

*Note: This seminar is based upon my thesis entitled 'A Doctrine of Good Faith in New Zealand Contractual Relationships' submitted in fulfilment of the Degree of Master of Laws in the University of Canterbury. In particular, this seminar is intended to provide a brief and non-technical overview of the law and economics aspects of the thesis research. The thesis will be available consequent on being deposited with the University of Canterbury Library.*

## **Good Faith in Contract: A Law and Economics Perspective**

### **1. Introduction:**

The majority of established legal systems recognise a universal obligation of good faith in contract law. The courts in the United States imply a covenant of good faith and fair dealing in almost every agreement. The Uniform Commercial Code, which applies in nearly every American state, also creates an obligation of good faith in the performance and enforcement of qualifying contracts. Similarly, most of the Civil Codes in continental Europe require good faith contractual performance. This is carried through into the Principles of European Contract Law, which are being developed under the sanction of the EU, and are ultimately intended to apply as general rules of contract law on the Continent.

England and the common law Commonwealth countries such as New Zealand, Australia and Canada have not yet committed to a universal and overriding obligation of good faith in contract. Lawyers and academics within these jurisdictions struggle to agree on a general definition of good faith. In particular, it is contentious whether good faith denotes cooperative conduct, reasonable conduct, honest conduct, or some combination thereof.

However, obligations of good faith do apply in the Anglo-Commonwealth jurisdictions, albeit in a piecemeal rather than a universal way. For example, good faith duties are recognised in some classes of contract within New Zealand such as contracts of employment, partnership, joint venture and insurance. My thesis research focuses on whether the New Zealand courts should abandon this piecemeal approach and instead adopt good faith as a universal principle such that it would apply in every contract within New Zealand.

### **2. The Importance of Law and Economics:**

As part of my thesis research, I elected to include a chapter engaging in a law and economics analysis of contractual good faith. It will probably come as no surprise that I had to turn to the Economics and Finance department for supervisory assistance for this chapter rather than the School of Law. I don't think the faculty members of the Law School would be too offended if I said that economics scholarship is by and large a foreign concept to them. It is a New Zealand wide phenomenon amongst law faculties. Undergraduate papers in law

and economics offered in New Zealand law schools are virtually non-existent.<sup>1</sup> This is quite the opposite of the United States experience where almost every major law school offers law and economics papers, entire law reviews are devoted to the subject and several law and economics scholars have taken up judicial appointment on the United States Courts of Appeals.<sup>2</sup>

Nonetheless, there is an increasing awareness within New Zealand of the importance of economic reasoning to law making. The Law and Economics Association of New Zealand, founded in 1994, is pursuing the objective of promoting the application of economics to legal and public policy issues. Economics scholarship also appears to be creeping into judicial reasoning. There are a number of recent judgments discussing concepts such as opportunity cost, marginal cost and transaction costs.<sup>3</sup> Perhaps the most notable decision in the area of contract law is the 2006 judgment of the Court of Appeal in *Paper Reclaim Ltd v Aotearoa International Ltd*.<sup>4</sup>

In *Paper Reclaim* the Court was required to determine whether exemplary damages can be awarded for breach of contract. The Judges adopted the reasoning of the English Law Commission, noting that to award exemplary damages would discourage an efficient breach of contract.<sup>5</sup> This economics principle is based on the idea that a contracting party should have the option of breaching a contract and paying compensatory damages if, after doing so, he or she can put the resources that would otherwise be allocated to the contract to a more beneficial use. The result is Pareto superior than if the contract is performed. The breaching party is better off and the non-breaching party is no worse off. To require a contracting party in breach to not only pay compensatory damages but also punitive or exemplary damages would reduce the incidence of efficient breach. This economic rationale was one of the factors that lead the Court to conclude that exemplary damages for breach of contract cannot be awarded in New Zealand.

It is therefore apparent that economic scholarship cannot now be dismissed as inconsequential by the New Zealand legal fraternity. The development of contract law within New Zealand should be informed by economic theory.

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<sup>1</sup> As to those law and economics courses offered by law faculties and economics faculties see, <[http://www.leanz.org.nz/SITE\\_Default/SITE\\_Education/Education.asp](http://www.leanz.org.nz/SITE_Default/SITE_Education/Education.asp)>, at 20 June 2009.

<sup>2</sup> Gaudo Calabresi, Frank Easterbrook and Richard A Posner.

<sup>3</sup> See Sir Ivor Richardson, 'Law and Economics – and Why New Zealand Needs It' (2002) 8 *New Zealand Business Law Quarterly* 151, at 159.

<sup>4</sup> [2006] 3 NZLR 188.

<sup>5</sup> *Ibid*, at 221 per Chambers J.

### **3. The Economic View of Good Faith – Remedying Contractual Incompleteness and Addressing Opportunism:**

What then do economists have to say about a duty of contractual good faith? Essentially good faith is perceived as a mechanism to address contractual incompleteness. It is elementary that all contracts are incomplete. A contract can never provide for every contingency that may arise.

There are a variety of reasons for contractual incompleteness. Parties may neglect to provide for a particular contingency, or a contingency may be entirely unforeseeable at the time a contract is drafted and executed. Alternatively, negotiating parties may make a rational decision not to specify for a particular event. The costs of providing for the contingency, such as incurring additional professional fees, may outweigh the anticipated benefit of specifying for the contingency within the contract. The cost is particularly likely to outweigh the benefit if the contingency has a low probability of arising throughout the life of the agreement.

There is however a more recent economic school of thought to the effect that transactions costs account for less contractual incompleteness than is observed. This idea of 'endogenous' incompleteness suggests that, even where transactions costs are zero, parties may not write complete contracts because they cannot observe relevant economic variables, or cannot verify those variables to the courts, or because they prefer not to disclose relevant information about themselves to their negotiating counterparties.

Contracting parties are more likely to write a deliberately incomplete contract where self-enforcement is effective and potentially more efficient than legal enforcement. Contracts are likely to be self-enforcing where the reputation of contracting parties is important and repeated interaction between the parties is required.

A good example of this notion of endogenous incompleteness is contained within a contract which I recently came across through my employment as a lawyer. The contract is one of ongoing supply of a particular product, which is seasonal and is subject to variations in quality. The agreement is for a term of 20 years and obliges the seller to supply the purchaser with any amount ordered up to a maximum annual quantity. There is no obligation on the purchaser to buy. The obvious incompleteness is contained within the pricing mechanism. It stipulates that, each time the purchaser places an order, the parties will negotiate the price in good faith having regard to prevailing market prices, the quantity ordered, quality and prices previously charged under the contract.

Some lawyers would suggest that this contract may not be enforceable because it is not sufficiently certain. The Court of Appeal decision in *Wellington City*

*Council v Body Corporate 51702 (Wellington)*<sup>6</sup>, which is well known amongst contract lawyers, suggests that an agreement to negotiate in good faith is not enforceable because the Court has no objective way of determining whether the parties are negotiating in good faith. As a general rule, an agreement to agree is not legally binding.

However, economists may take a different view of my supply contract. By leaving the price vague and incomplete, rather than fixing the price, the contract can accommodate for future contingencies such as a fluctuating costs and market prices. The parties have apparently relied upon the strength of the relationship under the long-term supply contract as an extra-legal mechanism to ensure good faith renegotiation of the price to achieve *ex-post* efficiency. This extra-legal factor explains why the parties have been content to employ vague language like good faith and have consented to an uncertain pricing mechanism, probably knowing full well that the courts may not necessarily be able or willing to enforce it.

The problem with contractual incompleteness is that it can lead to opportunistic behaviour. This idea of opportunism is now frequently mentioned in law and economics literature. However, like good faith, it is hard to find a universal definition of contractual opportunism. It has been described as an attempted redistribution of benefits which have already been contractually allocated. Opportunism is perhaps better explained with examples. The notion of shirking is an instance of opportunistic behaviour. A partnership agreement may provide for the equal sharing of profits but may not clearly and completely define the input expected of each partner. One of those partners may shirk, leaving the other partners to assume his or her work. Nonetheless, the uncooperative partner is still entitled to an equal share of the profits. Although the partner may not have breached the express terms of the contract, he or she has certainly acted in contravention of the reasonable expectations of the parties.

Opportunism is also subsumed in the concept of moral hazard. For example, an insured person will behave less carefully than an uninsured person. Often it is impossible for an insurer to write a policy which completely defines the degree of care expected of the particular insured.

Hold-out behaviour is also an example of opportunism. Because contractual performance is often sequential, one party may be put in a position where there is incentive to withhold performance in anticipation of securing additional benefits than those contemplated by the contract. Such behaviour is more likely where the other party has already committed resources to the contract. A good example is *Atlas Express Ltd v Kafco Ltd*.<sup>7</sup> The plaintiff was a road carrier. It agreed to deliver cartons owed by the defendant, which was a retailer and distributor of

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<sup>6</sup> [2002] 3 NZLR 486.

<sup>7</sup> [1989] 1 All ER 641.

basketware. Soon after the contract began, the plaintiff demanded an increase in the amount payable under the contract. The plaintiff knew that the defendant was heavily dependent on obtaining carriage to satisfy its contracts with its retailers. The plaintiff was also aware that the defendant would be unable to find an alternate carrier at short notice. These factors led the defendant to agree to the additional amount. It was subsequently held by the Court that the defendant was not liable for the extra sum. Its consent had been obtained by economic duress. The plaintiff had undoubtedly acted opportunistically in utilising the economic vulnerability of the defendant as a means to extract more monies than it was entitled to under the agreement.

The law of contract must be aimed at preventing opportunistic behaviour. The consequences of opportunistic behaviour are detrimental. A rational actor who fears that his or her contractual profits may be expropriated may not enter into a contract. The failure by the law to redress opportunistic behaviour may prevent what could otherwise be an efficient and wealth maximising exchange. Further, parties wary of opportunism might incur greater transactions costs. Negotiating parties may write longer and more complex contracts in an attempt to prevent opportunism fueled through incompleteness. Similarly, more resources may need to be expended to assess the background of a negotiating counterparty in order to determine his or her propensity for opportunistic conduct.

What then is the linkage between incompleteness, opportunism and good faith?

It is often reasoned that opportunistic conduct can be prevented and remedied through an obligation of good faith. Some perceive good faith conduct as the exact opposite of opportunism. We have already seen that contractual incompleteness is a catalyst for opportunism. In *Market Street Associates Ltd Partnership v Frey*, Richard Posner, an eminent law and economics scholar, and now a Court of Appeals judge, clearly explained the connection between contractual incompleteness, opportunism and good faith in the following passage:

The concept of the duty of good faith [ ] is a stab at approximating the terms the parties would have negotiated had they foreseen the circumstances that have given rise to their dispute. The parties want to minimize the costs of performance. To the extent that a doctrine of good faith is designed to do this by reducing defensive expenditures is a reasonable measure to this end, interpolating it into the contact advances the parties' joint goal...The office of the doctrine of good faith is to forbid the kinds of opportunistic behaviour that a mutually dependent, cooperative relationship might enable in the absence of [such a] rule.<sup>8</sup>

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<sup>8</sup> 941 F2d 588, at 596 (1991, US App).

Posner's comments clearly identify the economic rationale for good faith. The obligation is perceived as a means of remedying incompleteness and, as a result, preventing opportunism, whilst ensuring that transactions costs are minimised.

#### **4. Is Good Faith Efficient? – The Problem of Uncertainty:**

Despite the normative rationale for contractual good faith, my research has led me to the view that there are certain limitations to a universal good faith obligation. Many academics and lawyers in New Zealand and other Commonwealth countries are opposed to a duty of good faith because it is believed to be too uncertain. It vests a wide discretion in judges to apply a concept which is apparently incapable of being universally and clearly defined. Some economists assert that, as a result of this uncertainty, there is a chance that the courts may redistribute anticipated entitlements under a contract in the name of good faith. It may therefore result in unpredictable judicial decision making. I too share this concern.

Take, for example, the Californian case of *Vylene Enterprises Inc v Naugles Inc*.<sup>9</sup> The parties entered into a 10 year franchise agreement under which Vylene, the franchisee, assumed the operation of a restaurant owned by Naugles, the franchisor. Naugles subsequently opened a competing restaurant approximately 1.4 miles away from Vylene's restaurant. Vylene claimed that Naugles breached the implied covenant of good faith. However, the franchise agreement did not permit Vylene an exclusive territory. It was also well known that the Californian courts do not imply an exclusive territory into a franchise agreement if none is expressly stipulated. Nonetheless, the Court held that Naugles was in breach of the obligation of good faith and was not permitted to keep the competing restaurant open. The Court therefore utilised the good faith mechanism to impose a restriction on Naugles which was not evident from the contract. Arguably, Naugles had reasonably anticipated that it was entitled to open the competing restaurant. However, in applying the duty of good faith, the Court defeated this anticipated entitlement.

The unpredictability of good faith has transaction costs implications. Whilst an obligation of good faith may lead to savings on the cost of specifying for contingencies, it also gives rise to costs associated with the uncertainty of good faith and the possibility of judicial "mistake". Where the latter outweigh the former, the imposition of a good faith obligation may result in less efficiency.

I suggest that there are particular types of contract in New Zealand where specification cost savings are likely to outweigh the risks of judicial mistake associated with good faith. An obligation of good faith is more desirable in these

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<sup>9</sup> 90 F3d 1472 (1996, US App).

types of contract. Contracts where good faith is likely to be efficient include agreements involving a low-value exchange such as consumer transactions (where specifications costs are likely to be high relative to the contractual surplus), contracts where there is a significant inequality of bargaining power (where opportunistic conduct may be more likely), and contracts which fall within a homogenous class with which the courts are readily familiar (such that the probability of unpredictable judicial decision making, even with good faith, is lower).

However, within New Zealand we already have obligations which serve a similar function to good faith which often apply to these types of contracts. For example, the Disputes Tribunals Act 1988 permits the Tribunal to address bad faith unconscionable and oppressive conduct in low-value transactions, the Consumer Guarantees Act 1993 affords protection in consumer transactions, the Credit Contracts and Consumer Finance Act 2003 sanctions a lender who utilises superior bargaining power in an oppressive manner and the Employment Relations Act 2000 expressly recognises obligations of good faith in a homogenous class of contracts.

There are however certain contracts where it is postulated that an obligation of good faith is likely to be inefficient. These are contracts which involve complex and less common transactions and dealings. They are often between sophisticated commercial parties and involve large contractual surpluses. These types of contract will inevitably involve a vast number of contingencies which have to be specified by the parties. The courts cannot be relied upon to “fill the gaps”. Accordingly, there is unlikely to be any significant specification cost savings associated with good faith. Such contracts are also likely to be characterised by information asymmetry as between the contracting parties and the courts if the parties resort to litigation. The judiciary may be ill-equipped to understand highly specialised and technical agreements. As a result, it is not desirable to arm the judiciary with the discretion afforded under a good faith obligation. The results are likely to be unpredictable. In this scenario it is suggested that it is more efficient to avoid good faith altogether.

## **5. Conclusion:**

Accordingly, my research leads me to conclude that an obligation of good faith may be efficient in some contracts but not in all contracts. A universal duty of contractual good faith is not therefore supportable. The current “piecemeal” methodology within New Zealand is more desirable than a general good faith obligation.

We have seen that obligations of good faith, or obligations akin to good faith, are imposed, usually by the legislature, in specific types of contractual arrangement where it can be reasoned that efficiency is likely to be enhanced by including

such obligations. Notably, it is not possible to contract out of the majority of these statutory duties. The efficiency objective is defeated if parties, and particularly those parties with superior bargaining power, are permitted to contract out of obligations synonymous with good faith.

No doubt there is scope for the judiciary and Parliament to expand obligations of good faith into new categories of contract. However, because good faith is unlikely to be efficient in some circumstances, it should not be a matter of universal application to all contracts.