A UNIVERSAL DUTY OF GOOD FAITH: AN ECONOMIC PERSPECTIVE

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The liberal political environment of the nineteenth century and a belief in the economic model of the free market is still strongly reflected in modern contract law doctrine, including those doctrines relating to the implication of terms.[1] *Contract law rules were designed to provide incentives to rational, self-interested contracting parties to perform obligations they had voluntarily and expressly consented to. The strict enforcement of express contractual promises has traditionally been seen as the best way to provide these incentives and the recognition of an implied duty of good faith has been seen as unnecessary and undesirable judicial intervention.*

However, the assumption of self-interest that underpins the economic model of the free market has come under increasing attack from the 'second wave of law and economics'.[2] *Empirical studies suggest that preferences are in fact heterogenous; some individuals are self-interested whilst other have a preference for reciprocal fairness.*[3] *This article considers various economic studies and theories from the 'second wave'. It argues that if courts enforce express promises in a literal manner, self-interested norms will crowd out the preference for reciprocal fairness and that the recognition of a universal duty of good faith would overcome these crowding effects.*

I INTRODUCTION

Even though fifteen years have passed since Priestley JA's landmark judgment in *Renard Constructions*, in which an implied obligation of good faith was recognised

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1 P S Atiyah, 'Contracts, Promises and the Law of Obligations' (1978) 94 *Law Quarterly Review* 193, 199.

2 For a useful overview of the 'second wave' see Megan Richardson, 'The Second Wave in Context' and Gillian Hadfield, 'The Second Wave of Law and Economics: Learning to Surf' in Megan Richardson and Gillian Hadfield (eds), *The Second Wave of Law and Economics* (1999), 2 and 50 respectively.

3 Ernst Fehr and Simon Gachter, 'Fairness and Retaliation: The Economics of Reciprocity' (2000) 14(3) *Journal of Economic Perspectives* 159; Robert E Scott, 'A Theory of Self-Enforcing Indefinite Agreements' (2003) 103 *Columbia Law Review* 1641; Ernst Fehr and Klaus Schmidt, 'A Theory of Fairness, Competition and Cooperation' (1999) 114 *Quarterly Journal of Economics* 817.

in a commercial contract,[4] the good faith debate rages on within the academic and judicial communities.

Despite some initial resistance[5], the judiciary seems increasingly willing to impose implied obligations of good faith on contracting parties,[6] although acceptance of the appropriateness of doing so is far from universal.[7] Furthermore, guidance from the High Court to date has been slight and indeterminate.[8] In fact, the only thing that seems certain is that the law on good faith in Australia is in a state of confusion.[9]

4 *Renard Constructions (ME) Pty Ltd v Minister for Public Works* (1992) 26 NSWLR 234 ('*Renard Constructions*'). The term implied in *Renard Constructions* was actually a duty of reasonableness. Thus, Priestley JA's comments in relation to a duty good faith are *obiter*. However, it seems clear that his Honour believed the content of the two duties to be very similar: at 263. Furthermore, subsequent judges have treated *Renard Constructions* as establishing the existence of an implied duty of good faith. In *Burger King Corporation v Hungry Jack's Pty Ltd* [2001] NSWCA 187 ('*Burger King*') the Full Federal Court stated that 'Australian cases make no distinction of substance between the implied duty of reasonableness and that of good faith': at [169]. Cf Elisabeth Peden, 'The Meaning of Contractual Good Faith' (2002) 22 *Australian Bar Review* 235, 243.

5 *Hughes Bros Pty Ltd v Trustees of the Roman Catholic Church (Archdiocese of Sydney)* (1993) 31 NSWLR 91 ('*Hughes Aircraft*'); *GSA Group Pty Ltd v Siebe Plc* (1993) 30 NSWLR 573; *Station Association Ltd v Berg Bennett & Associates Pty Ltd* (1993) 45 FCR 84.

6 *Hughes Aircraft Systems International v Airservices Australia* (1997) 76 FCR 151; *Alcatel Australia Ltd v Scarella* (1998) 44 NSWLR 349; *Far Horizons Pty Ltd v McDonald's Australia Ltd* [2000] VSC 310; *Garry Rogers Motors (Aust) Pty Ltd v Subaru (Aust) Pty Ltd* [1999] FCA 903, [34]; *Burger King* [2001] NSWCA 187; *Overlook Management BV v Foxtel Management Pty Ltd* [2002] NSWSC 17 ('*Overlook*'); *Vodafone Pacific Ltd v Mobile Innovations Ltd* [2004] NSWCA 15.

7 *Saxby Bridge Mortgages Pty Ltd v Saxby Bridge Pty Ltd* [2000] NSWSC 433; *South Sydney District Rugby League Football Club Ltd v News Ltd* (2000) 177 ALR 611, 695; *NT Power Generation Pty Ltd v Power & Water Authority* (2001) 184 ALR 481; *Esso Australia Resources Pty Ltd v Southern Pacific Petroleum NL* [2005] VSCA 228.

8 The issue was raised before the High Court in *Royal Botanic Gardens and Domain Trust v South Sydney City Council* (2002) 186 ALR 289 ('*Royal Botanic*') when the appellant relied on the implied duty of good faith to give sufficient content to an ambiguous express term in order to avoid the admission of extrinsic evidence that favoured the respondent's construction of the express term. Gleeson CJ, Gaudron, McHugh, Gummow and Hayne JJ acknowledged the importance of issues relating to the existence and scope of a 'good faith' doctrine, but ultimately concluded this was not the appropriate occasion to consider them: at 301. Callinan J also stated that it was not necessary to answer the appellants 'far reaching' contentions about good faith: at 327. In his dissenting judgment, Kirby J made it clear that he believed that a universally implied duty of good faith is inconsistent with common law conceptions of economic freedom: at 312. Although some have gone as far as to argue that Kirby J's comments 'exclude the implied obligation from the law of Australia' (see Derek Cassidy, 'Case Note: *Royal Botanic Gardens & Domain Trust v South Sydney City Council*' (2002) 9 *Australian Property Law Journal* 282, 284-5), the author does not believe it is possible to be so definitive about the effect of *obiter* comments. Rather, Carter and Stewart's observation that '[t]he comments offered by Kirby J ... do not bode well for those who see good faith as an implied in law duty' better captures the effect of the *Royal Botanic* decision (see J W Carter and Andrew Stewart, 'Interpretation, Good Faith and the "True Meaning" of Contracts: The Royal Botanic Decision' (2002) 18 *Journal of Contract Law* 182, 193). Furthermore, it must be remembered that Kirby J also felt that the liberal approach to the admission of extrinsic evidence adopted by the majority judges was inconsistent with the primacy of the written document, and thus traditional contract law theory: at 306. As the majority disagreed with Kirby J's traditional approach to the admission of extrinsic evidence to resolve ambiguity, there is every possibility that they will disagree with his views on good faith.

9 J W Carter and Elisabeth Peden, 'Good Faith in Australian Contract Law' (2003) 19 *Journal of Contract Law* 155, 155; Carter and Stewart, above n 8, 190.

The academic community is also divided about the desirability of qualifying contractual obligations and termination rights with notions of good faith.[10] Common objections to the imposition of unexpressed good faith obligations include: the inconsistency of such obligations with long-recognised beliefs about the nature of contract,[11] concerns that recognising such duties will introduce an unacceptable level of uncertainty into the law,[12] and a belief that the imposition of such duties is unnecessary.[13]

Despite the increasing recognition of the appropriateness of economic analysis of contract law,[14] the good faith debate has not been greatly informed by economic theory.[15] This seems surprising as economics, which primarily involves the study of exchanges,[16] provides a normative standard that can be used to predict the effect that changing legal rules or sanctions will have on the likely behaviour of contracting parties.[17] The analysis that follows draws on the findings of recent empirical economic studies to determine the effect of imposing an implied obligation of good faith on the likelihood that parties will cooperate throughout their contractual relationship.

Part I considers how new behavioural economic theories may inform the good faith debate. Recent economic studies show that, contrary to the assumptions of traditional economic theories that underpin contract law, the world is not made up of exclusively self-interested people. Rather, a significant proportion of individuals

10 In *Hughes Aircraft*, Finn J expressly noted that scholarly opinions differ sharply: at 192.

11 See, eg, Adrian Baron, '"Good faith" and Construction Contracts – From Small Acorns Large Oaks Grow' (2002) 22 *Australian Bar Review* 54, 73. However, such an argument seems unconvincing on its own as the traditional view of the nature of contract has itself been subjected to much academic criticism, primarily on the basis that it does not reflect the reality of the modern market place and is ill-suited to deal with long-term contracting. See, eg, Donald B King, 'Reshaping Contract Theory and Law: Death of Contracts II Part One: Generalised Consent with Lawmade Obligations' (1994) 7 *Journal of Contract Law* 245; Roger Brownsword, 'Two Concepts of Good Faith' (1994) 7 *Journal of Contract Law* 197, 202; Charles J Goetz and Robert E Scott, 'Enforcing Promises: An Examination of the Basis of Contract' (1980) 89 *Yale Law Journal* 1261, 1261; Melvin A Eisenberg, 'Why There is no Law of Relational Contracts' (2000) 94 *Northwestern University Law Review* 805, 810.

12 Andrew Phang, 'Tenders, Implied Terms and Fairness in the Law of Contract' (1998) 13 *Journal of Contract Law* 126; Carter and Stewart, above n 8, 195; Baron, above n 11, 75.

13 Carter and Peden refer, inter alia, to the requirement that revocation of an offer be communicated, the requirement to give reasonable notice of terms said to form part of the contract, the objective approach to interpretation and the numerous vitiating factors that excuse parties from their contractual obligations to avoid unfair results as examples of doctrines that adequately ensure parties act fairly (see Carter and Peden, above n 9). See also W D Duncan, 'The Implication of a Term of Good Faith in Commercial Leases' (2002) 9 *Australian Property Law Journal* 209, 214-6; Carter and Stewart, above n 8, 192; Peden, above n 4, 245; Elisabeth Peden, '"Cooperation" in English Contract Law – To Construe or to Imply' (2000) 16 *Journal of Contract Law* 56; J W Carter and M P Furmston, 'Good Faith and Fairness in the Negotiation of Contracts Part I' (1994) 8 *Journal of Contract Law* 1, 5. Cf Brownsword, above n 11, 200.

14 Frank H Stephen, *The Economics of Law* (1988), 155; Richard Speidel, 'Article 2 and Relational Sales Contracts' (1993) 26 *Loyola of Los Angeles Law Review* 789; Gillian Hadfield, 'The Second Wave of Law and Economics: Learning to Surf' in Richardson and Hadfield (eds), above n 2, 50.

15 But see John N Adams, 'The Economics of Good Faith in Contract' (1995) 8 *Journal of Contract Law* 126.

16 Stephen, above n 14, 155.

17 Michael Trebilcock, 'The Value and Limits of Law and Economics' in Richardson and Hadfield (eds), above n 2, 13. Cf Robertson, below n 125.

have a strong preference for reciprocal fairness.[18] Further studies suggest that contractual rules play a role in determining whether self-interested or reciprocally-fair norms prevail throughout the exchange relationship.[19]

In Part III, the findings of the economic studies discussed in Part II are applied to determine the possible economic effects of imposing obligations of good faith on contracting parties. To put matters simply, the judiciary is broadly faced with a choice between a regime that only enforces obligations expressly assumed under the contract (even though this may render results that seem unfair) and a regime that qualifies expressly assumed obligations by notions of good faith (even though parties have not explicitly promised to act in this manner). It is argued, on economic grounds, that the latter regime is more likely to promote cooperation and contractual performance.

II CROWDING EFFECTS – THE PROMOTION OF RECIPROCAL FAIRNESS

A *Promoting Cooperation*

1 *Promoting Cooperation – A Traditional Perspective*

Cooperation is productive.[20] By working with others, parties can achieve cost reductions and efficiency improvements that neither party could achieve on its own. Such a proposition seems self-evident. Why else would parties enter into agreements with each other unless both expected to benefit from the arrangement?

Something that is less clear is how cooperation is best promoted. This question, however, is of particular importance when assessing the appropriateness of imposing obligations of good faith. Such obligations should not be imposed unless they are likely to increase the propensity of parties to cooperate.

Traditional thinking posits that contract law is necessary to ensure the benefits of cooperation are reaped.[21] This is because of the assumption implicit in traditional economic reasoning that parties are self-interested. Thus it is important that parties are able to use contractual promises to make credible commitments to cooperate

18 See above n 3.

19 Iris Bohnet, Bruno S Frey and Steffen Huck, 'More Order with Less Law: On Contract Enforcement, Trust and Crowding' (2001) 95 *American Political Science Review* 131; Sergio G Lazzarini, Gary J Miller and Todd R Zenger, 'Order with Some Law: Complementarity Versus Substitution of Formal and Informal Arrangements' (2004) 20 *Journal of Law, Economics, and Organization* 261; Ernst Fehr and Armin Falk, 'Psychological Foundations of Incentives' (2002) 46 *European Economic Review* 687; Ernst Fehr, Alexander Klein and Klaus Schmidt, 'Contracts, Fairness and Incentives' (Working Paper No 1215, CESifo, 2004); Robert E Scott, 'The Death of Contract Law' (2004) 54 *University of Toronto Law Journal* 369.

20 Robert Cooter and Thomas Ulen, *Law and Economics* (2nd ed, 1997), 203; Brownsword, above n 11, 213.

21 Stewart Macaulay, 'Elegant Models, Empirical Pictures and the Complexities of Contract' (1977) 11 *Law & Society Review* 507, 509.

with each other,[22] in circumstances when reputational or self-enforcement sanctions are unlikely to suffice.[23] Traditionally, the law and economics literature has focussed on contract law's ability to promote efficient levels of exchange and cooperation by establishing clear and certain rules[24] that respect and strictly enforce the bargain reached between the parties, which it is implicitly assumed is fully expressed in the written contract. Although implied terms are seen as an appropriate way to minimise transaction costs in certain circumstances,[25] the recognition of a universal duty of good faith is unlikely to be viewed as desirable from a traditional economic perspective as such duties qualify the right of self-interested individuals to enter into efficient exchanges on their own terms.

2 *Reciprocity – Rethinking Traditional Assumptions*

As noted above, traditional law and economics analysis is underpinned by the assumption that all individuals are self-interested and, as a result, will only respond to explicit incentives (such as those created by contracts). If this is true then cooperation may well be best promoted by strictly and literally enforcing agreements reached in a *laissez faire* environment.[26] However, scepticism toward the proposition that individuals are motivated solely by self-interest is as old as the proposition itself.[27] Furthermore, the results of several recent empirical studies suggest that such scepticism is justified[28] and that human behaviour is influenced by both extrinsic and intrinsic motivators.[29]

The finding that some parties are motivated by an intrinsic desire for reciprocal fairness improves the prospects of voluntary cooperation relative to the predictions of the standard economic model.[30] It necessitates reconsideration of the traditional belief that strict enforcement of express contractual promises by the courts is the best way to promote cooperation between parties. It also raises the possibility that different levels of contractual liability may increase or decrease the likelihood that parties cooperate.

22 Cooter and Ulen, above n 20, 202.

23 Alan Schwartz and Robert E Scott, 'Contract Theory and the Limits of Contract Law' (2003) 113 *Yale Law Journal* 541, 562; Cooter and Ulen, above n 20, 202.

24 See, eg, Stephen, above 14, 156. See also Kirby J's observation in *Woolworths Ltd v Kelly* (1991) 22 NSWLR 189 that contract law is an 'area of the law where certainty has great economic importance to society'. Kirby J also asserts that it is highly desirable that uncertainty about whether a bargain is legally enforceable be minimised: at 193.

25 Stephen, above n 14, 157.

26 Whilst unequal bargaining may lead to unfair results in a *laissez faire* system, such concerns may be best addressed through specific legislation (see, eg, *Trade Practices Act 1974* (Cth) pt IVA; *Fair Trading Act 1999* (Vic) pt 2B) rather than through the imposition of duties of good faith on all contracting parties.

27 Christine Jolls, Cass R Sunstein and Richard Thaler, 'A Behavioural Approach to Law and Economics' (1998) 50 *Stanford Law Review* 1471, 1473.

28 See above n 3 and n 19.

29 Bruno S Frey and Felix Oberholzer-Gee, 'The Cost of Price Incentives: An Empirical Analysis of Motivation Crowding-Out' (1997) 87 *American Economic Review* 746, 746.

30 Fehr and Schmidt, above n 3, 836.

It is important to draw a clear distinction between cooperative behaviour and reciprocally fair behaviour.[31] Cooperative behaviour may be exhibited by either reciprocally fair or self-interested parties. Selfish people may act in a cooperative manner because they believe they will be rewarded for doing so in the future. For example, a supplier may allow a retailer to cancel an order the retailer is contractually obliged to accept in the hope that this will strengthen their relationship with the retailer and, in the long term, result in more sales. Whilst such conduct is cooperative, it is still the product of self-interest rather than a desire for fairness and reciprocity.[32] Reciprocally fair people, on the other hand, are prepared to incur a cost to reward friendly actions and punish hostile actions, even if they don't expect to recoup this cost in the future.

Two laboratory simulations have been used to test whether individuals have a preference for fairness and reciprocity: the ultimatum game and the gift exchange game. In the ultimatum game participants assume the role of either a proposer or responder. The proposer is given a fixed sum of money and instructed to offer part of that money to the responder. If the responder accepts the offer, then the responder keeps the amount offered and the proposer keeps the balance. If the responder rejects the offer, both parties receive nothing. This process is repeated several times. To ensure self-interested cooperation is not mistaken for reciprocity, exchanges are anonymously entered into and participants are advised that the same responder and proposer will not interact repeatedly.[33]

The data collected in ultimatum game studies[34] contradict predictions based on the assumption that humans are self-interested. If purely motivated by self-interest, responders would accept any positive offer (and be indifferent about rejecting or accepting an offer of zero). After all, receiving a small sum of money is better than receiving nothing at all. Self-interest theory also predicts that the proposer will recognise this fact and offer a very low amount. However in almost all surveys conducted, a vast majority of proposers offer the responder between 40 to 50 per cent of the money given to the proposer.[35] Furthermore, there were very few offers of less than 20 per cent and no offers exceeding 50 per cent were reported.[36] The most likely explanation for these findings is that proposers recognise the possibility that responders will (contrary to self-interest theory) reject offers they believe to be unfair. If proposers were influenced by such concerns, they were right. Responders accepted all offers of 50 per cent of the money and almost always rejected very low offers.

The results of the ultimatum game provide evidence that non-pecuniary, internal factors (such as the perceived fairness of an interaction) motivate human

31 Fehr and Falk, above n 19, 689; Fehr and Gachter, above n 3, 160.

32 It is also possible that such conduct represents the first half of a gift exchange game (explained below) aimed at demonstrating the reciprocal fairness of the parties involved.

33 Scott, 'A Theory of Self-Enforcing Indefinite Agreements', above n 3, 1665.

34 See, eg, Werner Güth, Rolf Schmittberger and Bernd Schwarze, 'An Experimental Analysis of Ultimatum Bargaining' (1982) 3 *Journal of Economic Behaviour and Organization* 367.

35 Fehr and Schmidt, above n 3, 826.

36 Ibid 828.

behaviour. The results of the ultimatum game demonstrate inequity aversion and the willingness of people to incur costs to punish behaviour they perceive to be unfair.[37] The results do not suggest that all people are reciprocally fair though. Rather, they show that the world is made up of both self-interested types and reciprocally fair types.[38]

In the gift exchange game, the proposer offers a salary. The responder can either accept or reject the offer. If the responder rejects the offer, both participants receive nothing. If the responder accepts the wage offer, he or she receives the wage and must indicate the amount of effort he or she will expend in return. Various studies show that responders who accept the wage offer will generally reward generous salary offers with generous efforts.[39]

The finding that fairness motives affect many people suggests that much of the economic analysis of the law to date is based on an empirically questionable view of human behaviour.

3 *Behavioural Law and Economics – Bounded Self-Interest*

Normative law and economics assesses the effects of legal rules and makes policy recommendations aimed at giving individuals greater incentive to reach efficient outcomes. However, as the internal desire to reciprocate is not often factored into the analysis, traditional law and economics' predictions about how people are likely to react to legal rules may not be accurate.[40] This possibility has captured the imagination of the behavioural law and economics movement. Jolls, Sunstein and Thaler explain the task of behavioural law and economics quite succinctly: it is to 'explore the implications of actual (not hypothesized) human behaviour for the law'.[41] Behavioural lawyer economists have taken great interest in the finding that people exhibit bounded self-interest. This is because rather than simply being limited to steering inevitably selfish contracting parties toward efficient outcomes, legal rules now take on a greater significance; they determine whether fair or selfish norms prevail. Fehr and Falk have noted that this is particularly the case where contract theory is concerned.[42]

37 Furthermore, Fehr and Fischbacher believe that reciprocal persons and inequity averse persons behave in similar ways (see Ernst Fehr and Urs Fischbacher, 'Why Social Preferences Matter – the Impact of Non-Selfish Motives on Competition, Cooperation and Incentives' (2002) 112 *Economic Journal* C1-C33.

38 Scott believes the fraction of reciprocally fair subjects ranges from 40 to 60 per cent (as does the fraction of subjects who are self-interested): see Scott, 'A Theory of Self-Enforcing Indefinite Agreements', above n 3.

39 Ibid 1664 (at fn 101).

40 Fehr and Falk, above n 19, 687.

41 Jolls, Sunstein and Thaler, above n 27, 1476.

42 Fehr and Falk, above n 19, 687.

B *Enforcement Regimes – Low, Medium or High?*

1 *Heterogeneous Preferences – Crowding In and Crowding Out of Preference for Reciprocity*

The results of the empirical studies discussed above suggest that it is time to reconsider important contract law policy questions in light of the finding that individuals exhibit heterogeneous preferences. These studies build on observations that human behaviour is influenced by both extrinsic motivations (such as legal rules) as well as intrinsic motivations (such as reciprocal fairness). Of particular relevance to the duty of good faith debate are those studies that have looked at the effect the probability of contractual enforcement has on the likelihood that cooperation will continue throughout the contractual relationship and that reciprocally fair norms will prevail.

Bohnet, Frey and Huck[43] ('Bohnet et al') present empirical evidence they assert establishes that legal rules can 'crowd in' and 'crowd out' the preference for reciprocal fairness. This is because the nature of the enforcement environment affects the degree of trust and trustworthiness parties have for one another.[44]

Bohnet et al modelled an evolutionary game. Participants were presented with a situation in which two contracting parties have the opportunity to produce a contractual surplus. Player 1 must decide whether to enter into a contract with Player 2 without knowing whether Player 2 will perform. This game was repeated several times. In order to create different histories, parties operated under three different regimes in the first four rounds (low enforcement, medium enforcement and high enforcement). In the remaining six rounds, all participants operated in a low enforcement regime.[45]

Bohnet et al then observed performance rates of participants with different enforcement regime histories. They found that the longer a group plays in the low enforcement environment, the strongest the preference for reciprocity and the higher the rate of performance of that group (although fewer contracts were concluded in such an environment).[46] It is suggested that this is because in low enforcement environments parties will engage in a detailed screening process to ensure they deal with fair individuals. The norms of honesty and reciprocal fairness influence the decision making process. Trustworthy individuals are therefore likely to thrive.[47] Thus, Bohnet et al conclude that low levels of legal enforcement tend to crowd in intrinsic motives to cooperate.[48]

43 Bohnet, Frey and Huck, above n 19.

44 Ibid 132.

45 In a low enforcement regime, honest types should thrive. This is because in a low enforcement environment it is difficult to enforce contracts. Thus, parties will be more careful when selecting contracting parties.

46 Bohnet, Frey and Huck, above n 19, 136.

47 Ibid 132.

48 In this environment, selfish individuals act in a reciprocally fair manner as they recognise that it is in their best interests to do so.

High enforcement regimes are also found to promote high rates of performance.[49] Under high enforcement regimes, preferences are irrelevant because the prospect of high enforcement raises the opportunity cost of breach to a level that encourages performance.[50]

In medium enforcement regimes, self-interested parties thrive. Trustworthiness is crowded out by intermediate levels of contractual enforcement. Player 1 types will still enter contracts because doing so is more attractive than refusing to contract. However, the experimental results suggest that in such environments, interpersonal trust is replaced with institutional trust in the legal system. Bohnet et al note that in such environments, reciprocity is crowded out and self-interested norms prevail. The authors do not expressly explain why this is the case. However, Frey and Jegen offer an explanation for such experimental results. They suggest that external intervention is likely to undermine any intrinsic motivation parties have to act fairly. To put things simply, external intervention can crowd out intrinsic motivation if the individuals affected perceive them to be controlling. In medium enforcement regimes, the decision of whether or not to perform contracts is made by asking whether the terms of the contract, as they will be interpreted by the court, require performance rather than by reference to the desire to reciprocate.[51] Contractual loopholes will be exploited by self-interested parties. This explanation is consistent with Sitkin and Roth's finding that replacing an individual's good will with objective, formal requirements can decrease levels of cooperation[52] and Fehr and Gachter's suggestion that the act of requesting a formal contract may signal that no reciprocity is expected.

Lin and Yang made similar findings.[53] Their study considered different tactics that could be employed to encourage parents to pick their children up from day care on time. The study consisted of three periods: a period where no penalty was imposed on parents, a period in which a small but not insignificant fine was imposed and a period when the fine was removed. Lin and Yang found that cooperation decreased when the fine was introduced. The imposition of the fine put a price on lateness and eliminated the social norms that had encouraged parents to be on time whenever possible. Interestingly, when fines were removed again in the final period cooperation levels remained low. The social norms that encouraged parents to cooperate and pick the children up as punctually as possible had been eroded during the period in which the fine was imposed.

49 Bohnet, Frey and Huck, above n 19, 135.

50 Ibid 132.

51 Bruno S Frey and Reto Jegen, 'Motivation Crowding Theory' (2001) 15(5) *Journal of Economic Surveys* 589. Frey and Jegen provide some useful, everyday examples. A child who is paid for performing household chores is likely to expect payment again in the future (rather than performing chores to help out the family). Rewarding the performance of gifted children with gold stars shifts the focus of that child from embracing challenging tasks to focussing on excelling in tasks for which she will be rewarded with the gold star.

52 Sim B Sitkin and Nancy L Roth, 'Explaining the Limited Effectiveness of Legalistic "Remedies" for Trust/Distrust' (1993) 4 *Organization Science* 367.

53 Chung-Cheng Lin and C C Yang, 'Fine Enough or Don't Fine at All' (2006) 59 *Journal of Economic Behavior and Organisation* 195.

These findings directly contradict predictions based on standard economic theory.[54] This is because standard economic theory focuses on external motivators such as legal rules. Traditionally, rules have been assessed by reference to their ability to encourage self-interested individuals to cooperate. However, ignoring the possibility that (at least some) individuals are motivated by an internal desire for reciprocity and fairness and the possibility that contract law doctrines may influence whether or not such norms prevail throughout the parties' relationship may result in policy recommendations that do not promote efficient levels of cooperation.

2 *Challenges to the Crowding In/Crowding Out Theory*

Not all commentators agree with the finding that low and high enforcement regimes crowd in cooperation and medium enforcement regimes crowd it out. Some experimental evidence could be viewed as suggesting that explicit incentives do not crowd out implicit incentives (Lazzarini, Miller and Zenger)[55] whilst other evidence could be viewed as suggesting that the crowding out of implicit incentives will only get worse in high enforcement regimes because greater reliance is being placed on explicit incentives (Fehr, Klein and Schmidt)[56].

(a) Lazzarini, Miller and Zenger

Lazzarini, Miller and Zenger ('Lazzarini et al') found no evidence of semi-specified contracts crowding out cooperation in repeated transactions. In fact, their empirical data suggested that incomplete contracts facilitate the self-enforcement of dimensions that are non-contractible. Their findings do not challenge the finding of reciprocity. However, reciprocity was found to be supported by semi-specified contracts, not crowded out by it.

At first glance, the finding that formal contractual obligations complement informal enforcement mechanisms seems directly contradictory with Bohnet et al's findings. However, this is not necessarily the case. This is demonstrated by Lazzarini et al's explanation for their finding, namely that formal contracting complements self-enforcement because, initially, each party is not confident that the other party will perform.[57]

Lazzarini et al acknowledge that their main hypothesis is that the presence of a formal contract will contribute to a reduction in the likelihood of buyer exit[58] and that in the absence of the assurance provided by a formal document, some parties

54 Frey and Jegen, above n 51, 590.

55 Lazzarini, Miller and Zenger, above n 19.

56 Fehr, Klein and Schmidt, above n 19.

57 This is consistent with Lazzarini, Miller and Zenger's finding that self-enforcement with a formal contract requires a lower probability of continuation than without a formal contract (above n 19, 268). This finding is explained by the fact that the contract reduces the gain from short-term defection.

58 Buyer exit refers to a situation where the responder decides not to contract (see Lazzarini, Miller and Zenger, above n 19, 277).

simply may not transact at all. This argument is supported by their experimental data. The rate of contracting is quite low in the low enforcement environment, most probably because proposers are more selective about whom they will deal with.[59] Thus, Lazzarini et al's experimental results may simply establish that often parties will not transact without some form of formal contract in place.[60] The data does not establish that a linear relationship exists between the use of explicit incentives (formal contracts) and implicit incentives.

(b) Fehr, Klein and Schmidt

Fehr et al model the effectiveness (measured by reference to the rate at which contracts are entered into and effort expended under those contracts) of three types of incentive contracts with no repeat play: a trust contract, a bonus contract and an explicit incentive contract. Under a trust contract, the principal offers the agent an unconditional wage and hopes that generous wage offers will elicit high levels of effort. Under the bonus contract, the principal offers an unconditional base wage and promises to pay a discretionary bonus if the agent performs well. Under an explicit incentive contract, bonus criteria are defined *ex ante* in the terms of the contract.

Traditional theory suggests that principals are likely to opt for the incentive contract as they provide the agent with explicit incentives designed to encourage high levels of performance.[61] However, Fehr et al found that in most instances principals chose to use bonus contracts.[62] Furthermore, the use of bonus contracts increased the average effort expended by agents and the average payoff for principals.[63] These findings add strength to the argument that some individuals act in a reciprocally fair manner.[64]

Fehr et al also tested for crowding effects by giving principals the chance to use combined contracts (a contract that both rewards effort by way of bonus (an implicit incentive) and punishes shirking by way of a fine (an explicit incentive)). They find that effort is not significantly higher under combined contracts.[65] They also find that principals who use combined contracts reward effort less generously.

59 See above n 55. Buyer exit refers to a situation where the responder decides not to contract. Lazzarini, Miller and Zenger, above n 19, discuss their predictions about the effects of formal contracting on buyer exit at pages 267, 277 and 289 of their article.

60 Schwartz and Scott, above n 23, 565.

61 Traditional theory suggests that the bonus contract and trust contract are bound to fail. With respect to the former, this is because a selfish principal is unlikely to pay the bonus (as the interactions are non-repeat play, they will not be rewarded for doing so). With respect to the latter, agents will shirk (again, because there is no repeat play).

62 Fehr, Klein and Schmidt, above n 19, 17.

63 Ibid.

64 As parties will not necessarily deal with each other again, their conduct not explained by reference to self-interest. For example, a bonus payment cannot be explained by the employer's hope to induce hard work in the future.

65 Furthermore, once the verification costs associated with combined contracts are factored into the analysis, it is clear that bonus contracts are more efficient.

Fehr et al assert that this finding demonstrates that the use of explicit incentives crowds out the implicit incentives that operate under the bonus contract.[66] Another plausible explanation is that principals reward effort less generously under the combined contract because when they use combined contracts they also have to cover the drafting and enforcement costs. Such costs were quite high in Fehr et al's experimental set up.

Fehr et al and Bohnet et al agree that low enforcement regimes (or, to use the language of Fehr et al, regimes that rely heavily on implicit incentives) generate a high level of cooperation. However whilst Bohnet et al found that moving from a medium enforcement regime to a high enforcement regime (or, increasing explicit incentives) encourages parties to perform their contractual obligations, Fehr et al's finding that explicit incentives crowd out cooperation suggests that doing so would further decrease the likelihood of cooperation and contractual performance. Unfortunately, Fehr et al's study did not expressly test for this effect. When the combined contract (which, as it relies on both implicit and explicit incentives, seems closest to Bohnet et al's medium enforcement regime) was introduced parties stopped using the incentive contract (which, as it relies on explicit incentives only, seems closest to Bohnet et al's high enforcement regime).[67] As a result, Fehr et al were not able to compare the levels of reciprocal fairness demonstrated in medium and high enforcement regimes.

III PROMOTING COOPERATION – MEDIUM OR HIGH ENFORCEMENT

A *The Framework for Analysis – Bohnet et al Revisited*

Law and economics scholars have fought long and hard against the implication of obligations of good faith. However, in light of the finding that legal rules not only provide extrinsic incentives but also shape the type of behavioural norms likely to apply to the exchange relationship this position needs to be revised.

The analysis that follows attempts to determine the effect of imposing an implied obligation of good faith on the likelihood that parties will honour their contractual relationship by using the Bohnet et al enforcement regime findings. An argument will be developed that deciding whether to impose obligations of good faith essentially involves a choice between a medium enforcement regime and a high enforcement regime. As discussed above, Bohnet et al's findings are not universally accepted. However they are defensible and provide a useful framework in which to analyse the likely effects of imposing a duty of good faith on contracting parties.

66 Fehr, Klein and Schmidt, above n 19, 31.

67 When given the option of entering into a combined contract, no principals chose to use either the incentive contract or the trust contract.

B *Low Enforcement Regimes – An Unrealistic Goal*

Bohnet et al found that honesty and reciprocal fairness is crowded in by low enforcement regimes.[68] These findings are consistent with the wealth of relational contract theory literature that argues that the flexibility and expectation of future cooperation inherent in informal, norms-based agreements may be the best way to promote cooperation.[69]

Promoting trust and cooperation is an extremely effective way of fostering efficiency. With this in mind, it is tempting to argue against any further addition to the coverage of contract law (such as a universal duty of good faith) on the basis that, wherever possible, courts should provide a low enforcement environment so that trust and cooperation thrive. In fact, Professor Scott has recently put such an argument.[70] Despite acknowledging the 'end-game problem',[71] that the textualist approach seems insensitive to the parties' agreement and the fact that their relationship was premised on reciprocation and cooperation,[72] Scott nevertheless argues that any further expansion of contract law will only further crowd out cooperation. On this basis, Scott argues strongly against the imposition of duties of good faith[73] and for a 'return to the classical common law'.[74] However, the classical common law provides a level of enforcement closest to that found in Bohnet et al's medium enforcement environment.[75] To provide the degree of enforcement modelled in the low enforcement regime the courts would need to all but abandon contract law, something that is highly unlikely to happen.[76]

Furthermore, the business community appears to value enforceability (or at least the potential for enforceability). Even those parties who do not make planning, adjustment and dispute resolution decisions by reference to principles of contract law enter into contracts.[77] Weintraub's relatively recent survey indicated that 65.8 per cent of the general counsels surveyed believed that if compliance depended solely on non-legal sanctions business operations would be substantially and

68 Bohnet, Frey and Huck, above n 19, 136.

69 Scott, 'The Death of Contract Law', above n 19, 384.

70 Ibid.

71 Ibid 382.

72 Ibid 373.

73 Ibid 381.

74 Ibid 380.

75 Greater enforcement than in a low enforcement environment is provided as parties can be quite certain that they will be able to enforce express contractual promises. Less enforcement than in a high enforcement environment is provided as enforcement of express promises only opens up the possibility that parties will be able to escape the spirit of the bargain by making technical arguments about the wording of the express provisions.

76 Interestingly, Scott acknowledges that once the parties' relationship is governed by a contract, the parties may believe that reciprocity is not required (above n 19, 388).

77 Nonetheless, even participants in Macaulay's renowned 1960's empirical study of the manufacturing sector of Wisconsin who were not overly influenced by principles of contract law entered into contracts (see Stewart Macaulay, 'Non-Contractual Relations in Business: A Preliminary Study' (1963) 28 *American Sociological Review* 55).

detrimentally affected.[78] Not one of the general counsels surveyed indicated that relying on non-legal sanctions alone would substantially and beneficially affect business operations.[79]

There are a variety of reasons why contracts may be viewed as necessary. As noted above, Lazzarini et al's findings suggest that a formal contract is necessary to ensure parties feel comfortable transacting.[80] Parties may also enter into contracts because they realise that there is a risk that they are dealing with a self-interested individual and that incentives to cooperate or evade the contract do not remain constant over the life of the relationship.[81] They may appreciate that although self-interested individuals often find that it is in their best interests to mimic cooperative norms,[82] they will not hesitate to change strategies if reneging on the norms that have governed the relationship is in their best interests.[83] This concern is a valid one. Repeated interactions are subject to the end-game problem. The end-game problem describes 'the unwinding of cooperation as a repeated game approaches its final round'.[84] It results from the fact that parties (or, more correctly, self-interested parties) have no incentive to cooperate as the relationship draws to a close since there is no future to influence.[85] The deterioration in cooperation is likely to start when a self-interested person opportunistically reneges on the norms governing the relationship.[86] Furthermore, as reciprocally fair types are likely to respond by punishing such conduct, cooperation levels may quickly decline. Anticipation of the end-game problem can cause the entire cooperative pattern to unravel once the duration of the contract becomes finite.[87] Parties may therefore enter into the contract in the hope that doing so will protect them against such conduct, whilst still intending to perform the contract in a flexible manner.[88] However, for present purposes, the reason that parties view contracts as necessary is not overly important. The main thing to note is that contracting parties value some degree of enforceability.

78 Russell J Weintraub, 'A Survey of Contract Practice and Policy' (1992) *Wisconsin Law Review* 1, 24.

79 17.7 per cent indicated that business operations would not be affected much at all. The remaining 16.5 per cent indicated that business operations would be substantially affected, with about an even amount of detriment and benefit.

80 See also Robert E Scott, 'Conflict and Cooperation in Long-Term Contracts' (1987) 75 *California Law Review* 2005, 2042-4.

81 Ibid, 2030.

82 Fehr and Schmidt, above n 3, 855; Scott, 'The Death of Contract Law', above n 19, 384.

83 As Speidel notes, both relationalists and traditional economists recognise the importance of preventing opportunism in relational contracts (above n 14, 838).

84 Cooter and Ulen, above n 20, 197.

85 Robert Axelrod, *The Evolution of Cooperation* (1984) 10; Scott, 'The Death of Contract Law', above n 19, 382.

86 Speidel, above n 14, 838.

87 Scott, 'The Death of Contract Law', above n 19, 382.

88 Cooter and Ulen, above n 20, 202.

C *What is the Effect of Imposing Obligations of Good Faith?*

1 *Good Faith Equals High Enforcement*

As it seems that courts are unlikely to redesign contract law so that a low enforcement environment is created, Bohnet et al's findings suggest that courts should aim to provide a high enforcement regime. In high enforcement regimes, legal rules provide little scope for parties to avoid honouring their contractual obligations. Before continuing, it is necessary to clearly define how the term 'honouring contractual obligations' is being used. For discrete transactions, this may require parties to do little more than adhere to the strict letter of the contract. However, in the case of long-term, relational exchanges, it is important to recognise that the spirit of the deal is, within limits, just as much a part of the deal as the written instrument.[89] Furthermore, economic decisions (such as investment decisions) are often made by reference to expectations raised by the spirit of the deal. The parties' relationship and their understanding of the obligations that they are under are likely to evolve and adapt in ways that cannot be specified at the time of drafting the initial agreement.[90]

The idea that the written contract may only be a rough indication of how parties intend their exchange relationship to develop is not new.[91] Increasingly contracts are being viewed as evidencing a relationship between parties rather than describing only those promises reduced to written form.[92] The initial promises constitute but a fragment of the relationship.[93] Often by signing contracts, parties consent not only to be bound by the express obligations but also to be bound by the norms of the relationship.[94]

In order to ensure parties honour their contractual relationship, courts must acknowledge realties such as those just discussed rather than permitting parties the unqualified right to enforce or terminate an agreement by reference to terms that are almost certainly going to be incomplete[95] as well as out of sync with the expectations the parties have about the nature of their evolving exchange relationship and the cooperative spirit underpinning that relationship.[96] When

89 Robert S Summers, '"Good Faith" in General Contract Law and the Sales Provisions of the Uniform Commercial Code' (1968) 54 *Virginia Law Review* 195, 235. See also Stewart Macaulay, 'The Real and the Paper Deal: Empirical Pictures of Relationships, Complexity and the Urge for Transparent Simple Rules' (2003) 66 *Modern Law Review* 44.

90 Paul Gudel, 'Relational Contract Theory and the Concept of Exchange' (1998) 46 *Buffalo Law Review* 763, 769; King, above n 11.

91 Karl Llewellyn, 'What Price Contract? An Essay in Perspective' (1931) 40 *Yale Law Journal* 704, 737.

92 King, above n 11, 255.

93 Ibid 256.

94 Ibid 259.

95 Schwartz and Scott, above n 23, 594; Randy E Barnett, 'The Sound of Silence: Default Rules and Contractual Consent (1992) 78 *Virginia Law Review* 821, 821-2.

96 In *Overlook*, Barrett J noted that the duty of good faith underwrites the spirit of the agreement and precludes cynical resort to the black letter: [2002] NSWSC 17 at [87].

these realities are taken into account, it becomes clear that rather than overriding the intentions of the parties, the implied duty of good faith can be seen as effecting the intentions and reasonable expectations of the parties arising from their entire exchange relationship.[97]

Imposing an obligation to act in good faith is therefore an effective way to ensure courts provide a performance-inducing high enforcement environment. Absent the implication of obligations of good faith, there is a chance that parties' reasonable expectations about how the other party will perform the contract will be disappointed if contractual parties are permitted to escape honouring their contractual obligations by resorting to the black letter of their agreements. As contracts are inevitably incomplete and static in nature, contractual doctrines that give unqualified effect to the express terms of the agreement will generate a medium enforcement regime. As a result, Bohnet et al's empirical findings suggest that such doctrines will result in self-interest prevailing and decreased levels of cooperation between the parties.

D *Possible Objections to the Proceeding Analysis*

1 *The Likely Traditionalist Objections*

Traditionalists, who seek to limit the role of the courts to the interpretation and enforcement of the express agreement reached between the parties, are unlikely to be overly receptive to the proposition that contracts evolve and that a meaningful understanding of the entirety of contractual obligations requires consideration of more than the written instrument. However, in much the same way that the seemingly irrefutable 19th century belief in the prevalence of self-interest is increasingly being questioned, it is also time for economic analysis of the law to challenge the traditional fiction that all dimensions of the bargain are caught in the written document.

Traditionalists are also likely to dismiss the argument that imposing good faith obligations can in any way be justified on the basis that doing so respects the parties' reasonable expectations. However, objections of this nature are ideological and do not challenge the use made of recent empirical findings. Furthermore, the relevance of the parties' expectations and extrinsic materials to contractual analysis is becoming increasingly accepted in academic circles.[98]

97 Sir Anthony Mason, 'Contract, Good Faith and Equitable Standards of Dealing' (2000) 116 *Law Quarterly Review* 66, 75.

98 David Campbell, Hugh Collins and John Wightman (eds), *Implicit Dimensions of Contract* (2003) 289.

2 *Are The Empirical Results Applicable in the Competitive, Cut Throat World of Business?*

It is possible that as a result of competition between potential contracting parties and the tough-minded nature of business dealings that reciprocal fairness will be crowded out in all enforcement regimes. Fehr and Schmidt's study about the effect of competition on reciprocal fairness demonstrates that fairness considerations can have little or no effect in competitive environments if parties do not have the ability to punish the other party.[99] For example, as the number of responders is increased in the ultimatum game, acceptance thresholds of responders quickly converge to very low levels. This is because the rejection by reciprocally fair responders of unfair offers is of no consequence to proposers because, so long as the proposer is able to find a self-interested responder, their low offer will be accepted. Self-interested behaviour will therefore dominate and reciprocally fair parties will be unable to enforce an equitable outcome.

However, there are two reasons why competition will not fully eliminate fairness concerns between contracting parties. First, the repeated interaction between contracting parties means parties have the capacity to punish unfair conduct.[100] Secondly, the market for contract partners is not perfectly competitive. To put it in terms of Fehr and Schmidt's studies, there are not always a large number of potential responders able to appropriately meet proposers' needs.

There is also a possibility that the reciprocal fairness and crowding out findings do not apply in commercial contexts.[101] For example, Peden suggests that fairness is not always exhibited in tough-minded business deals where each party is looking for the most profitable arrangement available.[102] As business parties are generally judged by reference to profit-based measures of performance, it is possible that even those with a preference for reciprocity are induced to act in a self-interested manner.

However, not everyone shares this view. Feinman for one believes that commercial behaviour is often inconsistent with the assumption of self-interest.[103] One need only look at the degree of stubbornness often displayed during litigation for an example of businesses acting contrary to the predictions of self-interest theory to punish the other party. Furthermore, it seems fair to suggest that if participants are prepared to sacrifice their own financial interests in the name of reciprocity, this preference may stay with them in a business setting.

Further empirical research is required before a more definite conclusion can be reached about whether or not personal preferences for reciprocity play out in commercial settings.

99 Ernst Fehr and Klaus Schmidt, 'A Theory of Fairness, Competition and Cooperation' (1999) 114 *Quarterly Law Journal of Economics* 817, 834.

100 Ibid 835.

101 Summers, above n 89, 265.

102 Peden, "Cooperation in English Contract Law – To Construe or to Imply', above n 13, 56.

103 Jay M Feinman, 'Relational Contract and Default Rules' (1993) 43 *Southern California Interdisciplinary Law Journal* 43, 52.

Although not designed to explicitly test for whether reciprocity is present in business transactions, Weintraub's empirical findings provide some empirical support for the existence of fair thinking in business.[104] Weintraub asked whether parties should be able to escape, without penalty, a contract that they have quickly repudiated before the other party has relied on the promise in any way. Despite the fact that there was nothing in the question to suggest that the parties would deal again in the future, 31.7 per cent of respondents thought it was appropriate to release the party from the contract.[105]

3 *High Enforcement is Costly and Uncertain*

Contract law must provide parties with certainty.[106] Those who strongly oppose the imposition of good faith obligations insist that recognising a concept as amorphous as good faith will destroy the predictability parties' demand of contract law.[107]

The move from rule-based to fact-based dispute resolution is the alleged cause of uncertainty and associated increase to the cost of contractual performance. Some argue that fact-based adjudication will mean that parties will need to seek legal advice regarding the performance of their obligations.[108] Costs of litigation are also likely to be higher if the court is required to engage in an extensive factual analysis.

However concerns that good faith is an uncertain concept are overstated.[109] Courts routinely give meaning to concepts that are equally 'vague'.[110] For example, giving meaning to good faith is no more difficult than identifying the general standards set by legislation such as the *Trade Practices Act 1974* (Cth) or equitable concepts such as unconscionability,[111] two areas of law that have a direct impact on contract law. Summers takes this argument one step further and argues that dealing with issues of good faith directly, rather than masking them behind contrived applications of traditional rules will actually lead to more certainty.[112]

Concerns that good faith is an insufficiently certain concept generally stem from the fact that good faith is associated with concepts such as fairness, reasonableness and honesty. These concepts are believed to be too subjective and uncertain.

104 See above n 78 and the accompanying text.

105 Weintraub, above n 78, 30.

106 Rick Bigwood, 'Conscience and the Liberal Conception of Contract: Observing Basic Distinctions Part I' (2000) 16 *Journal of Contract Law* 1, 6.

107 Scott, 'The Death of Contract Law', above n 19, 376.

108 Lisa Bernstein, 'Social Norms and Default Rules Analysis' (1993) 3 *Southern California Interdisciplinary Law Journal* 59, 78; Scott, 'The Death of Contract Law', above n 19, 374.

109 Mason notes that recognition of the duty of good faith in the United States has not been unduly detrimental to commerce in that country (above n 97, 94).

110 Eileen Webb, 'The Scope of the Implied Duty of Good Faith – Lessons from Commercial and Retail Leasing Cases' (2001) 9 *Australian Property Law Journal* 1, 19.

111 Carter and Stewart, above n 8, 190.

112 Summers, above n 89, 264.

Furthermore, the fact that it is not possible to provide an exhaustive definition of good faith is said to add to these concerns.

However, just because a term cannot be defined in exhaustive terms does not mean that it is uncertain. Summers asserts that in the context of contract law, good faith is an excluder.[113] Drawing on observations made by Aristotle, Summers notes that the function of excluders is not to convey general meaning. Rather, the purpose is to exclude one or more of a variety of things.[114] Thus, the term of good faith excludes a range of different forms of bad faith.[115] When looked at in this light, the concept of good faith begins to sound a lot less indefinite.[116]

Priestley JA in *Renard Constructions (ME) Pty v Minister for Public Works* accepted that conceptualising good faith as an excluder was appropriate and workable.[117] The courts are able, over time, to develop a body of law that clearly establishes what types of bad faith are impermissible. In his seminal work, Summers describes an extensive range of conduct that could be viewed as bad faith.[118]

If the Australian courts were to adopt Summers' extensive list of recognisable forms of bad faith, concerns about uncertainty would have some merit. However, this has not occurred. Whilst a comprehensive review of the meaning given to the term good faith is beyond the scope of this piece, a few general observations will be made to demonstrate that good faith is a sufficiently certain concept. The courts have generally held that a duty of good faith prevents parties from acting unreasonably or for an extraneous purpose.[119] The former requires parties to conform to reasonable standards of fair dealing and to honour any expectations of fair play and cooperation they may have induced in the other party.[120] The latter directs attention to the parties' motives for a particular action.

Limiting the obligations imposed by a duty of good faith in the manner outlined above provides sufficient certainty. Furthermore, the courts have made it clear that obligations of good faith do not prevent parties from pursuing their legitimate interests.[121] If the scope of the duty of good faith continues to be limited in this way, the duty of good faith will promote reciprocally fair norms (and effectively constrain the ability of parties to opportunistically renege on the deal) whilst still ensuring contractual parties can pursue their own interests.

113 Ibid 201.

114 Ibid.

115 Ibid.

116 Mason, above n 97, 69.

117 *Renard Constructions* (1992) 26 NSWLR 234, 266.

118 Summers, above n 89, 223-241.

119 See, eg, *Burger King* [2001] NSWCA 187.

120 Jeannie Paterson, Andrew Robertson and Peter Heffey, *Principles of Contract Law* (2nd ed, 2005) 307.

121 Eg *Garry Rogers Motors (Aust) Pty Ltd v Subaru (Aust) Pty* [1999] FCA 903; *Alcatel Australia Ltd v Scarella* (1998) 44 NSWLR 349.

The outcome in *Burger King*[122] ties the above discussion together nicely. Hungry Jacks and Burger King entered into a Development Agreement. Hungry Jacks was appointed as franchisee and responsible for developing the Australian market. Burger King later decided that it wanted to take a more active role in the Australian market. Burger King engaged in a course of conduct that was inconsistent with its actions toward Hungry Jacks in the past and designed to place Hungry Jacks in breach of the Development Agreement. This would leave Burger King free to develop the market itself.

The Full Court of New South Wales Court of Appeal held that Burger King had breached the implied duty of good faith. It was exercising its contractual rights for the extraneous and unreasonable purpose of reneging on its deal with Hungry Jacks. Whilst the fact that an express right to terminate was qualified by notions of good faith surprised some, the conclusion that Burger King's conduct was contrary to notions of good faith seems self-evident and quite predictable.

Residual concerns may exist that the scope of the duty of good faith will grow over time to include many, less certain forms of good faith (such as those discussed by Summers).[123] However in other contexts Australian courts have demonstrated an ability to limit the scope of broad, general concepts. For example, Australian courts have resisted the trend in other common law jurisdictions to move from a proscriptive model of fiduciary law to a prescriptive model.[124]

4 *Do Contracting Parties Know of the Relevant Legal Rules?*

Normative economic analysis has also been criticised for proceeding on the questionable assumption that parties know, understand and react to applicable legal rules.[125] To put it in economic terms, the reasonableness of the assumption of perfect information is being challenged. For example, Professor Robertson has questioned whether parties would become sufficiently aware of mooted reforms to promissory estoppel to modify their behaviour in response[126] and Professor Macaulay has developed convincing arguments that individuals may not act on the basis of legal sanctions available to them.[127]

122 [2001] NSWCA 187.

123 Summers, above n 89.

124 See, eg, *Paramasivam v Flynn* (1998) 160 ALR 203; *Cubillo v Commonwealth* (2001) 183 ALR 249.

125 See, eg Andrew Robertson, 'The Failure of Economic Analysis of Promissory Estoppel' (1999) 15 *Journal of Contract Law* 69. Robertson also criticises economic analysis of the law on the basis that it assumes that efficiency is more important than fairness and because of the underlying assumption of self-interest. Robertson's first criticism has merit. However, the purpose of this piece is to ascertain the economic effects of imposing an obligation of good faith, not to suggest that the issue of good faith should be solely resolved by reference to efficiency. His second criticism articulates the very reason why it is important to apply new economic theories (that do not make this assumption) to the good faith issue. Cf Daniel Farber and John Matheson, 'Beyond Promissory Estoppel: Contract Law and the Invisible Handshake' (1985) 52 *University of Chicago Law Review* 903.

126 Robertson, above n 125.

127 Macaulay, 'Non-Contractual Relations in Business: A Preliminary Study', above n 77.

However the concerns expressed by Robertson and Macaulay are less concerning in the context of a discussion of good faith. With respect to the concerns raised by Robertson, because of its magnitude, any decision by the High Court to impose universal obligations of good faith will be widely known. Furthermore, the content of an obligation of good faith is far more a matter of common sense than the technical and complicated modifications to estoppel that Robertson was considering. With respect to Macaulay's concerns, it is important to note that his main finding was that in certain circumstances, parties prefer to rely on social norms rather than legal rules. These findings do not negate the potential importance of the legal background rules for these transactions. Enforcement action is an important option even when parties rely heavily on norms.

IV CONCLUSION

There will come a time when the High Court of Australia is forced to consider whether or not to recognise a universal implied duty of good faith. The academic and judicial debate on this issue to date has focussed on the nature of contract and the appropriate role of the courts. However, the ideological debate between traditionalists and contextualists is unlikely to provide the High Court with much guidance as to the likely effects of recognising a universal duty of good faith.

Given the inherently economic nature of contracts, the courts should pay close attention to the policy recommendations of the law and economics movement. Traditional law and economics has modelled the effects of recognising a universal duty of good faith and argued against the recognition of such obligations. However traditional economic analysis is premised on the unrealistic assumption that all individuals are self-interested. The empirical evidence discussed in this paper establishes that this is not the case. Some individuals have a preference for reciprocal fairness. As a result of the inaccurate assumption of self-interest, traditional law and economics has made an inaccurate assessment of the effects of legal rules. Rather than simply providing extrinsic incentives aimed at guiding self-interested individuals to reach efficient bargains, it is now recognised that legal rules also have an effect on intrinsic motivators, such as the desire to be reciprocally fair in contractual dealings.

When deciding whether to impose obligations of good faith, the courts have the option of creating a medium or high enforcement regime. If the courts provide medium levels of enforcement (namely the enforcement of express promises only), self-interested norms will regulate the exchange relationship and there is a risk that parties will opportunistically avoid their contractual obligations. As a result, it has been argued in this paper that the courts should provide high levels of enforcement. Enforcing contracts in a high enforcement regime is the best way to increase the likelihood that parties honour their contractual obligations in a cooperative and fair manner throughout the life of their agreement.