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ARTICLES

CONTROLLING CONTRACTUAL DISCRETION

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ABSTRACT. *This paper identifies the source, content and limits of the controls that might be imposed by a court on the way a party exercises discretionary powers conferred under the terms of a contract. It is argued that such controls boil down to a requirement of "good faith", in the sense that the party exercising the discretion must do so honestly, and that this can be tested by asking whether the decision is one that no reasonable person acting reasonably could have reached in the circumstances. It is suggested that a similar requirement should apply when a contracting party exercises a right to terminate for breach, whether at common law or under a termination clause.*

KEYWORDS: *Controlling contractual discretion; implied terms; construction; good faith; termination for breach.*

I. INTRODUCTION

There is a growing body of case law which shows that the courts are willing to control the way a party may exercise discretionary powers conferred under the terms of a contract. These authorities provide that a decision-maker's discretion will be limited, as a matter of necessary implication, by concepts of honesty, good faith and genuineness, and that it must not be exercised in an arbitrary, capricious or, perhaps, unreasonable manner.

This paper identifies the source, content and limits of the controls that might be imposed on the exercise of contractual discretion, and considers whether similar controls could be applied to the exercise of a right to terminate a contract for breach. The focus will be on commercial contracts, so as to strip out the specific legislative protection afforded to consumers,[1] and it will only be on those contracts that do

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not contain a fiduciary aspect which constrains the decision-maker's discretion, *e.g.*, as where a director of a company must act *bona fide* in the interests of the company.[2]

Part II of the paper focuses on contractual discretion. It reviews the case for imposing controls on a decision-maker, as well as the legal mechanisms through which such controls are imposed, before going on to identify the nature and content of those controls and asking whether there is scope for the parties to opt out of them. It will be argued that the controls that apply to the exercise of contractual discretionary powers boil down to a requirement of "good faith", in the sense that the party exercising the discretion must do so honestly, and that this can be tested by asking whether the decision is one that no reasonable person acting reasonably could have reached in the circumstances.

Part III takes the good faith requirement implicit in the contractual discretion cases and argues that a similar requirement should apply when a contracting party exercises a right to terminate for breach, whether the right arises at common law or under a termination clause. This is a radical step that, at first sight, appears to be out of line with traditional notions of freedom of contract, autonomy of the parties and the need for commercial certainty. Nevertheless, it will be argued that, contrary to some recent judicial statements, there is no material distinction between the discretion cases and the termination cases and that doctrinal coherence demands that both situations are treated alike.

II. Contractual discretion

The starting point for our investigation must be the controls that the courts have imposed on the exercise of contractual discretion. There are several questions to answer. Why do we need controls at all where a contract clearly states that one party may exercise a discretion unilaterally and in such a way that can affect the legal position of the other party? What is the source of the controls? The case law has embedded those controls into the contract through implied terms but it remains arguable that they should be brought into play through a process of construction rather than implication, in so far as it remains possible to argue that these are separate concepts after Lord Hoffmann's restatement of the law relating to the implication of terms in fact in *Att.-Gen. of Belize v Belize Telecom Ltd*.[3] What is the content of the controls?

[1] E.g. the Consumer Credit Act 1974; the Unfair Terms in Consumer Contracts Regulations 1999, S.I. 1999/2083.

[2] See, e.g., *Re Smith and Fawcett Ltd* [1942] Ch. 304, 306, and also the Companies Act 2006, s. 172, which gives the obligation a statutory basis.

[3] [2009] UKPC 10, [2009] 1 W.L.R. 1988, [16]–[27]; endorsed and clarified by the Court of Appeal in *Mediterranean Salvage & Towage Ltd. v Seamar Trading & Commerce Inc. (The Reborn)* [2009] EWCA Civ 531, [2009] 2 Lloyd's Rep. 639, [8]–[14], and by Aikens L.J. in *Crema v Cenkos Securities Plc*. [2010] EWCA Civ 1444, [2011] 1 W.L.R. 2066, [36]–[41].

Do they require more than subjective honesty? In Australia, the courts have imposed objective standards of reasonableness on the decision-maker and it could be argued that English law should follow a similar path. That would bring English law closer to that which applies in many civil law systems of Europe and in all the States in the United States where it is accepted that contracts should be performed in good faith.[4] Finally, we are left to consider whether freedom of contract and the autonomy of the parties leaves them free to exclude any and all obligations of good faith, whether subjective or objective, should they wish to do so? Only when we have answered these fundamental questions will we be able to test the suitability of similar controls in the context of the exercise of a right of termination for breach.

A. Justifying the control of contractual discretion

There is a case that the courts should not intervene to control the exercise of contractual discretion in the commercial arena. It is based on freedom and sanctity of contract and places a premium on commercial certainty.[5] The principle of autonomy of the parties means that the 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.[6] Hugh Collins has identified several reasons why one party might be prepared to enter into such an unbalanced contract and take the risk of opportunism by the decision-maker, including that discretion may provide a response to future uncertainty, discretion may be controlled by the economic self-interest of the decision-maker, since misuse may damage its reputation in the market, the party subject to the discretion may regard it as a price worth paying for a financially better deal, and, in some contracts, each party may enjoy discretionary powers so that they balance themselves out.[7]

On the other hand, an unfettered contractual discretion may not properly reflect the intention of the parties at the time of contracting. An understandable desire to "get the deal done" may well explain why one party is given the power to exercise discretion, but it can rarely be the intention of the parties that it may be exercised without restraint.

[4] See, e.g., US Restatement (2d) Contracts, s. 205; Uniform Commercial Code, s. 1–203. Good faith in negotiation of contracts has had a slower path to acceptance: see M. Furmston and G.J. Tolhurst, *Contract Formation: Law and Practice* (Oxford 2010), Ch. 12.

[5] J. Morgan, "Against Judicial Review of Discretionary Contractual Powers" [2008] L.M.C.L.Q. 230, 235, 239.

[6] T. Daintith, "Contractual Discretion and Administrative Discretion: A Unified Analysis" (2005) 68 M.L.R. 554, 575.

[7] H. Collins, "Discretionary Powers in Contracts" in D. Campbell, H. Collins and J. Wightman (eds.), *Implicit Dimensions of Contracts: Discrete, Relational and Network Contracts* (Oxford 2003), 219, 226–231.

As Mr. Recorder Havelock-Allen Q.C. observed at first instance in *Paragon Finance v Nash*:[8] "a contract where one party truly found himself subject to the whim of the other would be a commercial and practical absurdity". The risk of reputational damage alone might, in some cases, be enough to deter the party with the discretion from using it in a dishonest or irrational manner, but regulation of conduct by the market is, at best, unpredictable and, at worst, non-existent. Furthermore, in a long-term contract that depends on co-operation between the parties, an unfettered discretion afforded to one party may undermine the economic potential of the contract.[9]

B. Mechanism of control

1. Implied terms

The preferred mechanism by which the English courts have sought to control the exercise of contractual discretion is through the use of a term implied in fact. There are many examples. In *Gan Insurance Co Ltd. v Tai Ping Insurance Co Ltd. (No 2)*,[10] where a reinsurer had contractual discretion to approve a proposed settlement by the re-insured, the Court of Appeal held that an implied term prevented "unreasonableness in the sense of conduct or a decision to which no reasonable person having the relevant discretion could have subscribed".[11] In *Paragon Finance plc v Nash*,[12] the Court of Appeal held that there was an implied term that the mortgage lender must not exercise its express power to set the rate of interest payable by the borrower "dishonestly, for an improper purpose, capriciously or arbitrarily".[13] Although the court was prepare to imply a term that the interest rate would not be set in a way that "no reasonable lender, acting reasonably, would do", this did not prevent the lender from imposing an unreasonable rate.[14] In *Lymington Marina Ltd. v MacNamara*,[15] the Court of Appeal held that there was an implied term that prevented a marina owner from exercising its right to withhold permission for the grant of a sub-licence of a berth for wholly unreasonable, capricious, arbitrary or bad faith reasons.[16] In *Socimer International Bank Ltd. v Standard Bank London Ltd.*,[17] where, on the

[8] [2001] EWCA Civ 1466, [2002] 1 W.L.R. 685, as quoted by Dyson L.J. on appeal in that case at [26].
[9] See Collins, note 7 above, 231.
[10] [2001] EWCA Civ 1047, [2001] 2 All E.R. (Comm) 299.
[11] Ibid., at [64], *per* Mance L.J.
[12] Note 8 above.
[13] Ibid., at [32], *per* Dyson L.J.
[14] Ibid., at [41]. See also *Paragon Finance plc v Pender* [2005] EWCA Civ 760, [2005] 1 W.L.R. 3412, [120], *per* Jonathan Parker L.J.
[15] [2007] EWCA Civ 151, [2007] 2 All E.R. (Comm) 825.
[16] Ibid., at [42]–[44].
[17] [2008] EWCA Civ 116, [2008] 1 Lloyd's Rep. 558.

termination of a contract between two banks for the forward sale of securities, the seller was obliged to value and give credit for retained securities belonging to the buyer, the Court of Appeal held that the "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".[18]

In each of these cases, the controlling term was implied in fact and not in law. This is not surprising. Terms will only be implied in law into standard legal relationships.[19] Of the four examples given above, the one that comes closest to the implication of a term in law is *Nash*,[20] as the relationship between lender and borrower is a common one. Undoubtedly there were policy considerations in play and the court's reference to the parties' "reasonable expectations" as the driving force behind the search of a term implied in fact,[21] reflecting a similar statement of Lord Steyn in *Equitable Life Assurance Co. Ltd. v Hyman*,[22] seems to blur the distinction between a term implied in fact and one implied in law. This approach probably makes it easier to imply terms in fact. But we must not ignore the warning given by Mance L.J. in *Gan* that "the authorities do not justify any automatic implication, whenever a contractual provision exists putting one party at the mercy of another's exercise of discretion. It all depends on the circumstances".[23] In *The Reborn*,[24] Lord Clarke M.R. has also provided a gloss on what Lord Hoffmann said in *Belize Telecom*[25] about implying a term in fact, by stressing that it must still be "necessary" to imply the proposed term. But this does not mean that we can ignore the reasonable expectations of the parties, as they are central to Lord Hoffmann's statement. The need to give business efficacy is not the only relevant type of necessity. An express term of the contract may work perfectly

[18] Ibid., at [66].

[19] E.g., sale of goods, landlord and tenant, employment, the carriage of goods by land or sea. See generally, H. Beale *et al* (eds.), *Chitty on Contracts*, 31st ed. (London 2012), Vol. I, Ch. 13; E.Peel, *Treitel's Law of Contract*, 13th ed. (London, 2011), [6–041]–[6–045]; N. Andrews, *Contract Law* (Cambridge 2011), [13.03]–[13.07]. This restriction seems to have been ignored in Australia where there is evidence of the courts implying terms in law outside such common relationships: see, e.g., *Vodafone Pacific Ltd. v Mobile Innovations Ltd.* [2004] NSWCA 15, [125], [189]; *Burger King Corp. v Hungry Jack's Pty Ltd.* (2001) NSWCA 187, [159], [164]; *Alcatel Australia Ltd. v Scarcella* (1998) 44 NSWLR 349, 369; cf. *Renard Constructions (ME) Pty Ltd. v Minister of Public Works* (1992) 26 N.S.W.L.R. 234, 263, where Priestley J.A. referred to a "hybrid" between implied terms in fact and in law; and see generally, E. Peden, *Good Faith in the Performance of Contracts* (Sydney 2003), Ch. 6.

[20] Note 8 above.

[21] At [36] and [42], *per* Dyson L.J.

[22] [2002] 1 A.C. 408, 459.

[23] Note 10 above, at [62].

[24] Note 3 above, at [15]. Cooke J. has said that Lord Clarke's emphasis on necessity "tallies" with Lord Hoffmann's statement in *Belize Telecom* at [18]: *SNCB v UBS AG* [2012] EWHC 2044 (Comm), [65].

[25] Note 3 above, at [16]–[27].

well in that both parties can perform their express obligations, but the consequences would contradict what a reasonable person would understand the contract to mean. In such a case an implied term would be "necessary" to spell what the contract actually means.[26] In *Eastleigh B.C. v Town Quay Developments Ltd.*,[27] Arden L.J. clarified the nature of the relationship between necessity and the reasonable expectations of the parties when she said "Lord Hoffmann made it clear that the process of testing necessity for the purposes of an implied term is not an exercise to be carried out in a manner detached from the reasonable expectations of the parties to the particular agreement being interpreted. Therefore, in determining whether a term is to be implied, the court is in fact engaging in the process of interpreting the contract". This means that the nature and purpose of the contract will be crucial to determining whether or not a limitation is to be implied to control the exercise of a discretionary power.[28] Nevertheless, despite the cautionary words of Mance L.J. in *Gan*, it seems the current trend is that where one party to a commercial contract is given the right to make a decision on a matter which affects both parties whose interests are not the same, the court is likely to imply a limitation as necessary to give effect to the reasonable expectation of the parties.[29]

2. Construction

There are also cases where the courts have used principles of construction to control one party's apparently unfettered contractual discretion. In *Abu Dhabi National Tanker Co v Product Star Shipping Ltd (The Product Star) (No. 2)*,[30] a charterparty conferred on the owner and master a power to determine whether or not a port to which the charterer ordered the vessel was dangerous. On its face, the discretion was unfettered; however, the Court of Appeal held that it was to be restrained. Leggatt L.J. said:[31]

> Where A and B contract with each other to confer a discretion on A, that does not render B subject to A's uninhibited whim. In my judgment, the authorities show that not only must the discretion be exercised honestly and in good faith, but, having regard to the provisions of the contract by which it is conferred, it must not be exercised arbitrarily, capriciously or unreasonably.

[26] *Jackson v Dear* [2012] EWHC 2060 (Ch), [40], *per* Briggs J.
[27] [2009] EWCA Civ 1391, [2010] 2 P. & C.R. 2, [31].
[28] G. Thomas, *Thomas on Powers*, 2nd ed. (Oxford 2012), [10.194].
[29] *Horkulak v Cantor Fitzgerald International* [2004] EWCA Civ 1287, [2005] I.C.R. 402, [30], *per* Potter L.J.; *JML Direct Ltd. v Freesat UK Ltd.* [2010] EWCA Civ 34, [14], *per* Moore-Bick L.J. Cf. *SNCB Holding v UBS AG*, note 24 above, [108], *per* Cook J.
[30] [1993] 1 Lloyd's Rep. 397.
[31] Ibid., at 404.

There is no reference to the implication of a term to control the exercise of the discretion; Leggatt L.J.'s emphasis is on "having regard to the provisions of the contract by which [the power] is conferred".

Lymington Marina Ltd. v MacNamara,[32] provides an example of a court construing the terms of a contract to ascertain the limits of a power to approve or consent to a particular activity.[33] The licensee of a berth at a marina wanted to grant sub-licences to his brothers, which was allowed under the terms of the licence "provided always that such third party shall first be approved by [the owner of the marina]". Arden L.J. construed the licence agreement to ascertain the grounds on which approval of the sub-licence could be withheld. She held they were limited to those grounds which arose out of the sub-licensee's proposed use of the marina, and that the owner could not refuse to approve a sub-licensee on the basis that the sub-licence was contrary to its own commercial interests, unless its commercial interests coincided with the refusal of approval on grounds related to the particular sub-licensee.[34] This established the limits of the power to withhold approval. It was a crucial step in the process. Before a court is able consider the *manner* in which a power can be exercised, it must establish the *limits* of the power under the terms of the contract. In other words, the power has to be exercised within its proper scope and, we may add, for its proper purpose. This is an exercise in construction of the contract.[35]

Elizabeth Peden goes even further.[36] She argues that as "good faith is implicit or inherent in the institution of contract law, then an implication of good faith is unnecessary and confusing".[37] Her submission is that "any fetter on an express right or discretion can instead be achieved by construction, rather than implication of a term".[38] She takes issue with the English Court of Appeal in *Socimer*,[39] where the court implied a term of good faith to control the exercise of a contractual discretion, and also with the New South Wales Court of Appeal in *Renard Constructions (ME) Pty Ltd. v Minister for Public Works*,[40] which has led to numerous decisions in Australia (particularly

[32] Note 15 above.
[33] Commercial contracts often confer a power on one party to approve or consent to a particular activity, or to approve the progress of a construction project. The same questions arise as with the exercise of other types of contractual discretionary power. Daintith, note 6 above, has shown that the origins of the problem can be traced back to *Dallman v King* (1837) 4 Bing NC 105, 109.
[34] Note 15 above, at [28].
[35] *SNCB Holding v UBS AG*, note 24 above, [107], [136].
[36] E. Peden, "'Implicit Good Faith' – or Do We Still Need an Implied Term of Good Faith?" (2009) 25 J.C.L. 50.
[37] Ibid., at 51. For further development of the theory that good faith underpins contract law, see J.W. Carter and E. Peden, "Good Faith in the Australian Contract Law" (2003) 19 J.C.L. 155; "A Good Faith Perspective on Liquidated Damages" (2007) 23 J.C.L. 157.
[38] (2009) 25 J.C.L. 50, 51. See also E. Peden, "When Common Law Trumps Equity: the Rise of Good Faith and Reasonableness and the Demise of Unconscionability" (2005) 21 J.C.L. 226, 239–240.
[39] Note 17 above.
[40] (1992) 26 N.S.W.L.R. 234.

New South Wales) implying terms of good faith and reasonableness.[41] Peden's analysis is attractive because it rests on a narrow definition of good faith that focuses on subjective standards of honesty rather than on objective standards of reasonable behaviour, which would rarely correspond with the intention of the parties to a commercial contract. It could also be argued that by collapsing a requirement of good faith into construction, Peden merely anticipates Lord Hoffmann's statement in *Belize Telecom*[42] that the implication of terms is no more than a facet of construction.[43]

Nevertheless, there is a need for caution. First, English law has long set itself against any general doctrine of good faith, preferring instead to rely on an incremental approach towards good faith principles.[44] Resort to implied terms is part of that piecemeal approach.[45] Secondly, the case law and commentators following *Belize Telecom* have stressed the continued importance of the requirement of "necessity" when seeking to imply a term in fact,[46] thereby ensuring that a "high hurdle" must be met before such a term can be implied.[47] The parties remain free to control their own agreement and there is less scope for the court to impose external standards of good faith on a well-defined relationship. Thirdly, reliance on subjective standards of honesty and rationality through the mechanism of implied terms provides a form of independent control that goes beyond the somewhat elaborate and complex techniques of construction. It is submitted that principles of construction *and* implied terms have complimentary roles in the control of contractual discretionary powers. A discretionary power must be exercised within its proper scope and for its proper purpose.[48] 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.

[41] See, e.g., *Burger King v Hungry Jack's Pty Ltd.*, note 19 above, [169]–[170]; *Vodafone Pacific Ltd. v Mobile Innovations Ltd.*, note 19 above, [125].
[42] [2009] UKPC 10, [2009] 1 W.L.R. 1988, [16]–[27].
[43] *Unique Pub Properties Ltd. v Broad Green Tavern Ltd.* [2012] EWHC 2154 (Ch), [53], Warren J.
[44] *Walford v Miles* [1992] 2 A.C. 128, 138, H.L.; *Interfoto Picture Library Ltd. v Stiletto Visual Programmes Ltd.* [1989] Q.B. 433, 439, C.A.
[45] The approach is also seen in the construction of contracts, e.g., where there is a reluctance to construe an exemption clause so as to apply to a deliberate breach: see *Internet Broadcasting Corporation Ltd. v MAR LLC* [2009] EWHC 844 (Ch), [2009] 2 Lloyd's Rep. 295, [23]–[24], [33]; cf. *Astrazeneca UK Ltd. v Albemarle International Corporation* [2011] EWHC 1574 (Comm), [288]–[301]; *Shared Network Services Ltd. v Nextiraone UK Ltd.* [2011] EWHC 3845 (Comm), [13].
[46] *The Reborn*, note 3 above, [15]. See also *Chitty on Contracts*, note 19 above, [13-005]; G. McMeel, *The Construction of Contracts*, 2nd ed. (Oxford 2011), [11.28]; P.S. Davies, "Recent developments in the law of implied terms" [2010] L.M.C.L.Q. 140.
[47] *Eastleigh BC v Town Quay Developments Ltd.*, note 27 above, [30], *per* Arden L.J.
[48] See, e.g., *Nash*, note 8 above, [31], *per* Dyson L.J..

C. Content of the obligation

What is the content of the terms that the courts have been prepared to imply into a contract to control the exercise of apparently unfettered discretion? In *Socimer*, Rix L.J. reviewed the relevant authorities and said:[49]

> … 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 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.

Rix L.J.'s reference to "*Wednesbury* unreasonableness" is to the public law principle, enshrined in *Associated Provincial Picture Houses v Wednesbury Corporation*,[50] that a public authority's decision cannot be judicially impugned unless it was wholly unreasonable, i.e., a decision that no reasonable person acting reasonable could possibly have made. But, in *The Product Star (No 2)*,[51] Leggatt L.J. warned that the analogy "must be applied with caution to the assessment of whether a contractual discretion has been properly exercised, and in *Lymington Marina*,[52] Arden L.J. rejected any type of *Wednesbury* test in the context of the exercise of contractual discretion, and Pill L.J.,[53] whilst saying that a test on these lines might be appropriate, felt it best to avoid express reference to a public law concept in a contractual context.

Two questions remain. The first is whether the analogy with *Wednesbury* reasonableness imports an objective standard of reasonableness into the decision making process. The second is whether the requirement not to act irrationally, arbitrarily or capriciously really

[49] Note 17 above, at [66] (Rix L.J. delivered the main judgment with which Lloyd and Laws L.JJ. agreed). The authorities reviewed by Rix L.J. included *The Product Star (No2)*, note 30 above; *Ludgate Insurance Co Ltd v Citibank NA* [1998] Lloyd's Rep. IR 221; *Gan*, note 10 above; *Nash*, note 8 above.

[50] [1948] 1 K.B. 223. See generally, H.W.R. Wade & C.F. Forsyth, *Administrative Law*, 10th edn. (Oxford 2009), Ch. 11.

[51] Note 30 above, at 404.

[52] Note 15 above, at [37]; applied by Briggs J. in *Carey Group plc* v. *AIB Group (UK) Plc* [2011] EWHC 567 (Ch), [2011] 2 All E.R. (Comm) 461, [51].

[53] Ibid., at [69]–[70].

adds anything to the primary requirement to act honestly or in good faith.

1. Good faith and reasonableness: two concepts or one?

There has been much ink spilt on the subject of good faith.[54] There are a range of opinions as to what it means. Even within those countries that recognise a general principle of good faith there is no agreed formulation of its core principle.[55] Nevertheless, it is submitted that "good faith" and "reasonableness" are separate concepts. Good faith refers to a subjective state of mind generally characterised by honesty, whereas reasonableness is an objective norm of behaviour.[56] Jane Stapleton observes that the interrelationship of, and difference between, good faith and reasonableness is "subtle but of great importance", and notes that a requirement to satisfy a standard of reasonable behaviour is more demanding than the requirement of good faith.[57] Good faith should be seen as a conscious-related standard, exemplified in the example of the *bona fide* purchaser.[58] Stapleton acknowledges that acting in good faith is necessary for reasonable conduct: to be dishonest, deliberately contradictory (i.e., conducting himself contrary to his word/undertaking), or exploitative (i.e., exploiting a position of dominance or power over a person who is vulnerable relative to him) is always unreasonable. But she adds that acting in good faith is not sufficient to satisfy a reasonableness standard: "as most inadvertent negligence

[54] There is considerable academic support for a general requirement of good faith in English law: see, e.g., R. Powell, "Good Faith in Contracts" (1956) 9 C.L.P. 16; H.K. Lücke, "Good Faith and Contractual Performance" in Finn (ed.), *Essays in Contract* (1987); J. Steyn, "The Role of Good Faith and Fair Dealing in Contract Law: A Hair-Shirt Philosophy?" [1991] Denning Law Journal 131; R. Brownsword, "Two Concepts of Good Faith" (1994) 7 J.C.L. 197; J. Beatson and D Friedmann, "Introduction: From "Classical" to Modern Contract Law" in J. Beatson and D. Freidmann (eds.), *Good Faith and Fault in Contract Law* (1995); A. Mason, "Contract, Good Faith and Equitable Standards in Fair Dealing" (2000) 116 LQR 66. EU legislation has made the question more pressing: see, e.g., the Proposed Common European Sales Law (2011), art. 2(1).

[55] *Director General of Fair Trading v First National Bank plc* [2001] UKHL 52, [2002] 1 A.C. 481, [17], *per* Lord Bingham; and generally, S. Whittaker & R. Zimmerman (eds.), *Good Faith in European Contract Law* (Cambridge 2000).

[56] "Good faith" on its own is different from the composite expression "good faith and fair dealing", which introduces an objective standard of conduct. The Draft Common Frame of Reference keeps the concepts separate: "good faith" is defined as "a mental attitude characterised by honesty and an absence of knowledge that an apparent situation is not the true situation" (see list of definitions introduced by Art. I-1 : 108); "good faith and fair dealing" is "a standard of conduct characterised by honesty, openness and consideration for the interests of the other party to the transaction or relationship in question" (Art. I-1 : 103); and "reasonableness" is "to be objectively ascertained, having regard to the nature and purpose of what is being done, to the circumstances of the case and to any relevant usages and practice" (Art. I-1 : 104): C. Von Bar & E. Clive (eds.), *Principles, Definitions and Model Rules of European Private Law, Draft Common Frame of Reference (DFCR)* (Oxford 2010).

[57] J. Stapleton, "Good Faith in Private Law" (1999) 52 C.L.P. 1, 8.

[58] See, e.g., Sale of Goods Act 1979, s. 61(3); Bills of Exchange Act 1882, s. 90: "a thing is deemed to be done in good faith within the meaning of this Act when it is in fact done honestly, whether it is done negligently or not".

cases show, a person may act in good faith but nevertheless have acted unreasonably as judged by an objective standard".[59]

The fact that good faith is conscious-related has recently been stressed by Cooke J. in *SNCB Holding v UBS AG*.[60] UBS exercised a contractual right contained in a funding agreement to replace higher value bonds held in a collateral account with a mixture of cash and lower value bonds. This was in the commercial interests of UBS but against those of the other contracting party (SNCB Holding), who argued that, when the reasonable expectations of the parties had been taken into account, there were implied terms in the agreement between them that prevented UBS from acting in its own commercial interests and dealing with the bonds at its own discretion. Cooke J. ruled that the contract entitled UBS to dispose of the bonds at will, provided that adequate collateral was available in accordance with the original terms of the contract. He also held that there was no "extra" implied term of good faith based upon standards of reasonableness that controlled UBS's exercise of its rights under the agreement. The good faith exercise of rights, in the context of the funding agreement, meant no more than the honest belief in an entitlement to do so.[61] The judge noted that the claimant had made no allegations of dishonesty or lack of belief on the part of UBS as to the justifiability of its position. Earlier in his judgment Cooke J. had said:[62]

> A duty to exercise "good faith" in doing something is one which is usually to be contrasted with a duty to exercise reasonable care. It connotes subjective honesty, genuineness and integrity, not an objective standard of any kind, whether reasonableness, care or objective fair dealing. It cannot be equated with "utmost good faith" and although its exercise in practice may involve different actions or restraint, the concept is not one which goes beyond the notion of truthfulness, honesty and sincerity.

We have seen that, in *Socimer*, the Court of Appeal gave the clear answer to the question posed in this section of the paper by holding that the analogy with *Wednesbury* reasonableness does not bring with it an objective standard of reasonable conduct.[63]

[59] *Ibid.*. Because Stapleton (at 11–12) distinguishes "good faith" from "fair" or "reasonable" dealing ("an objective norm of behaviour") she is critical of Bingham L.J.'s dictum in *Interfoto Picture Library Ltd. v Stiletto Visual Programmes Ltd.*, note 44 above, 439, that "good faith...is in essence a principle of fair and open dealing" (a "regrettable development").

[60] Note 24 above.

[61] At [112].

[62] At [72].

[63] See main text to note 49 above (overturning Gloster J. [2006] EWHC 718 (Comm), who held that the seller bank was bound to take reasonable care in finding the true market value of the portfolio of securities: an analogy with the equitable duties of a mortgagee was rejected by Lloyd L.J. at [154]–[155]). Rix L.J. recently took the same approach, and applied *Socimer*, in *WestLB v Nomura Bank International Plc* [2012] EWCA Civ 495, [32], [58] (valuation of portfolio of stocks and shares); see also *McKay (t/a McKay Law Solicitors and Advocates) v Centurion Credit Resources*

The position in English law can be contrasted with that prevailing in Australia. In *Renard*,[64] the New South Wales Court of Appeal held that the ability of the principal under a building contract to rely on a "show cause" procedure was subject to a requirement of reasonableness. Priestley J.A. said:[65]

> The contract can in my opinion only be effective as a workable business document under which the promises of each party to the other may be fulfilled, if the sub-clause is read in the way I have intended, that is, as subject to requirements of reasonableness.

Following *Renard*, there have been a number of cases where Australian courts have implied an objective standard of reasonableness into the contract as the key ingredient of good faith.[66] This is to be regretted. Importing an objective standard of reasonableness risks substituting the court's discretion for that of the decision-maker and undermines the principle of autonomy of the parties. Moreover, reasonableness brings with it a measure of uncertainty that is unwelcome in the commercial arena.

2. Absence of arbitrariness, capriciousness, perversity and irrationality: does this add anything to honesty and good faith?

In *Socimer*, Rix L.J. presented the absence of arbitrariness, capriciousness, perversity and irrationality as something additional to honesty and good faith.[67] Similarly, in *The Product Star (No. 2)*, Leggatt L.J. said that "the authorities show that not only must the discretion be exercised honestly and in good faith, but, having regard to the provisions of the contract by which it is conferred, it must not be exercised arbitrarily, capriciously or unreasonably".[68]

Precise definition of expressions such as "irrationality", "arbitrariness", "capriciousness" and "perversity" is not easy: the expressions overlap and are often used interchangeably in the cases.[69] In *Socimer*, Rix L.J. preferred to use the expression "rationality" instead

LLC, unreported, 2nd May 2012 (lender exercising discretion not to make an advance under a loan agreement).

[64] Note 40 above.

[65] Ibid., at 258.

[66] J.W. Carter, E. Peden and G.J. Tolhurst, *Contract Law in Australia*, 5th ed, 2007, at [2-02]; Peden, note 36 above, 59, citing, e.g., *Burger King Corp v Hungry Jack's Pty Ltd.* [2001] NSWCA 187, reported in part (2001) 69 N.S.W.L.R. 558 and cases following. See, however, *Hunter Valley Skydiving Centre Pty Ltd. v Central Coast Aero Club Ltd.* [2008] NSWSC 539,[48]. For criticism of the assimilation of good faith and reasonableness, see E. Peden, "When Common Law Trumps Equity: the Rise of Good Faith and Reasonableness and the Demise of Unconscionability" (2005) 21 J.C.L. 226.

[67] See main text to note 49 above.

[68] Note 30 above, 405. See also Potter L.J. in *Ludgate Insurance Co Ltd.* v *Citibank NA*, note 49 above, [35].

[69] *Thomas on Powers*, note 28 above, [10.184].

of *Wednesbury*-type reasonableness and he distinguished it from an objective standard of reasonableness.[70] On this basis, an "irrational" decision is one that no reasonable person in the decision-maker's position and in those circumstances could have reached.[71] Thus, an irrational decision would be one that lacked a logical, factual basis.[72] There seems little difference between irrationality and arbitrariness. In *Gan*,[73] Mance L.J. saw *Wednesbury* unreasonableness (or irrationality) as merely an expanded expression of not acting arbitrarily, and in *Lymington Marina*,[74] Arden L.J. said that the essence of not acting arbitrarily was that the decision-maker had some basis for making the decision. The link between irrationality and arbitrariness was also made by Rix L.J. in *Mallone v BPB Industries Ltd.*,[75] where he thought the two concepts were "perhaps … very close to the same thing". Furthermore, these concepts must not be divorced from that of capriciousness, an example of which is often given as a decision based on the colour of a person's hair.[76] A capricious decision, according to Burton J. in *Clark v Nomura International Plc*,[77] "can carry with it aspects of arbitrariness or domineeringness, or whimsicality or abstractedness". Perversity does not seem to take the matter any further forward either. A perverse decision is an irrational one because it is "so outrageous in its defiance of reason".[78]

It seems, therefore, that no clear line can be drawn between these concepts and that "irrationality" seems to embrace them all. Furthermore, it is submitted that irrational conduct will often reflect a lack of honesty and good faith. In *Nash*,[79] Dyson L.J. thought it unlikely that a contracting party acting in a way that no reasonable person would act would not also be acting either dishonestly, for an improper purpose, capriciously or arbitrarily. But is it inevitable that an irrational decision must be a dishonest one? In *Mallone*, a case concerning the exercise of power by company directors to cancel share options, Rix L.J. said that "someone may act irrationally while being honest",[80] and he seems to have taken the same approach six years later

[70] Note 17 above, at [66]; applied in *WestLB AG v Nomura Bank International Plc*, note 63 above, [32], [58]. See also *Euroption Strategic Fund Ltd. v Skandinaviska Enskilda Banken AB* [2012] EWHC 584 (Comm), [105], where Gloster J. also referred to this "as the duty to act rationally".
[71] See *Council of Civil Service Unions v Minister for the Civil Service* [1985] A.C. 374, 410, *per* Lord Diplock.
[72] *Thomas on Powers*, note 28 above, [10.184].
[73] Note 10 above, at [73].
[74] Note 15 above, at [42].
[75] [2002] EWCA Civ 126, [2002] ICR 1045, [39].
[76] *Nash*, note 8 above, [31].
[77] [2000] I.R.L.R. 766, [40].
[78] *Jani-King (GB) Ltd. v Pula Enterprises Ltd.* [2007] EWHC 2433 (QB), [2008] 1 All E.R. (Comm) 451, [34]; *NSB Ltd (in Liquidation) v Worldpay Ltd* [2012] EWHC 927 (Comm), [42].
[79] Note 8 above, at [38]
[80] Note 75 above, at [39].

in *Socimer* when he considered "good faith and rationality" to be separate requirements.[81]

Nevertheless, it is submitted that the link between rationality and subjective honesty (or "good faith", when used in this sense) is a strong one. When a court asks whether a reasonable person acting reasonably could have exercised discretion in the way the actual decision-maker did, it is submitted that it is using a yardstick against which it can test the decision-maker's subjective honesty or good faith. If no reasonable person acting reasonably would have acted in this way then the court must inevitably reject a submission that the actual decision-maker acted *bona fide*.[82] On the other hand, where a decision is made "for a genuine commercial reason" it will not be irrational and the decision maker will have acted *bona fide*.[83] This probably goes further than the approach adopted by the courts when deciding the ambit of "subject to" clauses, which commonly refer to a person's approval or satisfaction, where a failure to act reasonably may be held to evidence a lack of honesty.[84] In such cases the yardstick being used is the more onerous one of objective reasonableness, hence failure to meet that standard only evidences, but does not determine, a lack of *bona fides*. By contrast, acting in a way that no reasonable person acting reasonably would act demands less of the decision-maker so that failure to reach that standard should regarded as both irrational *and* dishonest. In other words, it is submitted that rationality should be seen as part of the test of honesty.[85]

We can go even further. Would English law do better expressly to embrace a limited concept of "good faith" in this context, which would include honesty, and also an absence of irrationality, improper purpose, capriciousness or arbitrariness?[86] One advantage of this approach would be to enable the court to focus on the central issue, namely "the

[81] Note 17 above, at [116]. See also *Breganza v BP Shipping Ltd* [2012] EWHC 1423 (Comm), [91], Teare J.. Fiduciary law also recognises that a trustee may reach a perverse decision in good faith: see, e.g., *Hutton v West Cork Railway Co* (1883) 23 Ch. D. 654, 671.

[82] In a similar way that a professional trustee would be considered to have acted dishonestly and in bad faith, even if he were to have considered that he exercised his power in the best interest of the beneficiaries, if the belief was so unreasonable that no reasonable trustee in that profession would have shared that belief: *Walker v Stones* [2001] Q.B. 902, 939 (C.A.); *Barnes v Tomlinson* [2006] EWHC 3115 (Ch), [79]; *Fattal v Walbrook Trustees (Jersey) Ltd*. [2010] EWHC 2767 (Ch), [81]; and, generally, G. Virgo, *The Principles of Equity and Trusts* (Oxford 2012), 415, 550.

[83] *Pender*, note 14 above, [120]; *McKay (tla McKay Law Solicitors and Advocates) v Centurion Credit Resources LLC* [2011] EWHC 3198 (Q.B.), [50], affd. by C.A., unreported, 2 May 2012.

[84] See, e.g., *Ee v Kakar* (1979) 40 P & CR 223, 230. See generally, M. Furmston and G.J. Tolhurst, *Contract Formation*, note 4 above, [9.84], [9.99].

[85] See also Peden (2005) 21 J.C.L. 226, 235. Perhaps this is also what Rix L.J. is hinting at when he said in *Socimer* (at [112]) that the requirements of good faith and rationality "include both subjective and objective elements".

[86] Ed Peel seems to agree that "good faith", as used in this context, is in practice likely to be defined by reference to these other concepts: "Agreements to Negotiate in Good Faith" in A. Burrows and E. Peel (eds.), *Contract Formation and Parties* (Oxford 2010), 37, 52.

concern … that discretion should not be abused"[87] or that "abuse is caused by self interest.[88] By contrast, fragmentation into, and emphasis upon, individual concepts of irrationality, improper purpose, capriciousness or arbitrariness risks losing sight of that bigger issue. But reference to a concept of good faith, as we have defined it, must not be used to bring in an objective standard of reasonableness because that would replace the decision of the contracting party with that of the court. It seems that the English courts have already identified the elements of this limited standard of good faith in the myriad of cases on the implication of terms which fetter a contractual discretion. Moreover, in *Socimer*, Rix L.J. acknowledged that the danger of abuse caused by self-interest "is precisely what implicit good faith deals with. Commercial contracts assume such good faith which is why express language requiring it is so rare".[89]

D. Absolute discretion

A term cannot be implied in fact if it conflicts with the express terms of the contract.[90] It is not unusual to find a decision-maker's contractual discretion described in terms like "absolute discretion", "sole discretion" or even "sole and absolute discretion". Does the word "absolute" increase the level of discretion and free its exercise from any fetter that would otherwise be implied?

The first general observation is that the words in a contract must be interpreted against the background facts and this includes the other terms of the contract.[91] There is always a danger that a court will consider that the parties intended there to be a distinction between a discretion described in absolute terms and one that is not. We need go no further than the *Lymington Marina* case to illustrate the point.[92] Clause 3(k) of the licence provided that the Licensee might:

(i) assign this Licence as a whole (but not any of the rights hereby granted separately) to an assignee approved by the Company which approval may be granted or withheld at the Company's absolute discretion or

(ii) authorise a third party to exercise all the rights hereby granted as a whole but not any of the rights hereby granted separately for a period of not less than one month and not more than twelve

[87] *Socimer*, note 17 above, [66], *per* Rix L.J.
[88] Ibid., at [116].
[89] *Ibid.*. See also *Philips Electronique Grand Public SA v British Sky Broadcasting Ltd.* [1995] E.M.L.R. 472, 484 (C.A.).
[90] *Duke of Westminster v Guild* [1985] Q.B. 688, 700 (C.A.). See generally, *Treitel's Law of Contract*, note 19 above·, [6-039].
[91] *Nash*, note 8 above, [41].
[92] Note 15 above.

> months PROVIDED ALWAYS that such third party shall first be approved by the Company ….

The case turned on the exercise of discretion by the owner of the marina under clause 3(k)(ii), but when analysing the *limits* of the power to refuse approval Arden L.J. made reference to, and drew a clear distinction between, the exercise of discretion under clause 3(k)(i), where there was express reference to "absolute discretion", and the exercise of discretion under clause 3(k)(ii). She said that:[93]

> the contest is between an absolute discretion, which can be exercised on any ground, and a discretion which can only be exercised on the basis that there is some objection to the chosen sub-licensee arising in connection with his proposed use of the marina.

In the judgment of Arden L.J., the express wording of the two subclauses made it impossible to hold that there was no distinction between the owner's power to refuse approval under these provisions. In other words, clause 3(k)(ii) had to be interpreted in context.[94] But when Arden L.J. turned to consider the separate question of the level of control to be imposed on the *manner* in which the power could be exercised, she did not draw any further comparisons between the wording of clause 3(k)(i) and clause 3(k)(ii).

The real question is whether a decision-maker given "absolute discretion" may exercise the power without restriction or whether the standards of honesty and rationality represent the minimum criteria?[95] Jonathan Morgan suggests that the term which was "obvious" to imply into the power to approve the sub-licensee in *Lymington Marina* ("not to act in bad faith or capriciously") might not apply to a discretion stated in terms to be "absolute", and that "draftsmen of commercial contracts would be wise to use phrases such as "absolute discretion" to exclude the developing judicial review jurisdiction over contractual powers".[96]

Elizabeth Peden also argues that the principle of freedom of contract means that the parties are entitled and able to exclude the decision-maker's implied obligation to act honestly and in good faith.[97] As we have seen, Peden's approach to the control of contractual discretion is based upon principles of construction and not upon the

[93] Ibid., at [26]. That part of Arden L.J.'s judgment dealing with the limits of the power to withhold approval is considered in the main text to note 32 above.
[94] Ibid., at [28].
[95] The question is posed, but not answered, in *Treitel's Law of Contract*, note 19 above, [15-050], n. 209.
[96] Note 5 above, 239–240.
[97] (2005) 21 J.C.L. 226, 233–234. See also Carter, Peden & Tolhurst, *Contract Law in Australia*, note 66 above, [2–20].

implication of terms, nevertheless she submits that by the process of construction it may be possible to say that the parties do not intend principles of honesty and good faith to be incorporated into the exercise of discretion. She cites the decision of the New South Wales Court of Appeal in *Vodaphone Pacific Ltd. v Mobile Innovations Ltd.*[98] in support of her submission that an implied obligation of good faith can be excluded by the parties. In that case Giles J.A. held that the agreement had effectively excluded the operation of an implied term of good faith and reasonableness in the exercise of a discretion. The judge's reasoning was based in part on the fact that the discretion was described as "sole" in the terms of the contract and could be contrasted with other terms expressly requiring reasonable behaviour. However, it should also be noted that the court showed greater readiness to construe the contract as excluding an implied term proscribing "unreasonable" decisions, as opposed to proscribing arbitrary or capricious decisions.[99]

It is respectfully submitted that Peden's approach to this issue is wrong for three reasons.[100] First, it seems repellent to basic principles of subjective honesty and good faith that are so central to English contract and commercial law,[101] and also contrary to public policy, to allow the exercise of discretion in a dishonest way. By way of analogy, it is worth observing that, for reasons of public policy, a party cannot contract that he shall not be liable for his own fraud.[102] The same principle should apply to any attempt to contract out of a subjective honesty and good faith requirement when exercising contractual discretion. Secondly, even if Peden's reasoning is correct, it is submitted that an intention to contract out of a requirement of honesty and good faith would have to be "expressed in clear and unmistakeable terms on the face of the contract".[103] It is submitted that a court would be most reluctant to construe a term in this way unless it was spelt out in the clearest of terms. Thirdly, and this reason is also relevant to the construction issue, it seems highly unlikely that a reputable commercial institution would have intended at the time of contracting, or later want to go to court, to justify a dishonest or irrational decision on the

[98] Note 19 above.
[99] Daintith, note 6 above, 571.
[100] It is also said in *Chitty on Contracts*, note 19 above, [13-027] that "the discretion conferred may be found, on its true construction, to be unqualified". *Socimer* [2008] EWCA Civ 116 and *Looney v Trafigura Beheer BV* [2011] EWHC 125 (Ch) are cited in support of that statement. However, it is submitted that in both cases the court focused on, and rejected, the imposition of an *objective* standard of reasonableness, and was not concerned with the different question of whether a control on contractual discretion based on a *subjective* standard of honesty and good faith could be excluded by the terms of the contract.
[101] E.g., see note 58 above (SGA 79; BEA 82).
[102] *S. Pearson & Son Ltd. v Dublin Corp*. [1907] A.C. 351, 353, 362 (H.L.); *HIH Casualty and General Insurance Ltd. v Chase Manhattan Bank* [2003] 2 Lloyd's Rep. 61, [16], *per* Lord Bingham.
[103] Ibid., at [16], *per* Lord Bingham (when considering the undecided issue of whether it is possible to exclude liability for the fraud of an agent).

ground that it was entitled to make such a decision because it discretion was "absolute". The risk of significant damage to its commercial reputation would be too great.

In *Do-Buy 95 Ltd v National Westminster Bank plc*,[104] a bank, as merchant acquirer, refused to pay a jeweller who sold jewellery and took payment by debit card. The bank raised several defences and succeeded on the ground that the court held that the transaction was not genuine, which was a condition precedent to the right to payment under clause 4.3 of the bank's General Terms and Conditions (the "GTCs"). An alternative defence was based on clause 10.3(b) of the GTCs which entitled the bank to defer payments to the jeweller for such periods as it thought appropriate when "we in our absolute discretion consider that there are doubts as to the authenticity or validity of any transaction". The bank accepted that the expressed "absolute" discretion was constrained by the honesty and rationality criteria more fully articulated in the authorities culminating in *Socimer*, but contended that the effect of the clause was that it had a discretion to withhold payment permanently if it had an honest and not irrational belief that there was no genuine transaction.[105] So the point went by concession. But it is submitted that the concession was rightly made. In *RE Brown v GIO Insurance Ltd.*,[106] Chadwick L.J. said he was ready to construe the contract, and if necessary imply a term, to impose an obligation of good faith on the decision-maker and that "an agreement which did not permit of such a construction would, I think, be void". In *Bernhard Schulte GmbH & Co. KG v Nile Holdings Ltd.*[107] Cooke J. said that a "duty to act honestly and not to misrepresent facts" remained despite the fact that he held that a term requiring good faith should not be implied into the contract where it would be "inconsistent with the express terms which set out the parties' mutual obligations". The same judge recently said much the same again in *SNCB Holding v UBS AG*,[108] where he held that there was no "extra" implied term of good faith but accepted that the law ordinarily requires a party to be "honest and not misrepresent the position or deceive others". Similarly, in *Skidmore v Dartford & Gravesend NHS Trust*,[109] where a contract of employment provided for three different types of disciplinary offence and that it was for the employer to decide into which type the particular case fell. Lord Steyn held that a non-conforming decision would result in a breach of contract unless there was a provision (which there was not) making it clear that the employer's decision would be final "thereby excluding the

[104] [2010] EWHC 2862 (QB).
[105] Ibid., at [37].
[106] [1998] C.L.C. 650, 659.
[107] [2004] EWHC 977 (Comm), [2004] 2 Lloyd's Rep. 352, [113]–[114].
[108] Note 24 above, at [111]–[114].
[109] [2003] I.C.R. 721 (H.L.).

role of the court except, of course, in cases of bad faith or possibly the absence of reasonable ground for the decision".[110]

Nevertheless, if a reference to "absolute" discretion does not remove a requirement for the decision-maker to act honestly and in good faith, the question remains as to what the word "absolute" does actually mean. Much will depend on the circumstances of the particular case. In some contracts a reference to an absolute discretion might be construed as excluding any requirement of objective reasonableness, especially where other terms of the contract refer to discretion being exercised on reasonable grounds. It is also submitted that "absolute" could be given meaning when used to delineate the limits of the power that the decision-maker is exercising, but it should not be used to delineate the manner of the exercise of the power, which must be exercised honestly and in good faith. The distinction between delineating the limits of the power and the manner of its exercise has already been considered in the context of *Lymington Marina*.[111]

III. Termination for breach

If subjective honesty or good faith controls the exercise of contractual discretion, does the same requirement also control the way a contracting party exercises its right to terminate a contract for breach? In this section of the paper it will be argued that termination for breach generally involves the exercise of a type of discretion as the injured party has a choice whether or not to terminate.[112] It is submitted that making that choice should be treated no differently from the exercise of contractual discretion, so that the same standards of subjective honesty and good faith should be applied in both situations, otherwise there will be doctrinal incoherence.[113] We shall begin by examining the orthodox position when a right to terminate for breach arises.

A. At common law and under a termination clause

The common law gives one party the right to terminate a contract for the other party's breach where there has been renunciation, breach of a condition or serious breach of an "innominate" or "intermediate"

[110] Ibid., at [15].
[111] See main text to note 32 above.
[112] Although, as stated below (see notes 115 and 116), the injured party may sometimes have no choice but to terminate.
[113] Doctrinal incoherence arises where, on closer analysis, there is no rationale for treating certain transactional elements in different ways. For example, it is submitted that it is incoherent to limit the "practical benefit" test to promises to pay more (as in *Williams v Roffey Bros & Nicholls (Contractors) Ltd.* [1991] 1 Q.B. 1, C.A.), so that promises to pay less are subject to different doctrinal rules (as confirmed in *Re Selectmove Ltd.* [1995] 1 W.L.R. 474, C.A.). I am grateful to Roger Brownsword for this point.

term.[114] The injured party may choose (elect) to continue with the contract (affirm) or bring it to an end (terminate). It is well-established that this right of election is to a large extent unfettered.[115] As Lord Reid famously said in *White and Carter (Councils) Ltd v McGregor*:[116]

> It never has been the law that a person is only entitled to enforce his contractual rights in a reasonable way and that a court will not support an attempt to enforce them in an unreasonable way.

The court is not concerned with the injured party's motivation or rationale when exercising the right.[117] The desire for certainty in commercial matters and the need for speedy resolution of disputes (as the courts do not have to investigate the motives for termination) are powerful arguments in favour of a mainly unrestricted right to terminate.[118] This approach is also consistent with the absence of a general principle of good faith in the negotiation or performance of the contract,[119] and of any general theory of abuse of rights,[120] under English law. The relative ease with which the remedy of termination is available is one of the main reasons why Solène Rowan argues, in her masterly survey of the remedies for breach of contract, that the commitment in English law to the survival of the contract and the protection of performance is relatively weak.[121]

The same preference for a generally unrestricted right to termination is also found where the right to terminate arises out of a term of

[114] See generally, *Treitel's Law of Contract*, note 19 above, Ch. 18; Andrews, *Contract Law*, note 19 above, Ch. 17.

[115] But the duty to mitigate the resultant loss may in practice leave the injured party with little alternative than to terminate: see, e.g., *Treitel's Law of Contract*, note 19 above, [18-008]; E. McKendrick, *Contract Law*, 9th edn. (London 2012), [19.8]; S. Rowan, *Remedies for Breach of Contract: A Comparative Analysis of the Protection of Performance* (Oxford 2012), 100.

[116] [1961] A.C. 413, 431 (Lord Reid suggested two general limitations on the injured party's right to affirm the contract, continue with performance and claim the agreed price: performance must not require the cooperation of the other, defaulting, party (at 429), and the injured party must have a "legitimate interest" in performing (at 431)). See also *Clegg v Andersson T/A Nordic Marine* [2003] EWCA Civ 320, [2003] 2 Lloyd's Rep. 32, 48 (Hale L.J.).

[117] *SNCB Holding v UBS AG*, note 24 above, [73], Cooke J.

[118] D. Harris, D. Campbell and R. Halson, *Remedies in Contract and Tort*, 2nd ed. (Cambridge, 2005), 55. Cf. R. Brownsword, "Retrieving Reasons, Retrieving Rationality? A New Look at the Right to Withdraw for Breach of Contract" (1992) 5 J.C.L. 83, 90 (a slightly revised version of this paper was published as "Bad Faith, Good Reasons and Termination of Contracts" in J. Birds, R. Bradgate and C. Villiers, *Termination of Contracts* (Chichester 1995), 227). Brownsword proposes (at pp. 92 and 237 respectively) that "a right to withdraw would be available where it was conferred by legislation or case law, or where it was so agreed by the parties; but, failing such special provision, the right to withdraw would depend upon the innocent party having good reason for claiming the option of release from the contract, as opposed to settling for damages" – the proposal is criticised by E. McKendrick, *Contract Law: Text, Cases, and Materials*, 5th ed. (Oxford 2012), 784.

[119] See, e.g., *Interfoto Picture Library Ltd. v Stiletto Visual Programmes Ltd.*, note 44 above, 439; *Walford v Miles*, note 44 above, 138; *ING Bank NV v Ros Roca SA* [2011] EWCA Civ 353, [92].

[120] *Bradford Corp. v Pickles* [1895] A.C. 587; *Allen v Flood* [1898] A.C. 1.

[121] Rowan, note 115 above, especially Ch 2, which reveals a marked difference in approach in England (relatively broad right to terminate) and France (notable reluctance to allow termination).

the contract.[122] Indeed it is arguable that as an express termination clause represents the intention of the parties there is even less scope for judicial intervention,[123] although it may be possible to construe an ambiguously worded termination clause narrowly so as to restrict one party's right to terminate.[124] In *Lomas v JFB Firth Rixon Inc*,[125] Longmore L.J., speaking *obiter*, recently said that an earlier submission, not pursued on appeal, that a non-defaulting party under an ISDA Master Agreement was under a constant obligation to exercise its discretion whether or not to designate an Early Termination Date in a manner which was not arbitrary, capricious or unreasonable, would have been rejected as "hopeless". He continued:[126]

> The right to terminate is no more an exercise of discretion, which is not to be exercised in an arbitrary or capricious (or perhaps unreasonable) manner, than the right to accept repudiatory conduct as a repudiation of the contract … [N]o one would suggest that there could be any impediment to accepting repudiatory conduct as a termination of the contract based on the fact that the innocent party can elect between termination and leaving the contract on foot. The same applies to elective termination. Even if, moreover, it could be said that in some sense a contracting party had a discretion to bring the contract to an end and that such discretion should not be exercised capriciously or arbitrarily, it by no means follows that the same considerations could apply to allow the contract to continue which does not require any positive act on the part of the Non-defaulting Party.

Similarly, in *Sucden Financial Ltd v Fluxo-Cane Overseas Ltd*,[127] Blair J. held that there was no exercise of discretion where a broker closed out its client's position on the happening of an Event of Default, as the broker was contractually entitled to do. Blair J. said that the cases controlling the exercise of contractual discretion had no application to the termination of a financial contract upon an Event of Default.[128]

[122] Exemplified by *Union Eagle Ltd. v Golden Achievement Ltd.* [1997] A.C. 514, 519, where Lord Hoffmann, delivering the advice of the Privy Council, rejected a plea that equity will restrain enforcement of legal rights when it would be "unconscionable" to insist upon them because it would create uncertainty, although he did recognise that "the same need for certainty is not present in all transactions" (here vendor of a flat held entitled to rely on right to terminate under express clause making time of the essence when purchaser tendered purchase price 10 minutes late). Rowan, note 115 above, pp. 78–79; S. Whittaker, "Termination Clauses" in A. Burrows and E. Peel (eds.), *Contract Terms* (Oxford 2007), 253, 255–6.

[123] D. Harris, "Incentives to Perform, or Break Contracts" (1992) 45 C.L.P. 29, 35–36.

[124] *Rice (t/a Garden Guardian) v Great Yarmouth Borough Council* [2003] T.C.L.R. 1, C.A.; applied in *Dominion Corporate Trustees Ltd. v Debenture Properties Ltd.* [2012] EWHC 1193 (Ch), [2010] 23 E.G. 106. Cf. control of the exercise of contractual discretion through construction (see Sect. II.B.2 above).

[125] [2012] EWCA Civ 419, [46].

[126] Ibid.

[127] [2010] EWHC 2133 (Comm), [2010] 2 C.L.C. 217.

[128] At [50]. Although Blair J. said (at [49]) that "there may be some force" in a submission that where the right to close out the client's position arose on the broker's determination – in its "absolute discretion" – that the client had not performed (or might not be able or willing in future to

He stressed that "[t]he question in such a case does not concern the exercise of a discretion but whether the party concerned has the contractual right to terminate".[129]

B. Is discretion exercised?

What is discretion? The element of choice lies at the heart of the various definitions of discretion given both by academics and the judiciary. Davis gave the classic academic definition:[130] "A public officer has discretion whenever the effective limits on his power leave him free to make a choice among possible courses of action or inaction".[131] Barak writes that "discretion is a power to choose between two or more alternatives, when each of the alternatives is lawful".[132] The crucial feature, as Dyson L.J. stated, is that discretion "connotes the exercise of judgment in making choices".[133]

It is submitted that the injured party has just such a choice when faced with a repudiatory breach or an event of default (or other trigger) that activates a right to terminate under a termination clause. In deciding to terminate the injured party exercises its judgment in making a choice and, therefore, exercises discretion. Of course, the decision may be to ignore the breach and continue (affirm) the contract, but this still remains "the exercise of judgment in making a choice" and, therefore, an exercise of discretion. On the other hand, no choice is made were the injured party is unaware that he has a choice whether or not to terminate. There cannot be "an unconscious exercise of a discretion".[134]

It does not follow that because we speak of a "right to terminate", a "right of termination" or a "right of election" that there is no element of discretion exercised when making the choice whether or not to terminate. A meaningful definition of what is a right is notoriously difficult because, as Hohfeld famously wrote, "[t]he word "right" is used generically and indiscriminately to denote any sort of legal advantage, whether claim, privilege, power or immunity".[135] However, it has been said that "individual discretion is the single most distinctive feature of

perform) any of its duties, that discretionary power was subject to an obligation not to act arbitrarily, capriciously or unreasonably.

[129] Ibid.

[130] As it was described by R. Zakrzewski, *Remedies Reclassified* (Oxford 2005), 86. See also G. Thomas, *Thomas on Powers*, note 28 above, at [11.04].

[131] K.C. Davis, *Discretionary Justice: A Preliminary Inquiry* (Louisiana 1969), 4.

[132] A. Barak, *Judicial Discretion* (New Haven 1989), 7.

[133] *Carty v Croydon London Borough Council* [2005] EWCA Civ 19, [2005] 1 W.L.R. 2312, [25].

[134] *WestLB v Nomura Bank International Plc*, note 63 above, [48], *per* Rix L.J..

[135] W.N. Hohfeld, "Fundamental Legal Conceptions as Applied in Judicial Reasoning" (1916–17) 26 Yale LJ 710, 717. Hohfeld's solution to the problem remains open to criticism: see, e.g., J.W. Harris, *Property and Justice* (Oxford 1996), 120–5; J.E. Penner, *The Idea of Property* (Oxford 1997), 23–5.

the concept of rights."[136] Daintith is clear that "the basic contractual discretions are commonly not expressed in contracts but are contained within the general rules of contract law: those determining, for example, when a party may terminate a contract on the basis of the other's breach".[137] The relationship between contractual discretion and a right of termination is not as distant as Longmore L.J. would have us believe.

In Australia, ever since the New South Wales Court of Appeal decision in *Renard* in 1992,[138] there has been judicial support for the idea that rights of termination ought to be controlled by implied term requiring good faith and reasonableness.[139] The level of control is the more onerous obligation of objective reasonableness rather than one of subjective honesty. This has led Carter, Peden and Tolhurst to state that "[i]n most contracts (perhaps all contracts) a requirement of good faith must be implied, at least in connection with termination pursuant to an express term of the contract".[140] This is clearly a different position from that prevailing under English law. Even if the cases on controlling contractual discretion were to be applied to termination for breach, the standard emphasised in the English courts in cases like *Socimer*, is that of subjective honesty rather than objective reasonableness.[141]

C. The need for honesty and good faith

It is submitted that there would be much to gain, in terms of reducing opportunistic behaviour or other cases of perceived unfairness, if English law were expressly to adopt a similar approach to the exercise of a right of termination for breach as it does to the exercise of

[136] This stems from the "will theory" which was advanced by Hart to explain the nature of rights. However, the will theory has been strongly criticised by others, such as MacCormick and Raz, who advance the competing interest (or benefit) theory, which is seen by Freeman as "the most convincing explanation of what having a right entails" (see generally, M.D.A. Freeman, *Lloyd's Introduction to Jurisprudence*, 8th ed. (London, 2008), 394–396).

[137] Daintith, note 6 above, pp. 555–6.

[138] *Renard Constructions (ME) Pty Ltd. v Minister for Public Works*, note 40 above.

[139] See, e.g. *Hughes Bros Pty Ltd. v Trustees of the Roman Catholic Church for the Archdiocese of Sydney* (1993) 31 NSWLR 91.

[140] Carter, Peden & Tolhurst, *Contract Law in Australia*, note 66 above, [2-02].

[141] *Quaere* whether a standard of subjective honesty also applies where a party elects to rescind a contract on grounds of misrepresentation, duress or undue influence. It is arguable that, for reasons of consistency, the same standard should apply in these cases, although that argument is not explored in this paper, which is restricted to cases of termination for breach. However, unlike termination for breach, which operates *de futuro*, rescission sweeps away a voidable contract *ab initio* and leaves no scope for implying a term (or construing an express term) similar to that implied in cases of contractual discretion (although certain clauses, such as an exclusive jurisdiction clause or an arbitration clause, may survive rescission: see D. O'Sullivan, S. Elliott and R. Zakrzewski, *The Law of Rescission* (Oxford 2008), para. 1.12). This explains, for example, why a court must rely on the wide statutory discretion contained within s. 2(2) of the Misrepresentation Act 1967 to refuse rescission and award damages instead following a non-fraudulent misrepresentation (see J. Cartwright, *Misrepresentation, Mistake and Non-Disclosure*, 3rd ed. (London 2012), paras. 4-61 *et seq*).

contractual discretion. This would probably catch a case like *Arcos v Ronaassen*[142] where the buyers rejected timber for breach of condition, even though they could have used it for its intended purpose, because they wanted to take advantage of a falling market. Brownsword suggests that "if the innocent party has relied on collateral economic reasons – and, thus, is not seeking withdrawal "for breach" – this would constitute a lack of good faith and would disqualify withdrawal".[143] By contrast, in a case where the injured party was simply mistaken when giving a "bad" reason for termination, he would still be entitled to rely upon an unknown "good" reason that later came to his attention.[144] The shift would not be as radical as first thought. First, there is evidence in the case law that a default standard of subjective honesty already exists. For example, in *Bernhard Schulte GmbH & Co Ltd v Nile Holdings Ltd*.,[145] where Cooke J. refused to imply a term requiring good faith (in the sense of using "reasonable endeavours"), because it was inconsistent with the express terms of the contract, but stressed that "this leaves a duty of honesty". Cooke J. recently adopted the same approach in *SNCB Holding v UBS AG*,[146] where he said that "[a] party must be honest and not misrepresent the position or deceive others". There is also evidence of the implication of a *bona fides* requirement in the case of "subject to" clauses which commonly refer to a person's approval of satisfaction.[147] Secondly, whilst a subjective honesty would be the default standard, the parties would retain the ability to contract out of any higher standard of behaviour.[148] Thirdly, there have been recent legislative developments that show that it may be legitimate for a court to examine the behaviour of one party after the contract has been concluded when deciding whether it is enforceable. The Consumer Credit Act 2006[149] amended the Consumer Credit Act 1974 by replacing ss. 137–140 (extortionate credit bargains) with new ss. 140A–140D. The new provisions give the court power to re-open a credit agreement that is part of an "unfair relationship" because of (*inter alia*) "the way in which the creditor has exercised or enforced any of his rights under the agreement or any related agreement".[150] The provisions have wide

[142] [1933] A.C. 470.
[143] (1992) 5 J.C.L. 83, 93; "Bad Faith, Good Reasons and Termination of Contracts", note 118 above, 238.
[144] Illustrated by *Boston Deep Sea Fishing & Ice Co v Ansell* (1888) 39 Ch.D. 339 (C.A.). See also *Force India Formula One Team Ltd. v Etihad Airways PJSC* [2010] EWCA Civ 1051, [116]; *Tele2 International Card Company SA v Post Office Ltd.* [2009] EWCA Civ 9, [30] n. 17.
[145] Note 107 above, at [114].
[146] Note 24 above, at [111].
[147] See, e.g., *Astra Trust Ltd. v Adams* [1969] 1 Lloyd's Rep. 81, 87; *Albion Sugar Co Ltd. v William Tankers Ltd (The John S Darbyshire)* [1977] 2 Lloyd's Rep. 457, 466. Cf J.F. O'Connor, *Good Faith in English Law* (Aldershot 1990).
[148] See Sect. II. D above.
[149] ss.19–22.
[150] s.140A(1)(b). The wide-ranging powers of the court are set out in s 140B.

application. They apply to any agreement between an individual (debtor) and any other person (creditor) by which the creditor provides the debtor with credit of any amount.[151] Fourthly, EU law points in the direction of controlling remedies through reference to good faith and fair dealing. The proposed Common European Sales Law, art. 2(1), provides that "[e]ach party has a duty to act in accordance with good faith and fair dealing", and art. 2(2) says that "[b]reach of this duty may preclude the party in breach from exercising or relying on a right, remedy or defence which that party would otherwise have…".[152] Given the EU context, it is not surprising to see that "good faith and fair dealing" is defined as "a standard of conduct characterised by honesty, openness and consideration for the interests of the other party to the transaction or relationship in question". This goes further than advocated in this paper for the control of contractual discretion or the termination of a contract for breach. Nevertheless, the fact that the proposed Regulation states that the parties may not exclude, derogate from or vary the obligation of good faith and fair dealing,[153] is welcome support for the more limited submission that subjective honesty should be the default position that the parties cannot exclude.

IV. Conclusion

Freedom of contract, autonomy of the parties and the need for commercial certainty are important principles that lie at the heart of English commercial contract law. They ensure that terms that give one party contractual discretion, and also termination clauses, are not to be readily ignored. Nevertheless, there are limits to the extent to which a party is free to exercise contractual discretion and, as argued in this paper, those limits have a legitimate role to play in the exercise of any right of termination whether at common law or under a termination clause. It is submitted that there is no material difference between the discretion cases and the termination cases and, for the sake of doctrinal coherence, they should both be treated in the same way. The limitation is one of subjective honesty or good faith and, as such, it is at the lower end of the scale. However, it is reinforced by reference to a test that the decision is not one that no reasonable person acting reasonably would make in the circumstances. If the decision fell into that category then a

[151] s.140C(1). The term "individual" includes most small partnerships and unincorporated bodies but not companies (s.189(1)). The provisions do not apply to s.16(6C) exempt consumer credit agreements (which are regulated by the Financial Services Authority).

[152] *Proposal for a Regulation of the European Parliament and of the Council on a Common European Sales Law (CESL)* Com (2011) 635 final. The proposed CESL is optional to the parties and would be available only to contracts for the sale of goods, the supply of digital content and related services.

[153] Ibid., art 2(3).

court would be compelled to reach a finding of bad faith. The principles of freedom of contract and autonomy of the parties demand that the standard required is not an objective standard of reasonableness. When there is no underlying fiduciary relationship, one contracting party does not have to be fair and reasonable in the way he deals with the other. But he must act honestly towards the other and it has never been argued that principles of English commercial contract law suggest otherwise.