163</sup> This was the background under which the default rule began to develop – a time in which judges felt comfortable to reconstruct express terms based on ‘commercial logic’.

This recent shift in judicial thinking should impact how the courts interpret contractual discretions. Courts should enforce the plain meaning of discretions even if it differs from the parties’ reasonable understanding or expectation of that document.<sup>164</sup> Such an approach has successfully been taken in the

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<sup>160</sup> Stephen A. Smith “‘The Reasonable Expectations of the Parties’: An Unhelpful Concept” (2009) 48 C.B.L.J 367 at 370 and 384.

<sup>161</sup> Smith, above n 160, at 385.

<sup>162</sup> It is important to note this is not advocating a literalism approach to the canon of construction – the common law has always recognised that language is imprecise, that context may modify its meaning and the words may be used in a special sense. This shift is not between a literal and commercial interpretation, but between an approach to contractual construction which elucidates the meaning of words, and an approach which modifies or contradicts the words in pursuit of what appears to a judge to be a reasonable result. (Lord Sumption, above n 11).

<sup>163</sup> Lord Sumption, above n 11.

<sup>164</sup> Smith, above n 160, at 385.

treatment of exclusion clauses - reverting from the traditional interventionist, hostile approach to interpretation in place of giving effect to the plain and natural meaning to respect the parties' freedom to allocate risk between themselves.<sup>165</sup> If a discretion is provided in terms that do not limit its exercise, this is generally how it should be construed. While this may appear to create the harsh outcome of a broad, extensive power, there could be rational reasons as to why the power was termed this way and it is not for the courts to make such a judgement.

To provide an example, consider an unfettered discretion provided to Party A, a product supplier, to 'vary a payment scheme' to Party B. On its natural and ordinary meaning, this provides an unfettered discretion to vary the scheme as Party A sees fit. It may be more commercially reasonable or 'fair' to read this power as limited by notions of good faith and the absence of capriciousness, but this is not what the parties have expressly agreed to. The broad power may have been given in exchange for better delivery or cancellation rights for Party B, and this is not a completely absurd concept to have agreed to. When a discretion to vary the contract is built in at the contract's formation, it is in exchange for the consideration provided at the time.<sup>166</sup> Thus, to limit the exercise of this discretion is to undermine the bargain struck between the parties. Therefore, the clear words should be given primacy – leaving the party to vary the payment scheme however it pleases.

However, if the power involves variation of the actual amount to be paid, this could allow Party A to set the consideration it provides for Party B's services at \$0. This will raise concerns that the promise is illusory, as Party A is arguably not bound to provide any meaningful consideration. This concern must be addressed.

### 3.3.1 Could a broad, unfettered discretion render the contract illusory?

A valid contract requires consideration from both sides - consideration being any "practical benefit".<sup>167</sup> If freely agreed, a discretionary right is built into a contract, thus it is in exchange for consideration given at the time.<sup>168</sup> However, although seldom raised in litigation, if the discretion falls at the centre of the contract, meaning the performance of the contract is at the sole discretion of one party, it cannot be described as a promise at all and amounts to illusory consideration.<sup>169</sup> This lack of mutuality in being bound to perform could arise if a discretion surrounds an essential term, such as the

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<sup>165</sup> *Attorney-General v Seven Electrical Ltd* (2004) High Court, Wellington, 8/10/2003, CIV-2000-485-787.

<sup>166</sup> Burrows, Finn and Todd, above n 78, at 748.

<sup>167</sup> *Williams v Roffey Bros & Nicholls (Contractors) Ltd* [1990] 1 All ER 512.

<sup>168</sup> *Antons Trawling Co Ltd v Smith* [2003] 2 NZLR 23 at [93].

<sup>169</sup> *Biotechnology Australia Pty Ltd v Pace* (1988) 15 NSWLR 130 at 356.

payment or interest terms, the goods or services to be provided or a general power to vary the terms of an agreement.<sup>170</sup>

In *Barton v Air New Zealand Ltd*, Air New Zealand's power to vary the terms of the Koru Club membership program was challenged on this ground.<sup>171</sup> However, the Court found that an absolute discretion to change these terms so that no sensible area of obligation remained did not render the contract illusory, nor did the Court limit the exercise of this power. The Court held that Air New Zealand's actual prior performance of core obligations constituted consideration.<sup>172</sup> This left open the question of whether a broad discretion termed without restraint would make the agreement illusory and we can only speculate as to the approach that would be adopted if such a case came before the courts.

The fundamental flaw in the discretion is in the lack of mutuality in the power, making the performance of the contract optional to one party. In the New South Wales Supreme Court case of *Biotechnology v Pace*, Kirby P set out applicable principles to consider when determining if a contract is illusory.<sup>173</sup> The court will endeavour to uphold the validity of the agreement between the parties, but the court will not do so where, in effect, it is asked to spell out to an unacceptable extent, that to which the parties have themselves failed to agree. The court will not accept for itself a discretion which the parties have, by their agreement, reserved to either of them. The facts of *Biotechnology* involved an employment contract with an option to participate in an equity participation scheme. However, no scheme actually existed, thus the agreement was so devoid of meaning and so dependent upon the decisions of one party that it was rendered illusory. Particular emphasis was placed on the absence of any external standard which could be relied on to fix an 'appropriate' or reasonable equity participation scheme.

Therefore, if a contract leaves the decision solely to one party, the court may be able to intervene to limit the scope of this power in accordance with the contract's 'general purpose' and hence ensure some performance.<sup>174</sup> Good faith limitations are one potential way of salvaging an agreement, and are often implied to prevent a contract being rendered illusory in a number of United States decisions.<sup>175</sup> For example, a power to vary the payment scheme must be done in good faith – which would likely

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<sup>170</sup> For example, if a party has, "the discretion to vary the quantity of goods provided", they could set this at zero and thus have promised no "practical benefit" in the agreement.

<sup>171</sup> *Barton v Air New Zealand Limited* HC Wellington CIV-2002-485-838, 6 October 2004.

<sup>172</sup> At [80].

<sup>173</sup> *Biotechnology Australia Pty Ltd v Pace*, above n 169, at 235.

<sup>174</sup> *Daintith*, above n 1, at 587.

<sup>175</sup> As discussed by Ruth Loveranes "Termination for Convenience Clauses" (2012) 14 *University of Notre Dame Australia Law Review* 103 at 107.

prevent the setting of consideration at \$0. Thus, the default rule could be a necessary salvage mechanism to uphold the validity of the agreement, and in turn give effect to the parties' intention to be legally bound.<sup>176</sup>

However, it must be considered whether it is appropriate for the courts to be operating as a salvage mechanism. Generally, where there is a clear intention to create legal relations, the courts will strive to uphold and enforce an agreement. As stated in the Court of Appeal case of *Fletcher Challenge*:<sup>177</sup>

The intention of the parties, as discerned by the Court, to be bound or not to be bound should be paramount. If the Court is satisfied that the parties intended to be bound, it will strive to find a means of giving effect to that intention by filling the gap.

The general rule is that when a business transaction is undertaken between strangers, it will almost always be a reasonable inference that they were intending to create a legally enforceable relationship.<sup>178</sup> Therefore, in the commercial context, the requisite intention to be bound will generally be clear.

However, as the contract interpretation trend sways towards giving effect to the parties' express wording, rather than their 'reasonable intentions', this may lead a court to decline to impose the default rule through interpretation because the parties' express terms provide no such limits. Thus, the court may be left to rely on implication to impose any limitation on the exercise of the discretion.

However, it is not correct in principle to imply terms that create what would otherwise not be a legally binding bargain.<sup>179</sup> Their duty is primarily to enforce legally valid promises, not create promises. In a commercial context, the courts should not enforce limitations to which the parties have themselves failed to agree. Therefore, implying the default rule, or good faith obligations generally, to save a contract is not an appropriate intervention by the courts. The contract may have to be rendered illusory

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<sup>176</sup> Dixon, above n 109, at 241, presents a similar argument in the case of termination for convenience clauses. He notes that it has been argued that a strict interpretation of a termination for convenience clause could render a contract void and unenforceable on the basis that the party with a totally unfettered termination for convenience clause may terminate at any time, thus making the performance of the promise optional and the contract unsupported by valid consideration (where no compensation regime is in place). In keeping with the long standing doctrine that courts should adopt a construction of contractual terms which preserves the validity of the promise. Dixon suggested this may prompt courts to adopt a construction that places a good faith limitation on the exercise of the right to terminate for convenience so as to avoid any question of the contract being void and unenforceable.

<sup>177</sup> *Fletcher Challenge Energy Ltd v Electricity Corporation of New Zealand Ltd* [2002] 2 NZLR 433 at [60].

<sup>178</sup> *Fleming v Beevers* [1994] 1 NZLR 385 at 389.

<sup>179</sup> *Aotearoa International Ltd v Scancarriers A/S* [1985] 1 NZLR 513 (HC, CA and PC) at 556.

if such broadly drafted powers are provided in relation to essential terms.<sup>180</sup> Again, as we are dealing with commercial parties, they are considered capable of being properly advised and drafting to avoid such problems.

### **3.4 Summary**

In summary, if the judicial trend in favour of reverting back to the primacy of language continues, then on its true construction, the court will interpret an unfettered discretionary power to be just that - unfettered. If this renders the contract illusory, this is the parties' fault and the contract will be void. However, if there is a legally valid contract, the court must then turn to implication in order to determine whether it is necessary to imply any term that limits the exercise of the discretion. This will be discussed in the following chapter.

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<sup>180</sup> This may turn out to be a controlling mechanism – as if a holder of a broadly drafted unfettered discretion abuses this power, they risk the entire contract being challenged as illusory. However, on the other hand, this may lead to abuse, as if the non-holding party recognises this gap and dislikes the way the other party uses the power, this may lead them to get the contract struck out.

## CHAPTER FOUR

### Implication of the Default Rule

While rejecting an overarching implied good faith obligation, English authority supports this discrete limitation fettering the exercise of contractual discretions. Generally, the courts ostensibly proceed on an implied by fact approach, considering the particular facts of the case in order to determine whether it is necessary to imply any limitations.

However, the traditional stringent test for implying a term has not been regularly invoked in relation to discretions. Instead, the courts are starting from the default position that the power will be limited, unless ousted by the express words – essentially how implied by law terms operate, which must be justified on policy grounds. As the *locus classicus* of the rule was almost 25 years ago, a time of very different judicial approach, it is now appropriate to reconsider the validity of the default rule today by applying the orthodox ‘implied in fact’ principles.

#### 4.1 Principles of Implication

As parties cannot provide for every future contingency, many contracts will inevitably have some ‘gaps’. After interpreting the express terms of the agreement, the court will imply a term in fact if it finds that, based on the particular wording of the contract and the factual circumstances, the parties have omitted a term that they intended to be included in the contract, yet have not expressly stated.<sup>181</sup> There is a rebuttable presumption that there are no terms other than the written terms.<sup>182</sup> Thus, the agreed terms are given the greatest weight and a core concept is that no term will be implied if the contract is workable without it.<sup>183</sup> Any term implied in fact must be consistent with the express terms and hence can be avoided by appropriate wording.<sup>184</sup>

In relation to commercial contracts between parties of comparable bargaining power, it is generally considered that, due to the need for commercial certainty, it will be rare for a term to be implied.<sup>185</sup>

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<sup>181</sup> *Commercial Law in New Zealand* (online looseleaf ed, LexisNexis) at 4.4.

<sup>182</sup> Burrows, Finn and Todd, above n 78, at 80.

<sup>183</sup> *Ward Equipment Ltd v Preston* [2017] NZHC 240 at [23].

<sup>184</sup> Terms may also be implied by custom or law – due to policy grounds. However, as English and New Zealand courts have generally been justifying constraints on discretions through an implied by fact approach, this will be the focal point of this discussion. Such categories do overlap and are difficult to rigidly, discretely classify.<sup>184</sup> As Cooke P in *Vickery v Waitaki International Ltd* [1992] 2 NZLR 58 (CA) said, implied terms are best seen as “shades in a continuous spectrum”. The need for the default rule has not so far raised sufficient policy concerns to require an implied by law approach, which would not allow express exclusion.

<sup>185</sup> *Pernod Ricard New Zealand Ltd v Lion-Beer, Spirits & Wine (NZ) Ltd* [2012] NZHC 2801.

The decision to imply a term must satisfy certain strict requirements to ensure the courts are respecting the parties' autonomy and freedom of contract, as an implied term is essentially being imposed on the parties.

Implication was traditionally controlled by the 'business efficacy' and 'officious bystander' tests.<sup>186</sup> As Lord Pearson described:<sup>187</sup>

It is not enough for the court to find that such a term would have been adopted by the parties as reasonable men if it had been suggested to them: it must have been a term that went without saying, a term *necessary* to give business efficacy to the contract, a term which, although tacit, formed part of the contract which the parties made for themselves.

Thus, the standard for implication is necessity, not reasonableness, generally to resolve a difficulty for which the parties have not provided.<sup>188</sup> The courts will not imply a term to make a contract fairer.

However, recent case law has unsettled the test to determine whether a term should be implied in New Zealand. The stringent test in *BP Refinery* is conventionally applied, providing the five criteria that must be satisfied before a term will be implied:<sup>189</sup>

1. It must be reasonable and equitable, as the courts will not imply a term that is unfairly advantageous to one party.
2. It must be necessary to give business efficacy to the contract - if the agreement can function without the implied term, although perhaps less fairly, the term is not to be implied.
3. The term must be so "obvious that it goes without saying".
4. The term must be capable of clear expression.
5. The implied term must not contradict any express term of the contract.

The Privy Council created uncertainty when the issue was revisited in *Attorney General of Belize v Belize Telecom Ltd.*<sup>190</sup> Moving away from the *BP Refinery* test, Lord Hoffmann proposed that "the question for the court is whether such a provision would spell out in express words what the instrument, read against the relevant background, would reasonably be understood to mean". Thus, implication arguments are to be determined in the holistic process of contract 'construction', as they

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<sup>186</sup> *Shirlaw v Southern Foundries Ltd* [1939] 2 KB 206 at 227; *The Moorcock* (1889) 14 PD 64.

<sup>187</sup> *Trollope v Colls Ltd v North West Metropolitan Regional Hospital Board* [1973] 2 All ER 260 at 268.

<sup>188</sup> *Leisure Centre Ltd v Babytown Ltd* [1984] 1 NZLR 318 (CA).

<sup>189</sup> *BP Refinery (Westernport) Pty Ltd v Shire of Hastings* (1977) 16 ALR 363 at [40].

<sup>190</sup> *Attorney General of Belize v Belize Telecom Ltd* [2009] UKPC 11 at [16]-[27].

are spelling out what the instrument *really means*.<sup>191</sup> The New Zealand Supreme Court indicated support for the *Belize* approach in the cases of *Nielson v Dysart Timbers Ltd*, and the Court of Appeal applied the *Belize* approach in *Hickman v Turn and Wave Ltd*.<sup>192</sup>

However, over the past two years, appellate courts in the United Kingdom and New Zealand have begun to revert from the advanced interventionist position expressed in *Belize*. The United Kingdom Supreme Court in *Marks & Spencer v BNP* held that *Belize* merely imports a gloss on *BP Refinery*, not a substantial alteration of the criteria.<sup>193</sup> All judges agreed that *Belize* had no effect of watering down the stringent requirements for implying a term, regardless of whether this was done under the head of general contract construction or the discrete category of implication. The requirement of the term being necessary to give business efficacy was given particular emphasis.<sup>194</sup>

In consideration of *Marks & Spencer*, the New Zealand Supreme Court recently stated in obiter that there is scope for argument surrounding whether adoption of the undiluted version of Lord Hoffmann's approach is appropriate.<sup>195</sup> While extensive consideration of the correct approach to implied terms is outside of the scope of this dissertation, it is proposed that, as implication provides more latitude for serious impositions on the contract, New Zealand courts should strive to keep the processes of interpretation and implication clearly distinct, and the stringent *BP Refinery* test for implication should be applied, following *Marks & Spencer*. This test provides rigorous protection for the bargain struck and if it is not undoubtedly met, a term should not be implied into a commercial contracts.

The courts need to apply the test on a strict case-by-case basis to contractual discretions, to ensure the principles of freedom and sanctity of contract are upheld. I will demonstrate how the default rule is unlikely to consistently meet the *BP Refinery* criteria when considered in relation to a bare, unfettered discretion in a commercial contracts, and hence is an unjustified judicial intervention.<sup>196</sup>

## **4.2 Is the Default Rule Reasonable and Equitable?**

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<sup>191</sup> At [21].

<sup>192</sup> *Nielson v Dysart Timbers Ltd* [2009] 3 NZLR 160 at [25]; *Hickman v Turn and Wave Ltd* [2011] NZCA 100 at [248] stating “We agree that the approach adopted in the *BP Refinery* case should not necessarily be regarded as a cumulative list of elements all of which must be satisfied before a term may be implied. However, each element is a useful indicator relevant to the ultimate question of what a reasonable person would have understood the contract to mean. This is to be construed objectively by a notional reasonable person with knowledge of the relevant background”.

<sup>193</sup> *Marks & Spencer*, above n 25.

<sup>194</sup> At [37].

<sup>195</sup> *Mobil Oil New Zealand Ltd v Development Auckland Ltd* [2016] NZSC 89 at [81].

<sup>196</sup> In accordance with recent case law, contract interpretation and implication will be considered distinct processes. See for example, *Monk v Largo Foods Ltd*, above n 42, at [33].



The first criterion under the *BP Refinery* test is that the term must be reasonable and equitable.<sup>197</sup> In *Socimer*, the necessity of the default rule was justified to protect against abuse in the self-interest and due to the relational character of contracting. The good faith exercise of a discretionary power was held to represent, “the very essence of any business relationship”.<sup>198</sup> The Court in *Socimer* found:<sup>199</sup>

While, in any such situation, the parties are likely to have conflicting interests and the provisions of the contract effectively place the resolution of that conflict in the hands of the party exercising the discretion, it is presumed to be the reasonable expectation and therefore the common intention of the parties that there should be a genuine and rational, as opposed to an empty or irrational, exercise of discretion.

Similarly, the most recent justification by the United Kingdom Supreme Court in *Braganza* justified the intervention as a protective measure to prevent abuse:<sup>200</sup>

It is not for the courts to rewrite the parties’ bargain for them, still less to substitute themselves for the contractually agreed decision maker. Nevertheless, the party who is charged with making the decisions which affect the rights of both parties to the contract has a *clear conflict of interest*... The courts have therefore sought to ensure that such contractual powers are *not abused*.

Lord Steyn argued the certainty that literalism purportedly provides is at odds with the kind of behaviour that contract law ought to encourage and sanction.<sup>201</sup> As the default rule is not extensive or excessively onerous, it arguably merely prevents the ‘outrageously bad’. This can only be good for society and the economy as it allows parties to contract confidently in the market and provide these powers without fear that they will be completely abused.

These justifications for the rule are heavily influenced by ideas of fairness and commercial common sense – which are now recognised as generally immaterial when dealing with sophisticated commercial parties (as discussed in Chapter Three). Parties in contracts are often in positions of conflict, yet it has been consistently held that a duty of good faith does not represent the “essence” of a business relationship, nor does it represent the “ideal that lies behind contract”.<sup>202</sup> England and New Zealand courts have enabled the individual ethos and competitive nature of commercial relations to flourish in this regard. Discretions place parties in a particularly adversarial position, as the power of

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<sup>197</sup> *BP Refinery*, above n 189, at [40].

<sup>198</sup> *Socimer*, above n 5, at [106].

<sup>199</sup> At [65].

<sup>200</sup> *Braganza*, above n 25, at [18]. However, it is important to note this was in an employment contract context (emphasis added).

<sup>201</sup> Steyn, above n 129, at 440.

<sup>202</sup> *Vero Insurance*, above n 49, at [47] and [49]. With the possible exception of relational contracts.

choice is arguably allowing them to pursue their own interest. Therefore, an implied good faith duty seems repugnant to the express terms of an unfettered discretion.

Lord Sumption recently proposed that judges' notions of common sense tend to be moulded by their idea of fairness but, "fairness has nothing to do with commercial contracts".<sup>203</sup>

The parties enter into [contracts] in a spirit of competitive cooperation, with a view to serving their own interests. Commercial parties can be most unfair and entirely unreasonable, if they can get away with it. Measuring their intentions by a yardstick of commercial common sense means in practice it transforms the judge from an interpreter to an *amiable compositeur* – saving one party from what turned out to be a bad bargain. The question is no longer what the parties agreed, but what would they have agreed if they were objective, just and fair minded people that in practise they are not.

Some propose the common law has become increasingly willing to impose restrictions on individual autonomy and freedom of contract when it considers this to be necessary and reasonable.<sup>204</sup> There are already a number of contractual doctrines that restrict individual autonomy and seek to encourage commercial fairness, for example misrepresentation, unconscionable bargains, estoppel and undue influence.<sup>205</sup> Unconscionable bargaining faced similar criticism as the good faith doctrine but was found to reflect a balance between the need for certainty in commercial affairs and the need to avoid behaviour that is unacceptable to the community.<sup>206</sup> However, it is equity that intervenes to deprive parties of their contractual rights when they have been unconscionably obtained, rather than the courts trying to extract such intervention through determination of the parties 'intention' under the common law.

Furthermore, contract law already has sufficient mechanisms to protect deserving commercial parties when behaviour is unacceptably unfair.<sup>207</sup> Doctrines such as rectification intervene when contract formation does not represent the parties' intentions, and duress and undue influence operate to protect those whose ability to contract freely has been undermined.

It could alternatively be argued that the courts are best placed, and indeed it is their supervisory role in society, to control the exercise of discretionary powers. Due to the joint intention to be legally bound, by entering into a contract, parties bring themselves within the scope of the general law, which

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<sup>203</sup> Lord Sumption, above n 11.

<sup>204</sup> Elvin, above n 76, at 42.

<sup>205</sup> Elvin, above n 76, at 42.

<sup>206</sup> Elvin, above n 76, at 49.

<sup>207</sup> James Davies "Why a Common Law Duty of Good Faith is Not Required" [2002] CantLR 13 (2002); 8 Canterbury Law Review 529.

requires them to adhere to their agreement.<sup>208</sup> This inherently gives rise to the need for judicial controls, as the courts are society's means of enforcing the legal bond between contracting parties. Whatever the parties provide in the words of the contract will have a special dimension of meaning or special force since the law provides that their utterance shall effect legal changes.<sup>209</sup> Hence, it is argued that the parties have implicitly agreed that the power, given force by law, must be exercised properly in accordance with the values of the legal system.

On this basis, special control and intervention could be 'reasonable and equitable', as it is implicit in the parties' agreement that the powers must be exercised 'properly', in accordance with judicially imposed standards. The parties would have intended the courts to ensure the powers are not used to undermine the entire agreement and used irrationally, as otherwise they would not have entered a legal agreement. In making the document legally binding, they implicitly give the courts this power. This provides a justification for imposing a good faith obligation in relation to discretionary powers, yet not the general good faith duty or the duty in relation to termination – as this arguably occurs after the legally binding relationship is complete, so they are no longer under the court's jurisdiction.<sup>210</sup>

This inherent jurisdiction to control the exercise of discretions could be analogised to the court's role in controlling public powers. Terrence Daintith provided a comprehensive unified analysis of the judicial control of contractual and administrative discretion.<sup>211</sup> In a public law context, the court must judge whether a public body has used its powers in accordance with the statutes which confer such powers. If they make decisions that are outside the limits of their powers, they abuse them. The courts control any misuse of public power through the mechanisms of judicial review.<sup>212</sup> Similarly, when reviewing the exercise of contractual discretion:<sup>213</sup>

Courts committed to giving effect to the intention of the parties have therefore been led towards an approach to discretion which focuses not on the effects it might produce but on the quality of the decision through which it is exercised. Through the implication of appropriate terms in the contract, parties are taken to have intended that decision and the process through which it is reached, should respect certain standards.

In summary, Daintith found that discretions – legally constituted powers of decision – are staple elements in both administrative and contractual arrangements. In both contexts such discretions are

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<sup>208</sup> H.L.A Hart *Essays on Bentham: Jurisprudence and Political Philosophy* (Oxford University Press, Oxford, 1982) at 210.

<sup>209</sup> Hart, above n 208, at 209.

<sup>210</sup> However, this does not justify the different treatment of absolute discretionary powers.

<sup>211</sup> Daintith, above n 1.

<sup>212</sup> *Unison Networks Ltd v Commerce Commission* [2007] NZSC 74 at [51].

<sup>213</sup> Daintith, above n 1, at 576.

reviewed for the improper exercise of power. He notes the technique and focus of the reviews is on the decision making process, judged in light of the overall purpose and character of the power conferring source, rather than on the substance of the decision.<sup>214</sup> However, while judicial control is at the core of administrative law, it is hardly even acknowledged as an issue in standard authorities on contract law.<sup>215</sup> Kós J argues the similarities between administrative and contract law “recognise the important role the courts can and should play in the supervision of exercises of powers throughout society”.<sup>216</sup>

However, the analogy with administrative judicial review has significant shortfalls.<sup>217</sup> Daintith notes that while the techniques of control are similar, the contexts and purposes of the powers are radically different, being legislation and privately invented agreements.<sup>218</sup> Public authorities have an overriding duty to the public to exercise their power properly and act in accordance with the interests of society. They must not exercise their powers for furtherance of private interest. Furthermore, due the constitutional structure and the importance of the separation of powers, in the administrative law context, a court must give effect to discretionary powers as conferred by Parliament, who is perceived to intend all delegated powers to be exercised rationally and reasonably.

Conversely, contracts are entered for personal gain and thus are assumed to be motivated by self-interest. As contractual duties are only owed to the contracting parties, there is less incentive for going beyond what the parties have expressly provided. The courts should confine their search for relevant limitations within the bounds of the parties’ economic interests in the particular transaction, as represented in the express terms. Therefore, the values underpinning how restraints on autonomy are justified should be of a profoundly different character to the public law realm.<sup>219</sup> While Parliament also has the ability to exercise its own controls on the powers it has conferred, enforcement of contracts is primarily the judiciary’s task.<sup>220</sup> This supports the strict enforcement of contracts as the courts’ key duty is to give the effect to the contracting parties’ intentions.

There are a much broader range of potential concerns when ensuring the ‘proper’ exercise of public power, justifying a more stringent default standard. In contract, it is not the role of the courts to

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<sup>214</sup> At 576.

<sup>215</sup> At 555.

<sup>216</sup> Kós, above n 6, at 36. His Honour notes, powers are special because they postpone to a different time, and allocate to a single party, the distribution of private benefits under trust and contract, and public resources and with power must come some restraint. Otherwise the powers would instead become mechanisms for oppression and neither efficient nor acceptable in a common law jurisdiction.

<sup>217</sup> *The Product Star*, above n 17.

<sup>218</sup> Daintith, above n 1, at 584.

<sup>219</sup> At 592.

<sup>220</sup> By calling the executive to account or through withdrawal of support. While the market is suggested as a discipline for control, courts never explicitly trust it to carry the full weight of necessary control, arguably due to the often individualised nature of the contract, which fails to secure the insulation of competitive pressures (Daintith, above n 1, at 589).

determine what fair and reasonable parties should be considering. There is no overriding duty to society to exercise this discretion fairly, yet there is a conflicting duty to respect freedom of contract. As Lord Curriehill proposed, "a certain degree of cunning, craft and even deceit, against which, although they may be transgressions of the strict rules of morality, the law does not protect the contracting parties, but leaves them to protect themselves".<sup>221</sup> This observation may be suited to a time when stricter notions of freedom of contract held sway, but it still carries a certain resonance, especially where the contracting parties are both suitably aided business entities.

Overall, this analysis provides no overwhelming justification for the conclusion that it is reasonable and equitable to go beyond the parties' expressly provided discretion by implying the default rule. As this is to be a limiting principle, under which the courts must be *convinced* in order to imply a term, it is argued that the requisite standard is not met. The current default rule limits the parties' autonomy in a way they have not expressly signed on for – which is not reasonable nor equitable. A default position of adhering to the express terms of the contract can provide more confidence and certainty as it enables parties to predict the likely result if the issue goes to litigation, and thus contract accordingly.

Furthermore, it can be expected that contracts will be modified as courts make pronouncements. If courts take a strict (and potentially slightly hostile) approach, commercial parties will explicitly provide for how they would like their discretion to be treated. This is more equitable than providing one commercial party additional protection, and will lead to increased certainty in the commercial sphere.

#### **4.3 Is the Default Rule Necessary for Business Efficacy?**

The second requirement in the *BP Refinery* criteria is that the term must be necessary to give business efficacy to the contract.<sup>222</sup> This requirement aligns with the economic role of the court to facilitate efficient contracting. The test for business efficacy was initially articulated in *The Moorcock*, which provides that terms will be implied at common law only if they are, obvious and necessary, but not if they are merely desirable and reasonable.<sup>223</sup>

Courts have become increasingly less willing to imply a term when the contract has practical and commercial coherence without it. The Supreme Court in *Marks & Spencer* found that if the contract

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<sup>221</sup> *Gillespie v Russel and Son* (1859) 21 Dunl Ct of Sess 13.

<sup>222</sup> *BP Refinery*, above n 189, at [40].

<sup>223</sup> *The Moorcock*, above n 186.

can operate without the implied term, although perhaps less fairly, the term is not to be implied. This is increasingly being considered the key criteria when determining whether to imply a term.<sup>224</sup>

As good faith is not considered to be necessary in the general performance of commercial contracts in New Zealand, this consideration again turns on whether there is anything inherent in the nature of discretions themselves which renders the default rule a necessary limitation.

Unlike an actual missing term that it is necessary for the courts to fill - such as what is to occur if the business restructures - the “gap” with discretionary powers is merely that the limits of the term are not expressly given. However, the plain meaning can be applied, leaving the discretion unfettered. Therefore, it is not actually necessary to imply a default limitation. As is often cited, “parties at arms’ length may contract in a way which allows the arbitrary, abnormal, or even down-right stupid”.<sup>225</sup> And further:<sup>226</sup>

If there is one thing which more than another public policy requires it is that men of full age and competent understanding shall have the utmost liberty of contracting, and that their contracts when entered into freely and voluntarily should be held sacred.

Thus, if the contract can continue without the implied term, the default rule is not required to provide the contract business efficacy.

#### **4.4 Is the Default Rule So Obvious It Goes Without Saying?**

Thirdly, under *BP Refinery*, the term must be so obvious it goes without saying for it to be implied into an agreement.<sup>227</sup> This may provide a strong argument in favour of implication of the default rule. It seems likely that if you asked a party whether the discretion in question could be exercised dishonestly or capriciously, most parties would say no. This resonates with the idea of such an exercise being in conflict with the purpose of contract law - to co-operate in order to gain the benefit of exchange. This reasoning is evidenced in cases such as *Paragon Finance*, where the Court of Appeal found:<sup>228</sup>

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<sup>224</sup> *Marks & Spencer*, above n 25.

<sup>225</sup> *Gregory v Rangitikei District Council* [1995] 2 NZLR 208 (HC).

<sup>226</sup> *Printing v Numerical Registering Co v Sampson* (1875) LR 19 Eq 462 at 465.

<sup>227</sup> *BP Refinery*, above n 189, at [40].

<sup>228</sup> *Paragon Finance*, above n 19, at 158.

If asked at the time of making the arrangement whether it is accepted the discretion to fix rates of interest could be exercised dishonestly, for improper purpose, capriciously or arbitrarily, I have no doubt that the Claimant would have said of course not.

However, this requires the court to know with certainty what the parties would have provided had the matter been drawn to their attention at the time of contract formation.<sup>229</sup> As discussed previously, the express terms of the document are the only objective representation of what the parties intended. The parties have signed an agreement conferring an unfettered discretion, rather than a discretion that must be “exercised in good faith” or “with proper purpose”. The parties are assumed to have consciously opted to make the discretion unfettered, therefore it clearly does not meet this high threshold of being “so obvious it goes without saying”. Consequently, it is unlikely that the third criterion will be satisfied.

#### **4.5 Is the Default Rule Capable of Clear Expression?**

The fourth *BP* criteria requires the term to be capable of clear expression.<sup>230</sup> Despite the case law providing varying definitions of the rule, the general idea is capable of being well-defined. There can be no universal expression of a rule, because the discretions themselves are so varied. Therefore, this requirement is likely to be met.

#### **4.6 Does the Default Rule Contradict the Express Terms of the Agreement?**

Finally, the key proposition against the implication of the default rule is found in the primacy of express language and freedom of contract in the commercial context, reflected by the fifth *BP* requirement.<sup>231</sup> A contractual discretion vested in one party must reflect the intention of both parties, even if the exercise of that discretion appears capable of rendering the contract of little or no benefit to one of them.<sup>232</sup>

The language of the parties’ agreement, read as a whole, is the only direct evidence of their intentions. Using the reasoning in *Wood*, a seemingly unfettered discretion is the clearest evidence of “where the tog o’ rope lay” when the negotiation ended.<sup>233</sup> The parties had contradictory interests when making the contract, thus this unfettered discretion may have been conceded in the bargain for something else. Language was the only way to tell a future court how far the parties succeeded in protecting their

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<sup>229</sup> *Shirlaw*, above n 186.

<sup>230</sup> *BP Refinery*, above n 189, at [40].

<sup>231</sup> *BP Refinery*, above n 189, at [40].

<sup>232</sup> R Hooley, above n 4, at 66.

<sup>233</sup> *Wood v Capita Insurance Services*, above n 152.

interests. As Lord Sumption argues, “the parties are the masters of their own agreement, and anything which marginalises the role of words in the process of construction is a direct assault on their autonomy”.<sup>234</sup>

The more elaborate the drafting and precise the wording, the more inequitable it is to imply terms into the agreement. Thus, in a commercial context, where it is commonly considered that the parties are neither vulnerable nor in need of protection, it is correct to follow the express language of an unfettered discretion. If the parties have expressly provided and agreed on an unfettered discretion, an unstated, non-agreed fetter contradicts this power.

This reasoning was used by the New South Wales Supreme Court, which held that where a power is given to one party to be exercised in its sole discretion so as to bind the other, the terms of the contract will necessarily be inconsistent with a constraint on the exercise of that power by considerations of reasonableness or good faith.<sup>235</sup> This approach is submitted as the correct approach because if a party is clearly given the sole or absolute discretion and consideration is paid for this in the bargain, then other terms cannot be implied to limit this.

Imposing terms based on commercial common sense, “may have done a disservice to commercial parties by depriving them of the only effective means of making their intentions known”.<sup>236</sup> An apparently harsh or extensively broad power may have been agreed by way of compromise or in exchange for another concession. As Lord Sumption reasons, if the express terms are not given sufficient weight, “we are no longer discovering how the parties understood each other. We are simply leaving judges to reconstruct an ideal contract which the parties might have been wiser to make, but never actually did”.<sup>237</sup> Therefore, the default rule would likely fail this final stage of the *BP Refinery* test and should not be implied, as express terms of the agreement must not be contradicted.

#### 4.7 Summary

Overall, regardless of whether the *BP Refinery* criteria are considered a cumulative test or a balance of considerations, it is submitted that the current default rule does not sufficiently meet the high threshold required for implication. Therefore, this rule extends too far in the commercial sphere and is an inappropriate default position. Instead, the default rule should be that the plain meaning of the expressly provided discretion is followed. To imply a limitation, the court should undergo the strict

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<sup>234</sup> Lord Sumption, above n 11.

<sup>235</sup> *Sundarajah v Teachers Federation Health Ltd* [2009] NSWSC 1443.

<sup>236</sup> Lord Sumption, above n 11.

<sup>237</sup> Lord Sumption, above n 11.



*BP Refinery* test on the facts of the case, or the parties should be left to impose their own limitations if they so desire.

While this approach may seem harsh, it more correctly prioritises protection for the bargain made, as opposed to imposing ideals of fairness and justice. It is not proposed that the default rule will never be an appropriate constraint on a discretionary, but instead that it should not be the default, starting position.

## CONCLUSION

When the appropriate case comes before a New Zealand court, it is my argument that the default rule must be rejected. The analysis reduces down to balancing the competing considerations of freedom of contract and the courts' role in ensuring fairness in contractual relationships. In the case of sophisticated commercial parties, the balance must lie with freedom of contract. This dissertation has demonstrated that the current judicial approach of imposing the default rule on contractual discretions does not correctly reflect this balance, nor does it accord with the proper role of the court in the competitive, commercial environment. Therefore, the default rule is unjustified and should be displaced.

The starting point must be that the plain meaning of the discretion will be followed, save for exceptional circumstances. This respects the rightful assumption that when sophisticated commercial parties enter these agreements to be legally bound, they have carefully and purposefully determined the express terms of their contract to reflect the full extent of their rights and obligations. It is inappropriate for a generally applied assumption to displace this position on the basis of commercial common sense or to protect one party's autonomy, at the expense of limiting the other's legal right.

Once interpreted, in order to limit a discretionary power, the onus will then be on the party seeking the limitation to convince the court that the stringent standard of *BP Refinery* is met. This will ensure that limitations are only implied when the contextual circumstances provide compelling evidence that the limitation is clearly necessary to give effect to the intention of the parties. This rightfully provides rigorous protection for the bargain struck between the contracting parties, which the application of the default rule without reference to such tests currently critically undermines. Generally, there is nothing sufficiently unfair about a commercial discretion to justify the current targeted application of a duty strongly akin to good faith. Restricting the default rule will thus provide doctrinal coherence, in that commercial parties will not be subject to good faith obligations, unless they expressly provide for them.

Furthermore, this will reflect the fundamentally different role of the judiciary in ensuring the proper exercise of administrative law powers, which demands a higher standard of intervention than contract law. In the public law context, the overarching purpose is to ensure that powers entrusted in public bodies are exercised properly in accordance with the public interest. This is in stark contrast to contractual discretionary powers, which are privately allocated, through agreement, to one party to individually set a term of their relationship. In the context of competitive, commercial endeavours, it is implicit that this will be exercised in the holder of the power's self-interest. This is how the

contractual powers have been allocated. When dealing with relatively equal commercial parties, it is not the role of the court to protect against unfairness or harsh results, but instead to give effect to the parties' intentions as reflected in their contract.<sup>238</sup>

While the law must attempt to be just to individuals, the achievement of this goal must be considered holistically. A default position of imposing a term beyond what the commercial parties have expressly agreed upon does not ensure that the parties' intentions are followed, nor does it respect the sanctity or freedom of contract. Confining judicial intervention within narrow limits enables the law to be applied consistently, predictably and efficiently, while also respecting the parties' autonomy. Parties can thus have confidence in the courts' ability to enforce their agreements, something essential in the commercial sphere.<sup>239</sup> In this sense, contractual discretions are as discretionary as the parties make them.

“With all things being equal, the explanation requiring the fewest assumptions is most likely to be correct.”

*‘Occam’s razor’ problem solving principle*

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<sup>238</sup> More judicial intervention may be justified when contracting with vulnerable parties, such as consumers.

<sup>239</sup> Minimal intervention also promotes explicit bargaining from contracting parties, which will be beneficial to all sides, including the courts, and leaves parties with the valuable discretions they have contracted for.

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