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Three years ago this Bulletin reported on the recognition at law of contractual good faith negotiation — that is, whether courts would recognise a contractually agreed requirement to negotiate in good faith prior to litigating a dispute arising under the contract.

Back then, the dominant law was the NSW decision in Elizabeth Bay Developments Pty Ltd v Boral Building Services Pty Ltd (1995) 36 NSWLR 709. Since then the law has been thrown into a state of flux, following a decision from the same court which contradicts Elizabeth Bay. This article brings readers up to date with the current situation and fleshes out two theories which may help provide an operational definition of good faith negotiation in the performance of a contract.

But first, a reminder of the law post-Elizabeth Bay. Prior to and during 1995 the NSW Law Society and other bodies, such as the Australian Commercial Disputes Centre (ACDC) and LEADR, suggested the use of ADR clauses that contained a reference to the parties resolving disputes in ‘good faith’. The decision of the Supreme Court of NSW in Elizabeth Bay raised doubts about this practice.

In Elizabeth Bay the plaintiff, Elizabeth Bay Developments Pty Ltd, was a corporate trustee. The trust entered a joint venture to develop a residential subdivision at Lake Munmorah on the central coast of NSW. In September 1993, the plaintiff executed two contracts with the defendant. The first was a construction management contract that required the defendant to provide construction and design management services for the project. The second was a building contract whereby the defendant built and sold houses on the subdivision and, after deducting the cost of the land and the building costs, split the profit with the plaintiff.

Problems developed on the site and the defendant ceased its involvement in the project around the middle of 1994. The plaintiff claimed damages as a result of the defendant’s repudiation of the contract. The defendant filed a defence stating it was not bound to proceed with the contracts and, therefore, was entitled to discontinue its involvement.

The defendant sought to invoke mediation clauses in the contract, moving the Supreme Court of NSW to stay any further proceedings leading to a hearing of the matter until after mediation. The plaintiff refused to participate in mediation. The contracts stated that, in case of any dispute arising under the contracts, the parties shall participate in mediation administered by ACDC.

Since 1993 ACDC had published guidelines for its various ADR processes. The defendant submitted, and the plaintiff conceded, that ACDC’s guidelines for mediation were incorporated into the contracts because of the reference made to ACDC in the ADR clauses in the contracts. ACDC’s mediation guidelines stated that prior to mediation the parties shall sign a mediation appointment agreement which sets out the terms of the mediation.
mediation appointment agreement required the parties to mediate with a commitment to attempt, in good faith, to negotiate towards achieving settlement of the dispute.

In deciding whether the parties should mediate the dispute as agreed to in the contract, his Honour Giles J had some difficulty ascertaining the meaning of attempting to negotiate in good faith as described in the contracts. In particular, Giles J stated at p 716 of the judgment:

> It is not easy to take a course requiring a party to assert a state of mind which it may well not have, and even less easy to take a course which compels a party to commit itself to the vagueness of attempting in good faith to negotiate with the other party to the dispute. The latter difficulty lies not so much in the ascertainment of the presence or absence of good faith, or even in the uncertainty of attempting, but rather in the necessary tension between negotiation, in which a party is free to, and may be expected to, have regard to self interest rather than the interests of the other party, and the maintenance of good faith. ... 

So Giles J hypothesised that defining the presence or absence of good faith was not an insurmountable issue; rather, what was difficult was accounting for a party's right to act with self-interest and how under those circumstances the parties could act in good faith.

On 1 October 1999 the Supreme Court of NSW handed down its decision in Aiton v Transfield (1999) 153 FTR 236. In Aiton the parties to the proceedings entered into three contracts between May and June of 1997 for the construction of the Osborne Co-Generation Project, an independent power production project based in Adelaide. Proceedings commenced on the basis that the plaintiff, Aiton, claimed that the defendant had made certain representations during the tender negotiations that were misleading and deceptive. As a result of the defendant's conduct, the plaintiff claimed to have been unable to execute the construction works in the manner, sequence, time and for the price agreed between the parties.

The plaintiff relied on the relevant sections of the Trade Practices Act 1974 (Cth) and the Fair Trading Act 1987 (NSW) and claimed damages allegedly incurred by the reliance on the defendant's representations.

The defendant sought to invoke express contractual procedures for dispute resolution prior to either party commencing litigation. All three contracts contained identical ADR clauses that required the parties to use all reasonable endeavours in good faith to resolve expeditiously any dispute by mediation. Einstein J, in hearing the matter, made the following comments about the view expressed by Giles J in Elizabeth Bay, at p 254 of the judgment:

> With great respect, I disagree — such tension ought not be the linchpin in an argument that a good faith requirement in negotiation is too vague and uncertain to be meaningfully enforced. It is clear that a tension may exist between negotiation from a position of self-interest and the maintenance of good faith in attempting to settle disputes. However, maintenance of good faith in a negotiating process is not inconsistent with having regard to self-interest...

His Honour favoured the view that good faith is not a synonym for settlement, nor does it prevent a party from withdrawing from negotiations. Einstein J went on to canvass the various definitions of good faith in the academic community and the popular view that good faith can be identified not by what it constitutes, but rather by identifying when it is absent. This issue is dealt with in more detail below.

Alton's case stands at odds with Elizabeth Bay on the issue of the recognition of contractual good faith negotiation. There now exist two cases emanating from the Supreme Court of NSW that are diametrically opposed to each other on the issue of good faith negotiation in the performance of a contract. This now leaves the situation in NSW, and other jurisdictions that may be persuaded by the findings of the NSW Supreme Court in Elizabeth Bay and Alton, in an unsatisfactory position.

The author's hypothesis is that contractual good faith negotiation is a concept that can be defined and should be known to the law. This paper will explore two theories that seek to define an operational standard of good faith negotiation.

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The excluder theory

Associate Professor Robert Summers (as he then was) wrote the first paper on his 'excluder theory' in 1968.1 His theory pertained to good faith as defined in the American Uniform Commercial Code. However, Summers' theory can still be applied to contractual good faith negotiation, as will be seen.

Summers began by defining an 'excluder' concept. He stated that an excluder has no general meaning or a meaning of its own; it is defined by what it is not. Accordingly, in order to define good faith, one must exclude what is recognised as being bad faith performance:

... in cases of doubt, a lawyer will determine more accurately what the judge means by using the phrase 'good faith' if he [sic] does not ask what good faith itself means, but rather asks: What, in the actual or hypothetical situation, does the judge intend to rule out by his use of this phrase? Once the relevant form of bad faith is thus identified, the lawyer can, if he wishes, assign a specific meaning to good faith by formulating an 'opposite' for the species of bad faith being ruled out.2

Therefore, an understanding of good faith develops by formulating a list of behaviour classed as bad faith. Summers listed six different types of distinguishable bad faith performance in his paper and went on to elaborate on each type of bad faith as an identifiable criterion. The six types of bad faith performance behaviour are as follows.

<table>
<thead>
<tr>
<th>Form of bad faith conduct</th>
<th>Meaning of good faith</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Refusing to participate in a contractually agreed ADR process</td>
<td>Performing contract as agreed</td>
</tr>
<tr>
<td>2. Not attending the ADR process</td>
<td>Willingness to co-operate</td>
</tr>
<tr>
<td>3. Disagreeing on procedural elements without reason</td>
<td>Acting with procedural fairness</td>
</tr>
<tr>
<td>4. Refusal to consider options for settlement</td>
<td>Refraining from abuse of bargaining power</td>
</tr>
<tr>
<td>5. Failing to offer options for settlement</td>
<td>Participating in the spirit of the process</td>
</tr>
<tr>
<td>6. Being unresponsive during an ADR process</td>
<td>Acting co-operatively</td>
</tr>
<tr>
<td>7. Withdrawing from the ADR process without reason</td>
<td>Acting with honesty while preserving self-interest</td>
</tr>
<tr>
<td>8. Reneging on an agreed settlement</td>
<td>Unwillingness to mislead</td>
</tr>
</tbody>
</table>

Evasion of the spirit of the deal

Simply put, to evade the spirit of a deal agreed to between the parties is to act in bad faith even if the evasive behaviour is within the letter of the agreement or the agreement is silent on the matter. In terms of good faith negotiation, this could amount to a party attending a contractually agreed ADR process, participating in a minimalist sense and then failing to settle for no good reason.

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Lack of diligence and ‘slacking off’

A party to a contract that is aware of a change in circumstances and, whether required to disclose by contract or not, does not inform the other party may be guilty of bad faith. In terms of good faith negotiation, this could amount to a devaluation of a good or service — the subject of the contract and subsequent dispute — during negotiations to resolve the dispute. If the party informed of such devaluation does not tell the other party, the informed party would be guilty of acting in bad faith.

Willfully rendering only substantial performance

Australian contract law, like American contract law, allows for substantial performance to discharge a contract providing the substantial performance was not in bad faith. As Summers stated, this situation is most common in construction contracts. In terms of good faith negotiation, this could amount to only substantially performing an agreed settlement which is the result of a good faith negotiation, or only substantially performing any part of the procedural or substantive requirements of a good faith negotiation.

Abuse of power to specify contract terms

Where a contract states that one party shall specify terms of a condition or warranty, and the party with the power to specify the terms takes advantage of the other party, then that power has been exercised in bad faith. In Australian law, this rarely happens as courts are more inclined to render such a term void for uncertainty or incompleteness. However, in terms of good faith negotiation, this could amount to a party taking advantage of procedural terms in an ADR process.

Abuse of power to determine compliance

The hallmark of contract is the exchanging of promises and, in this respect, compliance with an executed promise falls to the promisee. In other words, the promisee has the power to state whether or not the promise has been carried out to her or his satisfaction and to take the appropriate action under contract, common law or statute. In terms of good faith negotiation, this could amount, for example, to a party not considering options for settlement without giving due consideration; or, under certain legislation, claiming that the other party has not participated in a mediation in good faith.

Interfering with or failing to co-operate in the other party’s performance

A party that hinders a promisor’s performance will be guilty of acting in bad faith. In terms of good faith negotiation, this could amount to a party hindering the participation of another party in an ADR process, for example, by not being forthcoming with certain documents or, should a settlement be reached, not being co-operative in the implementation of the settlement.

The recapture theory

Burton’s recapture theory relies on the premise that when parties enter a contract, they give up certain opportunities. The terms of a contract direct parties to give up one set of opportunities and replace them with another set of opportunities that binds the parties together. Once having accepted this proposition, Burton hypothesised:

Bad faith performance consists of an exercise of discretion in performance to recapture opportunities lost at formation … A recapture of opportunities necessarily harms the other. A reasonable person accordingly would enter a contract that confers discretion on the other party only on the belief that the discretion will not be used to recapture foregone opportunities.

The test of whether a party has recaptured a foregone opportunity is stated as being both subjective and objective. Burton hypothesised that the question of whether a party identified a foregone opportunity is to be determined by an objective standard that focuses on the expectations of reasonable persons in the position of the dependant.
In relation to contractually agreed good faith negotiation, a party who uses its discretion not to participate in good faith negotiation, and who rescinds the contract (assuming a valid terminating breach has arisen) in order to enter another contract with a third party on more favourable terms, displays the requisite objective expectation to evidence bad faith, by the party having identified the foregone opportunity in the first place before acting on it.

However, Burton stated that the question of whether a party used its discretion to recapture a foregone opportunity is one of subjective intent and a question of fact. In relation to contractually agreed good faith negotiation, a party who uses its discretion not to participate in good faith negotiation, and who rescinds the contract in order to enter another contract with a third party on more favourable terms, displays the requisite subjective intent to evidence bad faith by the party’s own actions.

Therefore, if a party uses its control to recapture a foregone opportunity, one may conclude that the party is not acting within the contemplation of the parties. However, if a party acts for a reason that is within the contemplation of the parties, one may conclude that the party is not seeking to recapture a foregone opportunity.

The benefit of Burton’s theory is that by employing the subjective and objective standards, one can isolate specific actions and determine whether they constitute bad faith and, therefore, whether a party has acted with the required good faith as agreed between the parties under the contract.

For example, if party A listens to party B and actively participates in formulating options for settlement during a contractually agreed ADR process, but then A refuses to settle based on having been approached by C to enter a contract under more favourable terms than the contract with B, has A participated in good faith?

Using Burton’s recapture theory, we first apply the objective test; that is, would a reasonable person in A’s position identify the approach by C as a chance to recapture a foregone opportunity? In answering this question, one would need to consider whether an alternative commercial opportunity was foregone at the time of the formation of the contract. In our example, given the approach by C, one would have to answer that question in the affirmative.

Next, we apply Burton’s subjective test to assess the actions of A: was it A’s intention to recapture a foregone opportunity? The foregone opportunity was the chance to enter a contract with C under more favourable terms than that entered into with B. The answer in our example would be in the affirmative.

In attempting to define bad faith as a way of identifying an operational standard of good faith, adopting one or both theories is useful …

Therefore, based on both tests being applied and both having been answered in the affirmative, one could conclude that A has acted in bad faith in that A has attempted to recapture a foregone opportunity. Therefore, the logical conclusion is that A has not performed the contractual term requiring good faith in negotiation.

Conclusion

This article has attempted to explain the dilemma facing the courts when it comes to defining an operational standard of contractual good faith negotiation. The dilemma is identifying exactly what is and what is not good faith participation in a contractually agreed upon ADR process. While this must surely be a source of frustration for the courts charged with the responsibility of accurately determining whether good faith performance has occurred, it is equally frustrating for lawyers charged with the responsibility of drafting ADR clauses into contracts.

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This article has been extracted from a paper delivered at the Australasian Law Teachers Association Conference, 2 July 2001, University of the South Pacific, Vanuatu.

Endnotes

2. As above at 200.
4. As above at 387.