

IT BYTES

ANSWERING YOUR COMMON IT CONTRACT LAW QUESTIONS

WHEN IS A DUTY TO ACT IN GOOD FAITH IMPLIED IN A CONTRACT?



WHEN DOES THIS QUESTION TEND TO ARISE?

You are negotiating a long-term supply agreement with a key business partner. The contract gives your counterparty broad discretion to set delivery schedules and approve variations but is otherwise silent on how this discretion should be exercised. As the relationship progresses, you notice your counterparty making decisions that, while technically within the terms of the contract, seem designed to frustrate your business objectives or extract additional concessions. When you raise these concerns, your counterparty insists they are simply exercising their contractual rights. This leaves you wondering: is there an implied duty for your counterparty to act in good faith in their dealings with you, or are they free to do as they wish within the strict letter of the contract?

WHAT DOES THE LAW SAY?

Australian law recognises that contractual performance and the exercise of contractual rights may be subject to obligations of good faith, but there is no definitive High Court ruling supporting a universal, implied duty across all contracts. The presence, content and scope of any good faith obligation depends on the terms of the contract, its context and commercial purpose, and the approach of the courts to interpreting any such obligation in the context of a contract.

Australian courts have recognised three primary pathways by which obligations of good faith may arise:

- **Implication in fact.** A duty of good faith may be implied into a particular contract under the orthodox *BP Refinery* test for implied terms (including by reference to necessity for business efficacy, obviousness, and consistency with express terms). This is a contract specific inquiry turning on the language, context and commercial purpose. It is most persuasive in long term, relational or cooperative arrangements where an opportunistic approach to exercising rights granted under the contract would be inconsistent with the underlying bargain.
- **Implication in law (as a legal incident).** Some decisions, particularly in New South Wales, have suggested a duty of good faith may be implied as a matter of law in certain classes of contract (e.g. franchising or distribution agreements, where a duty may be implied to prevent the franchisor sabotaging the franchisee's legitimate interests by relying on technical breaches, or joint venture agreements where a duty may be implied to prevent the parties from exercising rights in a way that would be fundamentally inconsistent with the joint venture's contractual aims). The High Court has not endorsed a general implied term of good faith but has left the point open.
- **Constructional limits on discretions ('reasonableness/rationality' constraints).** Courts can also construe contractual discretions and powers as being subject to limits such that they cannot be exercised arbitrarily, capriciously or for an extraneous purpose. This is sometimes described as a good faith or rationality constraint and is commonly applied to termination for convenience, approval and pricing discretions and satisfaction clauses. It arises from interpretation rather than by implying terms into contracts by operation of law.

A good faith obligation, when it has been implied, typically includes acting honestly, having regard to the bargain's purposes, avoiding capricious or bad faith conduct, and not using powers for an ulterior purpose. It does not require parties to self sacrifice or subordinate their individual legitimate commercial interests, and it cannot contradict clear express terms in the contract.



WHAT ARE THE PRACTICAL IMPLICATIONS FOR YOUR CONTRACT?

Given the uncertainty and context-specific nature of the law in this space, if you intend for a duty of good faith to apply (or not apply), it is best to include clear language to that effect in your contract. For example, language expressing that certain rights must be exercised 'in good faith and reasonably' will avoid the uncertainty of whether an implied duty of good faith may apply. Conversely, if there are terms in the contract that authorise one party to act 'in its absolute discretion' this could have the effect of expressly excluding obligations to consider the interests of the other party or align with any objective standard of reasonableness.

Where a contract is silent, a court may imply a duty of good faith, particularly in long-term contracts depending on the context. If one party has significant discretionary power, unless there are express terms to preserve an absolute discretion, the courts could be more inclined to recognise a duty of good faith to avoid undue consequences. However, as noted above, the approach may vary between courts and jurisdictions, as well as based on the type of contract and underlying context in which it was made. To minimise uncertainty and the risk of disputes, parties should:

- Clearly define any express good faith obligations, including the scope and any limitations.
- Consider whether to include (or exclude) good faith requirements either on a generalised basis or in relation to the exercise of specific rights, such as termination, renewal, or variation.
- Ensure that the contract's express terms are consistent with the parties' intentions regarding good faith, as an implied duty cannot override clear language in the contract itself.

In making drafting choices, it is worth noting that a requirement to act 'reasonably' will not necessarily be synonymous with a requirement to act 'in good faith'. These are likely to be interpreted as related but distinct standards. In simple terms, a duty to act in good faith is generally about honesty, proper purpose and fidelity to the bargain, whereas a duty to act reasonably tends to ask more of a decision-maker, often requiring a fair, balanced and objectively justifiable choice. There is overlap: a wholly arbitrary or ulterior decision will breach both standards. However, a decision taken honestly for a proper contractual purpose may still fail an express 'reasonableness' requirement if it is outside the range of objectively defensible outcomes. Conversely, a tough but commercially protective choice can still be justified as being made 'in good faith' even if it is unfavourable to the counterparty, provided it is not capricious or for an extraneous purpose.

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