

CONSTRAINTS ON THE EXERCISE OF CONTRACTUAL POWERS

*Hon Justice Stephen Kós**

This article considers a topic largely ignored by the standard contract texts: contractual powers vested, usually without express restraints, in one of the contracting parties. It gathers the leading Commonwealth decisions on the subject and considers the nature and limits of the commonly-implied "default rule" that such powers may not be exercised arbitrarily, unreasonably or for an improper purpose. The author concludes that in the case of substantive principles such as error of law, improper purpose and irrationality, there is no fundamental difference between the interests protected by contract law, trust law and public law – and nor is there any fundamental difference between the tools used by each to provide that protection.

"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."¹

I INTRODUCTION

Contractual powers abound. A credit card agreement empowers the bank to alter lending and default rates, and other terms, on notice. An electricity supply agreement with a householder permits the utility to increase its prices on notice, and to enter the householder's property to inspect the meter. A stock exchange listing agreement enables the exchange to alter the listing rules, which bind the listed issuer. Likewise, a Lloyds' syndicate's rules permit Lloyds to modify the rules from time to time. A charterparty permits the owner to offload cargo at a different port in times of war or danger. A construction contract gives the builder flexibility in the event that rock is located where trenches are to be dug. A franchise agreement requires compliance with an operating manual, the terms of which may be altered on notice by the franchisor. A university professor's contract of employment

* Judge of the High Court of New Zealand. An earlier version of this article was delivered at a seminar at the Canterbury University Law School on 10 September 2008. The assistance of Matthew Smith, formerly of Stout Street Chambers, is acknowledged with appreciation. An even greater acknowledgement is due to Professor David McLauchlan (and to the late John Thomas), who first instilled an unquenched enthusiasm for contract law in the author in the late 1970s.

1 *Abu Dhabi National Tanker Co v Product Star Shipping Co Ltd (No 2)* [1993] 1 Lloyd's Rep 397 (CA) at 404 per Leggatt LJ.

requires her to comply with the university's policies and procedures from time to time, which may be altered as and when the university sees fit. A club member agrees to conform to the club's rules, which the committee may change from time to time. A licence permits assignment of the licensed rights, but only with the approval of the licensor. A frequent flyer agrees that the terms of access to an airline lounge may be altered unilaterally by the airline in its absolute discretion.

Each example given involves a contractual power, vested in one of the contracting parties, which they alone may exercise. Potentially, the exercise of those powers may alter substantially the relative benefits and burden of the contract for each party.

This article examines the constraints the law imposes on the exercise of contractual powers of this kind. It is a subject which receives surprisingly little attention in the contract law texts.

A An Introduction to the Law of Powers

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 or public resources (governed then by public law). They therefore deserve the law's particular attention and intervention.

One can conceive of a 'spectrum' of powers, with public law powers at one end and private law powers at the other. In between are what might be termed 'hybrid' powers.

Public law powers primarily comprise statutory powers (for example s 342A of the Local Government Act 1974, which allows a senior member of the police to temporarily close a road in defined circumstances) and prerogative powers (for example the prerogative of mercy).

Hybrid powers fall somewhere between public law and private law powers. They are many and varied, and include discretions exercisable by private clubs, associations and incorporated societies, such as powers to admit, discipline and expel members and to apply funds. *Church v Commerce Club of Auckland*² is an example of a successful judicial review of a decision of a club to suspend a member.

This leaves private law powers. These include powers exercisable by trustees (for example to distribute funds to beneficiaries), powers exercisable by company directors (for example to approve the transfer of shares or the issuing of new capital) and contractual powers.

A relatively settled framework for the exercise of unilateral contractual powers is now emerging. This framework has taken hold more clearly in comparable common law jurisdictions than in New Zealand.

This article collects together some of the leading Commonwealth decisions on this subject. Its purpose is to make the jurisprudence in this area more accessible (bearing in mind its absence from

2 [2006] NZAR 494 (HC).

the leading contract law texts) and to promote debate on the common law framework for the exercise of contractual discretions in this country.

B Context

Contract cases generally fall within one or other (or both) of two classes: those concerned with the *formation* of the contract; and those concerned with its *performance*. Cases concerning mistake, undue influence and unconscionability typically involve the former class. Cases concerned with breach involve the latter.

Cases concerned with the exercise of discretionary contractual powers normally involve issues of performance, and breach. However they also raise formation issues for example, whether the power is so extensive as to render the contract void for lack of consideration ("illusory contracts"), and (if not void) what express or implied constraints exist as terms of the contract.

C Illusory Contracts

Dealing first with the former point, where the discretionary power is so broad as to reserve performance entirely to the discretion of one party, consideration may be treated as illusory; the contract consequently is unenforceable. Such a situation may arise where an exemption clause is so sweeping as to effectively exclude the assumption of any executory obligation.³

On the other hand, the conferral of a broad power to vary terms does not mean the contract is necessarily illusory. *Barton v Air New Zealand Limited*⁴ dealt with a contract for the provision of airport lounge services to a frequent flyer. It contained a provision that its terms might be changed by the airline at any time and "in its sole discretion". When the power to change terms was exercised by the airline to withdraw privileges for members and guests not holding a current ticket, the plaintiff demurred. One of his arguments was that the discretion rendered the contract unenforceable. The Court disagreed.

One of the essential reasons why such a clause does not render a contract illusory is because implied constraints exist controlling the extent to which the power may be exercised. The airline may not take the traveller's money on a Monday, and lock the lounge door against him on the Tuesday.

D Discretionary Powers in Contracts

It is not unconscionable, and it is no breach of any common law duty of good faith, to provide discretionary powers in the contract in the first place. Such powers are commonplace. The examples earlier show that.

³ See *MacRobertson Miller Airline Services v Commissioner of State Taxation (Western Australia)* (1975) 133 CLR 125 (HCA).

⁴ HC Wellington CIV-2002-485-838, 6 October 2004.

Indeed their provision is more than commonplace. Unilateral contractual powers are quite simply *necessary*. By definition, contracts containing such powers are ones where the parties are thrown together for a time. It is unreal to imagine in any of the examples given that the contract should be limited to a fixed framework, with the parties having to renegotiate in the event of certain contingencies, or start again from scratch in the event of others. Commerce would be congested, and the cost of supply would increase in consequence. So the provision of such powers can be seen as commonplace, necessary and efficient.

But with power must come some constraint. Otherwise the powers would instead become mechanisms for oppression and neither efficient nor acceptable in a common law jurisdiction.

The primary constraint is the "default rule" meaning that a contractual discretion must not be exercised arbitrarily, capriciously or in bad faith, or unreasonably in the sense that no reasonable contracting party could have so acted.

This article looks at three topics:

1. The "default rule".
2. Limits to (and limiting) the default rule.
3. Going beyond the default rule.

II THE "DEFAULT RULE"

A The Rule

According to the common law developed by a number of Commonwealth courts, there is a well recognised default rule for the exercise of unilateral contractual powers. It is, shortly stated, that where a contract confers a discretionary power on one party, that party must not exercise the discretion arbitrarily, capriciously or in bad faith, or unreasonably in the sense that no reasonable contracting party could have so acted.

Contractual duties of good faith (of which the rule forms part) are particularly appropriate where issues of process – including the exercise of discretionary powers vested unilaterally – are involved. They are less easy to apply where the substantive outcome is challenged.

The default rule was justified and defined by Leggatt LJ (with whom Balcombe and Mann LJJ agreed) in the following terms in *Abu Dhabi National Tanker Co v Product Star Shipping Co Ltd*:⁵

For purposes of judicial review the Court is concerned to judge whether a decision-making body has exceeded its powers, and in this context whether a particular decision is so perverse that no reasonable body, properly directing itself to the applicable law, could have reached such a decision. But the

⁵ *Abu Dhabi National Tanker Co v Product Star Shipping Co Ltd (No 2)*, above n 1.

exercise of judicial control of administrative action is an analogy which must be applied with caution to the assessment of whether a contractual discretion has been properly exercised. 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.

That is the *locus classicus* statement of the default rule.

The case concerned a charterparty of a merchant tanker entered at the time of the 1987 Iran-Iraq war. It contained a clause which gave two discretions: first, the owners were given the right to decline to load or discharge where "the loading or discharging of cargo at any ... port be considered by the Master or the owner in his or their discretion dangerous"; second, the charterers then had the option to direct loading or discharge at another convenient (and safe) port. The charterparty also provided for a war risk premium to be paid for voyages involving certain ports, including those in the United Arab Emirates (UAE). After four successful voyages between Ruwais (in the UAE) and Chittagong (in Bangladesh), the owners (without any prior warning) refused to permit loading at Ruwais.

The trial judge, upheld by the Court of Appeal, applied the default rule against the owners. The owners' purported decision under the clause was unwarranted. First, the owners could not point to any material on which a reasonable ship-owner could have considered that the risks at Ruwais were greater than they were at the start of the contract. Secondly, the owners were using the contractual power for a collateral purpose, ie to resolve a separate dispute under the charterparty concerning overage insurance.

The principle stated in *Abu Dhabi* has been affirmed, and discussed, in a number of subsequent English cases. Together those cases make clear that "unreasonableness" in Leggatt LJ's terms means *Wednesbury* type unreasonableness rather than some lesser objective standard of fairness or reasonableness which thereby would substitute the courts for the empowered party as decision-maker. This issue is discussed in more detail later in this article.

The English Court of Appeal has exercised something of a stranglehold over the exposition of the default rule. It has done so in six decisions subsequent to *Abu Dhabi*.

In *Ludgate Insurance Co Ltd v Citibank NA* the Court of Appeal took the opportunity to reinforce the point that the threshold for intervention is a high one:⁶

It is very well established that the circumstances in which a court will interfere with the exercise by a party to a contract of a contractual discretion given to it by another party are extremely limited. ... These cases show that provided that the discretion is exercised honestly and in good faith for the purposes for which it was conferred, and provided also that it was a true exercise of discretion in the sense that it was not capricious or arbitrary or so outrageous in its defiance of reason that it can properly be categorised as perverse, the courts will not intervene.

Mr Rowland sought to derive comfort from some of the language used by Leggatt LJ, with whom the other members of this court agreed, in *The Product Star* at p 404 in support of a contention that the courts are more ready today to apply a standard of objective reasonableness when assessing whether a discretionary decision can stand. That Leggatt LJ had not the slightest intention of watering down the well-established test is manifest from the passages of his judgment ... in which he applied the law to the facts, where it is clear that he is using the epithet "unreasonable" to characterise a view which no reasonable decision-maker could reasonably have formed on the material before him.

*Gan Insurance Co Ltd v Tai Ping Insurance Co Ltd*⁷ concerned a reinsurance contract that provided that no settlement of a claim could be made, or liability admitted, without the prior approval of the reinsurer. A Queen's Bench Judge had decided that the reinsurer could not withhold approval unless it had reasonable grounds for doing so. The Court of Appeal applied a higher standard for intervention. Mance LJ said:⁸

I would therefore accept as a general qualification, that any withholding of approval by reinsurers should take place in good faith after consideration of and on the basis of the facts giving rise to the particular claim and not with reference to considerations wholly extraneous to the subject-matter of the particular reinsurance.

If there is any further implication, it is along the lines that the reinsurer will not withhold approval arbitrarily, or (to use what I see as no more than an expanded expression of the same concept) will not do so in circumstances so extreme that no reasonable company in its position could possibly withhold approval. This will not ordinarily add materially to the requirement that the reinsurer should form a genuine view as to the appropriateness of settlement or compromise without taking into account considerations extraneous to the subject-matter of the reinsurance.

6 [1998] Lloyd's Rep IR 221 (CA) at [35]–[36] per Brooke LJ.

7 [2001] EWCA Civ 1047, [2001] 2 All ER (Comm) 299.

8 Ibid, at [67] and [73].

Abu Dhabi and Gan Insurance were discussed by the Court of Appeal in *Paragon Finance plc v Nash*,⁹ a case concerning interest rates set by a finance company under a "variable interest clause". That gave the company the power to change rates on notice to borrowers. One issue arising was whether that clause was subject to an implied term constraining its exercise, and if so how? The company contended against such implication, asserting that the power was unfettered. The Court of Appeal disagreed, noting that the consequence of that submission, if accepted, would be that the lender could specify interest rates "at the most exorbitant level". It went without saying that the power could not be used dishonestly, for an improper purpose,¹⁰ capriciously or arbitrarily.¹¹ But the "unreasonableness" extension of the proposed implied term exercised the Court. Applying the earlier authorities, Dyson LJ concluded that the implied term might extend to unreasonable variation of interest rates, but only in a *Wednesbury* sense:¹²

It is one thing to imply a term that a lender will not exercise his discretion in a way that no reasonable lender, acting reasonably, would do. It is unlikely that a lender who was acting in that way would not also be acting either dishonestly, for an improper purpose, capriciously or arbitrarily. It is quite another matter to imply a term that the lender would not impose unreasonable rates. It could be said that as soon as the difference between the Claimant's standard rates and the Halifax rates started to exceed about two percentage points, the Claimant was charging unreasonable rates. From the appellants' point of view, that was undoubtedly true. But from the Claimant's point of view, it charged these rates because it was commercially necessary, and therefore reasonable, for it to do so.

In a 2004 decision, *Cantor Fitzgerald International v Horkaluk* the Court made the important point that although the exercise of a discretion of this kind arises in a situation of conflicting interests:¹³

... 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.

That case concerned the construction of a discretionary bonus clause in the contract of employment of an investment banker.

In 2007 the Court of Appeal delivered its judgment in *Lymington Marina Ltd v Macnamara*.¹⁴ The case does not take principles much further than the earlier cases. It concerned a marina licence.

9 [2001] EWCA Civ 1466, [2002] 1 WLR 685 (CA).

10 Dyson LJ gave as an example of this the lender deciding that the borrower had become a nuisance, and increasing rates to get rid of him: *ibid*, at [31].

11 *Ibid*, at [36].

12 *Ibid*, at [41].

13 [2004] EWCA Civ 1287, [2004] IRLR 942 at [30] per Potter LJ.

14 [2007] EWCA Civ 151, [2007] 2 All ER (Comm) 825.

The licence permitted sub-licences for periods of not more than 12 months, subject to the approval of the sublicence by the marina company. The licence-holder sold his yacht. To make use of the marina berth, he sought to grant sub-licences to his two brothers for short, but recurring, periods. The marina company refused to consent. A High Court Judge concluded that no reasonable marina company could have reached such a decision. The company appealed. The Court of Appeal dismissed the appeal. Arden LJ delivered the leading judgment. Her Honour held that the High Court Judge had been wrong to use *Wednesbury* principles per se. The right approach was to ask whether a term should be implied so that the exercise of the power, even if prima facie valid, could be set aside if the grounds for refusal were in bad faith or wholly unreasonable. In that case the marina company's exercise of its power was simply based on a mistaken view of its extent. It was not absolute, and it did not prohibit rotational sub-licences. Despite rejecting the *Wednesbury*-based approach, the operative part of the judgment reads very much like a conventional administrative law decision on error of law.

In February 2008 the Court of Appeal delivered judgment in *Socimer International Bank Ltd v Standard Bank London Ltd*.¹⁵ The facts are not important at this stage (it concerned swap trading arrangements between banks), but Rix LJ gathered usefully the principles expressed in the earlier decisions of the Court:¹⁶

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: as for instance when there might be an implication of a term requiring the fixing of a reasonable price, or a reasonable time. In the latter class of case, the concept of reasonableness is intended to be entirely mutual and thus guided by objective criteria. ... Lord Justice Laws in the course of argument put the matter accurately, if I may respectfully agree, when he said that 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.

The threshold for intervention remains a high one, one of irrationality. Given that the context is contract, where the parties write their own code, it is submitted that that approach is a correct one.

¹⁵ [2008] EWCA Civ 116, [2008] 1 Lloyd's Rep 558.

¹⁶ *Ibid*, at [66].

B Default Rule Down Under

A number of Australian authorities hold similarly that where a contract confers a discretionary power on one party, that party must not exercise the discretion arbitrarily or capriciously or in bad faith. They do not take matters usefully beyond the English cases. Some of these authorities are collected in *Vodafone Pacific Ltd v Mobile Innovations Ltd*,¹⁷ which will be discussed later in this article.

In New Zealand, thus far at least, I have been able to identify only one case that deals directly with the default rule in similar terms to the United Kingdom case law and the reference in that case is contained in a short obiter passage in the context of a wider discussion of good faith obligations.¹⁸ However there is a line of cases in our Court of Appeal that concerns a subsidiary aspect of the default rule, in other words the permissible scope of the exercise of a unilateral power reserved to a contracting party to change the terms of the contract. The law in New Zealand has been expressed in clear terms by the Court of Appeal in two decisions in the 1980s.

In *Black White & Grey Cabs Ltd v Reid*¹⁹ taxi drivers entered an agreement with a cooperative company on terms which required them to comply with operating rules laid down by the company from time to time. The company introduced a new rule that prohibited drivers from redeeming taxi chits otherwise than through the company itself (for which it charged 7.5 per cent, whereas other entities had emerged who were happy to do so for less). The Court of Appeal upheld the right of the company to make that change:²⁰

It is sufficient to add that, in considering a provision such as cl 4 which provides for the parties to be bound by operating rules as laid down from time to time, it is a matter of deciding what the parties have bargained for in that respect. Whether or not a regulation subsequently laid down by one party is within the powers of amendment under the provision must be determined having regard to the surrounding circumstances including the relationship of the parties and the nature and object of the agreement. As Lord Tomlin put in *Hole v Garnsey* [1930] AC 472, 500, the power of amendment in a contract 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.

In that case the new rule simply secured the continuation of the business practice that applied when the contract was entered. Plainly it was the sort of rule that could have been in contemplation at that time.

17 [2004] NSWCA 15.

18 *Todd Pohokura Ltd v Shell Exploration NZ Ltd* HC Wellington CIV-2006-485-1600, 13 July 2010 at [213]–[221].

19 [1980] 1 NZLR 40 (CA).

20 *Ibid*, at 49.

However, the Court of Appeal soon qualified the "reasonably in contemplation" limitation prescribed in *Black White & Grey*.

*New Zealand Stock Exchange v Listed Companies Association Inc*²¹ concerned the exchange's listing rules. The exchange's listing agreement, entered by each listed issuer, provided that the exchange could vary the listing rules from time to time, upon notice to issuers. The Court applied its earlier decision in *Black White & Grey*, noting that the potential constraint on the exercise of the power of variation necessarily depended on the implication of a term. That implication would "not arise almost automatically", but would depend on the individual contract terms and context.²²

Thus, as in the case of the default rule, clear words or necessary implication from words or context might exclude or limit the qualification expressed by the House of Lords in *Hole v Garnsey* (on which *Black White & Grey* was reasoned). The listing rules had to be ubiquitous; they could not sensibly be negotiated individually with each issuer (and renegotiated each time there needed to be a change). They had to be variable at short notice, given the potential for rapidly changing economic conditions. If issuers did not like the changes, they were (at least in theory) entitled to terminate their listing at any time.

Beyond these two cases, there is of course an abundance of cases dealing with express terms as to refusal not being unreasonably withheld (for example of a sublease or assignment). And likewise, there is ample authority on the statute-implied proviso to leasehold covenants against transacting without consent – for example that the consent not unreasonably be withheld.²³ Finally there is a shapeless mélange of cases dealing in broad terms with general obligations of good faith *inter se* the contracting parties.²⁴ These inferred obligations, which frequently defy rational analysis (for example whether they arise in contract or in equity) or definition (for example how far they reach), tend to arise in joint ventures if at all, and then erratically. They are not needed in the present context, because contract law has developed its own effective mechanism to ensure good faith exercise of contractual discretions: the default rule.

C Analogy with Trustees' Powers and Duties

There is an analogy with trustees' powers in these passages. For instance, the trustee's power to appoint trust property to discretionary beneficiaries (and associated duty of impartiality) is one which may only be challenged by beneficiaries in extreme circumstances.

21 [1984] 1 NZLR 699 (CA).

22 *Ibid*, at 705.

23 Property Law Act 2007, s 226(2).

24 Usefully collected in Justin Smith "Good Faith" in Christine French and others *The Law of Obligations – "Contract in Context"* (New Zealand Law Society Intensive, Wellington, 2007) at 27–34.

A trustee's duty to act *impartially* does not of course mean that he or she must treat discretionary beneficiaries *equally*. The discretion to choose amongst discretionary beneficiaries can be unequal so long as it is not exercised in bad faith, irresponsibly, capriciously or wantonly. In *Edge v Pension Ombudsman* Sir Richard Scott VC said:²⁵

Neither a duty to act impartially nor a duty to act in the best interest of all the beneficiaries describes, in my judgment, the nature of the duty on the trustees when considering what steps to take to deal with the surplus. ... They certainly had a duty to exercise their discretionary power honestly and for the purposes for which the power was given and not so as to accomplish any ulterior purposes. But they were the judges of whether or not their exercise of the power was fair as between the benefited beneficiaries and other beneficiaries. Their exercise of the discretionary power cannot be set aside simply because a judge ... thinks it was not fair.

Earlier in the judgment, the Vice Chancellor said:²⁶

What is "undue partiality?" The trustees are entitled to be partial. They are entitled to exclude some beneficiaries from particular benefits and to prefer others. If what is meant by undue partiality" is that the trustees have taken into account irrelevant or improper or irrational factors, their exercise of discretion may well be flawed. But it is not flawed simply because someone else, whether or not a judge, regards their partiality as "undue." It is the trustees' discretion that is to be exercised. Except in a case in which the discretion has been surrendered to the court, it is not for a judge to exercise the discretion. The judge may disagree with the manner in which trustees have exercised their discretion but, unless they can be seen to have taken into account irrelevant, improper or irrational factors, or unless their decision can be said to be one that no reasonable body of trustees properly directing themselves could have reached, the judge cannot interfere. In particular he cannot interfere simply on the ground that the partiality shown to the preferred beneficiaries was in his opinion undue.

But the analogy cannot be taken too far. Trustees operate under fiduciary, rather than contractual, powers. The courts' supervision of trustees' actions is more readily accepted. And beneficiaries do not normally have the opportunity to agree the terms of the trust under which they are to benefit. The contrary is the case with contracting parties.

D Some Residual Uncertainties

Overseas courts appear to be considering and applying the rule that contractual powers must not be exercised arbitrarily or capriciously or in bad faith with ever greater frequency. However, judges have so far refrained from offering significant general guidance on the topic of what will qualify as an "arbitrary", "capricious" or "bad faith" exercise of contractual power.

25 [1998] Ch 512 at 535 per Scott VC. Upheld in the Court of Appeal: [2000] Ch 602 (CA). See also in *Re Londonderry's Settlement* [1965] Ch 918 (CA).

26 *Edge v Pension Ombudsman*, *ibid* at 534.

These definitional uncertainties were noted, but by no means resolved, by the New South Wales Court of Appeal in *Vodafone Pacific*:²⁷

In addressing contrary intent, it is necessary to have in mind a content for the obligation of good faith and reasonableness. Only then can one sensibly enquire whether there is inconsistency with the terms of the contract. There is regrettable lack of uniformity in the cases. Reasonableness can be seen as part of good faith, and acting in bad faith is hardly reasonable. The difficulty in arriving at the content of an obligation of good faith, in particular, has often been noted ...

Good faith meaning honesty and good faith meaning doing what is necessary to enable the party to have the benefit of the contract were two elements of the implied obligation taken up by the judge They are really different. Perhaps different again is good faith meaning reasonableness, which the judge seems also to have taken up.

English judges similarly have shied clear of defining with any precision *what* will qualify as an "arbitrary", "capricious" or "bad faith" exercise of contractual power. In particular, there is conflicting English authority on whether the courts might draw on public law principles in interpreting and applying the (default) common law fetters on the exercise of contractual powers described above.

On the one hand, the English Court of Appeal in *Lymington Marina* held that the High Court Judge erred by informing his analysis of the contractual power with express reference and reliance on Lord Greene MR's *Wednesbury* doctrine. On the other, a differently constituted English Court of Appeal in *Socimer International* went in the opposite direction a little under one year later – in the passage quoted earlier (where it reasoned by direct analogy to *Wednesbury*).

This divergence of judicial opinion in England was recently noted in the New Zealand High Court by Dobson J in *Todd Pohokura Ltd v Shell Exploration NZ Ltd* where his Honour said:²⁸

I do not treat *Paragon Finance* or *Socimer* as importing any of the other trappings of public law challenges. Rather, it is simply that "*Wednesbury* unreasonableness" is useful because it is such a recognisable label for decision-making that defies common sense by virtue of arbitrariness or perversity.

It is clear that the courts in refraining from providing clear guidance on *what* will qualify as an "arbitrary" or a "capricious" or a "bad faith" exercise of contractual power are proceeding on a context-centric basis. They are placing more weight on the need to preserve sufficient flexibility to accommodate the complexity of human interaction, than on the need to provide determinate rules to ensure certainty in the contracting process. In that respect, at least, there is direct analogy with public law.

²⁷ *Vodafone Pacific*, above n 17, at [192]–[193] per Giles JA.

²⁸ *Todd Pohokura Ltd v Shell Exploration NZ Ltd*, above n 18, at [216].

E Breach of the Default Rule

Little needs to be said on this topic. The breach of the default rule is the same as the breach of any other implied term. Whether it sounds in damages or a right of cancellation, or both, depends on the usual considerations applying under the Contractual Remedies Act 1979: essentiality or substantial effect upon the relative benefits and burdens under the contract.

III LIMITS TO (AND LIMITING) THE DEFAULT RULE

The courts have identified two principal limits to the default rule. First, the party in whom the contractual discretion is reposed is not obliged to justify objectively the exercise of its power. Second, that party is not obliged to prefer the interests of the other contracting party to the detriment of its own. Each limit is of course subject to clear words to the contrary.

A No Obligation for the Discretion-holder to Justify Objectively its Exercise of the Contractual Power

Lymington Marina deals directly with the first limit. As noted earlier, the case concerned a discretion under a marina licence to consent (or not) to a sub-licensee using a berth. As we have already seen the Court of Appeal concluded that there could be no doubt that the possessor of such a power must act in good faith and that its approval was not to be withheld arbitrarily, capriciously or in bad faith.

Arden LJ (who delivered the leading judgment) refused, however, to imply into the contract that the possessor of the power might only withhold approval if its decision was "objectively justifiable". Her Honour reasoned²⁹ that the implication of a term that any refusal of approval be objectively justifiable would be onerous to the possessor of the power and therefore could not be so obvious that the parties to the licence would not have thought it necessary to mention it. Arden LJ did not set out in any detail the difference between an "objectively justifiable" exercise of the discretion to consent to a sub-licensee using the marina and a decision made arbitrarily, in bad faith or capriciously. However, her Honour did note³⁰ a "practical difference" between those "two ends of the spectrum". Arden LJ illustrated this practical difference with a hypothetical example:³¹

Suppose that LML [the marina company] refuses to approve the grant of a sub licence to X on the ground that it genuinely and on the basis of some material, but nonetheless mistakenly, considers that X's understanding of English is poor, and that this could lead to an accident when X is manoeuvring his yacht into or in the marina. The licence holder may respond that LML has failed to make any appropriate investigations into X's ability to speak English and that X is in fact able to understand and

29 *Lymington Marina Ltd v Macnamara*, above n 14, at [43].

30 *Ibid*, at [42].

31 *Ibid*.

speaking English sufficiently well. If LML has to establish that its decision is objectively justifiable, it may have to make investigations in this situation as to X's ability to speak English. If its only obligation is not to act arbitrarily, then it need only have some basis for its decision.

Following that example, Pill LJ added³² that (without deciding or assuming that it was relevant to seafaring) some knowledge of an enquiry into X's linguistic ability was necessary. It was, Pill LJ thought, essential to any genuine view. To assume an absence of knowledge of English, and act upon it, would be to act capriciously. Where a genuine view could be formed, however, Pill LJ agreed that a decision about linguistic ability did not have to be justified objectively.

The Court of Appeal thus concluded that all that the marina company had to do was to consider any application for approval made to it. It had no obligation to the licence holder to seek out other facts. Provided it considered an application in good faith and it did not refuse to approve a sub licensee arbitrarily, the Court would not second guess the exercise of its contractual power. Unless, of course, it had misconstrued its powers as a matter of law (which was what it had done).

B No Obligation for the Discretion-holder to Prefer the Interests of the Other Contracting Party to the Detriment of its Own

The possessor of a contractual power is (in the absence of clear words to the contrary) not obliged to prefer the interests of the other contracting party, to the detriment of its own interests. An analogous principle has been developed in relation to "best endeavours" clauses.³³

By way of example, in *Thiess Contractors Pty Ltd v Placer (Granny Smith) Pty Ltd*³⁴ Templeman J declined to read down a broad power of the principal to terminate for convenience, in the face of an express contractual obligation on the parties to act in good faith. His Honour reasoned that a clear and absolute discretion to terminate is not required to be exercised reasonably merely by virtue of the existence of a requirement to act in good faith. Moreover – and importantly for present purposes – Templeman J held that a contractual obligation of good faith does not prevent either party pursuing legitimate commercial interests, even though the pursuit of those interests may result in the renegotiation or termination of the contract.

Socimer International is to the same effect. Having glided past its facts earlier, we must grapple with them now. It concerned a dispute between two banks which, before the failure of one of them, had been trading together in the securities of emerging markets. When, shortly before the failing bank (Socimer) entered into liquidation, it was put into default, it owed its counter-party bank

32 Ibid, at [71].

33 See for example *IBM United Kingdom Ltd v Rockware Glass Ltd* [1980] FSR 335 (CA).

34 [2000] WASCA 102.

(Standard) some US \$24.5 million in respect of a portfolio of forward sales of securities which it had bought.

Under the operative agreement between the banks, the creditor bank, Standard, had to "liquidate or retain" that portfolio to satisfy the amount due to it. For these purposes it had to value the portfolio on the termination date. The critical clause provided that: "The value of any Designated Assets liquidated or retained and any losses, expenses or costs arising out of the termination or the sale of the Designated Assets shall be determined on the date of termination by Seller".

At trial Socimer claimed that Standard did not have a "wide discretion" in valuing, but instead was bound (to take reasonable care) to find "the true market value". The trial Judge, Gloster J, accepted this submission. The English Court of Appeal disagreed. It reasoned:³⁵

Standard's position is governed by its commercial contract, not by the law of equity. This is the world of sophisticated investors, not that of consumer protection. These merchants in the securities of emerging markets have made an agreement which speaks of the need for a spot valuation, not of the more leisurely process of taking reasonable precautions, such as properly exposing the mortgaged property for sale, designed to get the true market price by correct process. Meanwhile, the assets involved are those of Standard, not of Socimer: and the underlying background is that where the buyer defaults, he loses both the right to complete his purchase and his downpayment.

... What happens, however, is that a valuation is made on the termination date to allocate the market risk between the past and the future. In such circumstances that allocation needs to be made in order to protect Standard's interests, not the buyer's. Of course that allocation must be made honestly and rationally, but subject to that there is no reason whatever to think that Standard should be left with any risk of what the markets will do. Otherwise, in a manner quite contrary to the whole of the rest of the agreement, the full risk from the termination date forwards would bear unfairly and entirely on Standard, who is simply reacting in an emergency to its buyer's default.

The Court concluded, on the basis of this reasoning, that Gloster J had erred in construing the clause as requiring an objective inquiry into the true market value of the Designated Assets, or as imposing a duty of reasonable care upon Standard. In short, the Court was not prepared to go so far as to require a party exercising a unilateral contractual power to prefer the interests of the other contracting party to the detriment of its own interests.

In New Zealand Venning J reached a similar conclusion in *Topline International Ltd v Cellular Improvements Ltd*.³⁶ Venning J commented in that case that an express good faith obligation "adds little to the parties' general contractual obligations".³⁷ In particular, the clause did not oblige the

35 *Socimer International Bank Ltd v Standard Bank London Ltd*, above n 15 at [122]–[123].

36 HC Auckland CP144-SW02, 17 March 2003.

37 *Ibid*, at [102].

parties to act only in the interests of both. Instead, "each was entitled to protect and advance its own commercial interests".³⁸

C Defining (Diminishing) the Default Rule

It is clear that if the rule applies, it must accommodate the particular terms of the parties' contract. McDougall J has made this point extra judicially.³⁹ The same point is articulated judicially by the New South Wales Court of Appeal in *Vodafone Pacific*.⁴⁰ This is a reflection of freedom of contract. As McGechan J recognised in *Gregory v Rangitikei District Council*: "Parties at arm's length may contract in a way which allows the arbitrary, abnormal, or even downright stupid."⁴¹ More to the point, as Cooke P noted in *Offshore Mining Ltd v Attorney-General*:⁴²

... the content of any general duties to the other contracting party has to be determined in the light of the scheme and express provisions of the contract.

D Expressly Defining (Modifying) the Content of the Default Rule

Contracting parties have a choice. The default rule by definition is ubiquitous. If a contract contains a unilateral power, parties will be taken to have accepted the implied inclusion of the default rule in the absence of contrary words or necessary implication.

Whilst it is clear that the courts will seek to imply obligations that contractual powers not be exercised arbitrarily or capriciously or in bad faith, it is equally clear that implied terms cannot stand in the face of express terms or necessary implication to the contrary. Take *Savelio v New Zealand Post Ltd*.⁴³ There Hammond J regarded as "highly problematic" an argument that an obligation of good faith should be implied in an owner/driver courier contract where "there was a complete, written, commercial agreement between the parties". Would that such reasoning were expressed more frequently.

It follows however that if the parties seek to define expressly the default rule, they run the risk (which may be what they want to do) of excluding any implied default rule altogether. Thus, if the exercise of unilateral contractual power is to be expressly fettered at all, very careful attention needs to be given to drafting the form of obligation in a way that meets expressly the parties' common objectives.

38 Ibid, at [103].

39 Robert McDougall "The Implied Duty of Good Faith in Australian Contract Law" (2006) Supreme Court of New South Wales <www.lawlink.nsw.gov.au>.

40 *Vodafone Pacific*, above n 17, at [191]–[208].

41 [1995] 2 NZLR 208 (HC).

42 CA116/86, 28 April 1988 at 23.

43 HC Wellington CP143/02, 18 July 2002 at [19].

E Implicitly Defining (Modifying) the Content of the Default Rule

If the parties to a contract do not expressly define the content of the rules which are to inform the unilateral exercise of power under the contract, then any modifications to the (default) common law rule that contractual powers must not be exercised arbitrarily or capriciously or in bad faith will depend on necessary implication from all the other terms of the contracts: a necessarily uncertain process.

F Excluding the Default Rule

Whatever the basis for the implication of the default rule, it cannot stand in the face of contrary contractual intention, either express or derived by necessary implication from the contract as a whole considered against its factual matrix. As Wild J noted in *Todd Petroleum Mining Company Ltd v Shell (Petroleum Mining) Company Ltd*,⁴⁴ the Courts will not imply a term into a contract which "would conflict with" or "cut right across" the clear effect of the terms agreed to by the parties.

This is contract law orthodoxy. It is also fair to contracting parties. Placing the ball in their court respects their contractual sovereignty. It is also efficient: respecting the choice of parties to exclude the default rule expressly respects the fact that parties have chosen (and paid for) their rights as they appear on the face of the agreement.

G Implicitly Excluding the Default Rule

If there is no express exclusion either of implied terms generally, or specifically of an implied obligation not to exercise contractual powers arbitrarily or capriciously or in bad faith, then negation of the default rule will depend on necessary implication from all the other terms of the contracts: again, an uncertain process.

There is High Court of Australia authority that an "entire agreement" clause may not exclude terms implied by law.⁴⁵ However a different conclusion has been reached in other Australian authorities.⁴⁶ New Zealand lawyers are conditioned to look sceptically at entire agreement clauses, in light of almost three decades under section 4 of the Contractual Remedies Act 1979 – albeit that it does not deal with implied terms. Elias J (as she then was) observed in *Stanley v Fuji Xerox New Zealand Ltd*⁴⁷ that a clause to the effect that the contract "purports ... to embody the entire understanding of the parties and exclude the implication of any other terms", prompts "caution" on

44 HC Wellington CIV-2005-485-819, 19 June 2006 at [99].

45 *Hart v MacDonald* (1910) 10 CLR 417.

46 See for example *Vodafone Pacific*, above n 17, and *Tomlin v Ford Credit Australia Ltd* [2005] NSWSC 540.

47 HC Auckland CP479/96, 5 November 1997 at 24.

the part of a Court which was being asked to imply a term into the contract. The provision was, however, "not conclusive".

H Expressly Excluding the Default Rule: "Sole" or "Unfettered" Discretions

The other way to negate any application of the default rule is to grasp the nettle and exclude, in express words, any fetters to the performance of any contractual duty or in the performance of specified contractual duties.

Any general exclusion will have to be in clear contractual language. This may take the form of excluding specifically "any implied obligations of good faith or reasonableness" in exercising any (or a specified) contractual right, power or function. Another option is to include a term in the contract that the exercise of any (or a specified) contractual power is at the "sole discretion" or in the "unfettered discretion" of the party exercising those powers (or that power).

*Vodafone Pacific*⁴⁸ illustrates the potential effectiveness of "sole discretion" clauses. In that case Giles JA concluded that the relevant contractual powers were not fettered by an implied obligation of good faith and reasonableness, laying particular emphasis upon the fact that the power "was emphatically described as a sole discretion". "[T]he point of 'sole'", Giles JA reasoned, "lay in the exclusion of any constraint".⁴⁹

That conclusion was reinforced by other provisions of the contract which, his Honour said, "weigh[ed] against the implied obligation of good faith and reasonableness in the exercise of the power".⁵⁰ Thus, Giles JA pointed to the distinction between the absolute discretion conferred by one clause and the obligation to act reasonably specified in others. He concluded that "without more, in my opinion, the implication of the obligation to act in good faith and reasonably in exercising the power of determining target levels ... was excluded."⁵¹ Giles JA relied also on the entire agreement clause which expressly excluded all implied terms "to the full extent permitted by Law and other than expressly set out in this Agreement".⁵²

*Tomlin v Ford Credit Australia Limited*⁵³ is another example of a case where a reading of the contract as a whole prevented the implication of any fetters on the exercise of the contractual power in question. One issue in *Tomlin* concerned the right of the defendant (a bailor) to determine the true

48 *Vodafone Pacific*, above n 17.

49 *Ibid*, at [195].

50 *Ibid*.

51 *Ibid*, at [198].

52 *Ibid*.

53 *Tomlin v Ford Credit Australia Ltd*, above n 46.

wholesale value of bailed vehicles, and its right to terminate the bailment agreement. The plaintiffs argued that those (and other) rights were conditioned by an obligation that the determination or decision be made in good faith. MacDougall J concluded (although obiter, having regard to his finding that there was no relevant bad faith) that the rights were not so qualified. There were two reasons why this was so.

First, there was an entire agreement clause in the bailment agreement. Second, the powers were given to the defendant "for the protection of its legitimate commercial interests". In circumstances where there might be legitimate differences of opinion as to the subject matter of the powers, and where the powers were given to one party for the protection of its commercial interests, MacDougall J inclined to the view that there was no basis for constraining the powers by implying an obligation of good faith.

MacDougall J reserved the question of whether the exercise of the contractual powers might be vitiated by the existence of actual bad faith, ie an exercise for some ulterior and unlawful purpose. He noted, in this context, that the doctrine of fraud on a power may have some surviving relevance. MacDougall J observed in this regard that the doctrine of fraud on a power is of broad application and does not seem to be limited to the exercise of fiduciary powers.⁵⁴

It seems to me that must be right. The law does not love an ouster clause. A "sole discretion" clause cannot be expected to be treated as effective authority to permit the wholesale hijacking of the original bargain.⁵⁵ The unremitted exercise of a "sole discretion" clause, if asserted to be valid at law, merely serves to attract equity's attention instead.

IV GOING BEYOND THE DEFAULT RULE

Justice Paul Finn wrote of "judicial review of contractual discretion" in a 2005 article, "Good Faith and Fair Dealing: Australia".⁵⁶ After referring to a selection of relevant Australian cases, he said:⁵⁷

For my own part, I regard this cautious embrace of a judicial review jurisdiction as both a predictable and a welcome development. In asking whether a decision has been made, or an action taken, 'in a capricious or arbitrary manner or for an extraneous purpose', not only are the courts pursuing known and well worn paths of judicial inquiry ..., they also are locating at the centre of that inquiry the legitimate interests and expectations of the parties in light of their contractual relationship.

54 Ibid, at [120]. As to fraud on a power in its conventional trusts application, see the recent decision of the New Zealand Supreme Court in *Kain v Hutton* [2008] NZSC 61, [2008] 3 NZLR 589 at [15]–[23].

55 See the discussion of *Barton v Air New Zealand Ltd*, above n 4.

56 P Finn "Good Faith and Fair Dealing: Australia" (2005) 11 NZBLQ 378.

57 Ibid, at 385–386.

These observations recognise the important role the courts can and should play in the supervision of exercises of power throughout society. As observed earlier, 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 (governed then by public law).

Justice Finn's observations also recognise the reality that there is a strong analogy between the supervision of powers in both public and private law. Whether *Wednesbury* is in or out, certainly the concepts sound similar, and the outcomes look similar. That coalescence of ideas from the streams of private and public law suggests that there is much utility in each stream informing and, where appropriate, modifying the course of the other.

There will, however, be limits to how far public law can inform private law principles, and vice versa. It is, in particular, unlikely that the courts will graft procedural limitations, akin to those of natural justice, on the exercise of unilateral contractual powers. As Daintith notes:⁵⁸

The need to observe procedural fairness is a familiar constraint on the exercise of administrative powers, but hardly fits in the context of a bilateral contract between supposedly equal parties.

Broad concepts of "fairness" (including procedural fairness) are alien to contract law, just as they form no part of trust law either.

But when it comes to substantive principles such as error of law, improper purpose and irrationality, there is no fundamental difference between the interests to be protected in contract law, trust law and public law; and there is no fundamental difference between the tools used by each to provide that protection. As Professor Lon Fuller put it, there is good justification "for modulating the assertion of power without regard for the source of the power, though the institutional source would counsel differing levels of activism in the judiciary".⁵⁹ The common themes that run across judicial review of the exercise of contractual powers, trustees' powers, and powers vested in public officials, suggest that, in this field at least, that is the case.

58 Terence Daintith "Regulation by Contract: A New Prerogative?" (1979) 32 *Current Legal Problems* 41 at 58.

59 Lon Fuller *Anatomy of the Law* (New American Library, New York, 1969) at 113.