

General

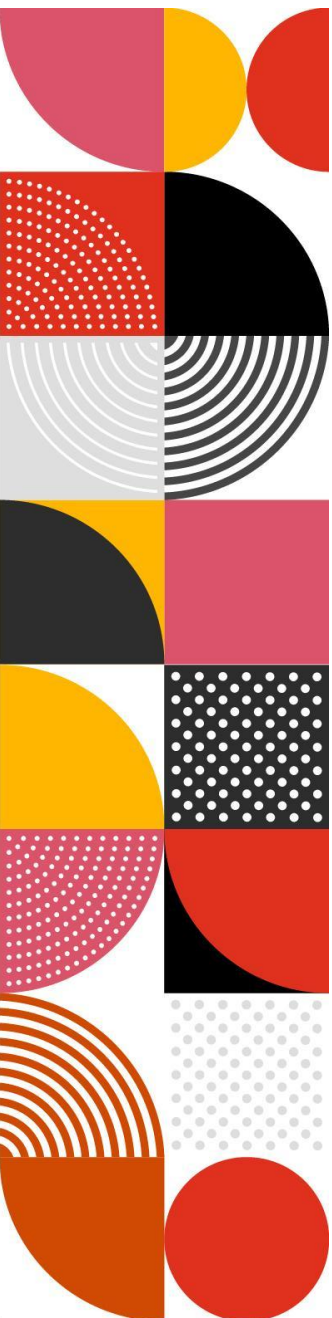
# 26 Key issues for exercising discretions

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# Introduction

Infrastructure contracts sometimes give Principals and their representatives unilateral discretions. The way in which these discretions are exercised may have unintended consequences. Set out below are some of the issues you need to be aware of when drafting such discretions, together with suggested ways of avoiding unintended consequences.



## Contractual discretions generally

Many infrastructure contracts give one party (usually the Principal) discretions to make decisions or exercise certain contractual rights. Such discretions are often linked to circumstances such as the approval of work, personnel or subcontractors, and the granting of extensions of time (in circumstances where the Contractor has not claimed an extension of time).

It is important to understand whether there are any limitations on the exercise of such discretions.

### Principal

From a Principal's perspective, it is important to know whether you are limited in how you exercise a discretion, in order to avoid any challenge by the Contractor about the way in which you exercise a particular discretion.

### Contractors

From a Contractor's perspective, it is important to know whether agreeing to give the Principal a contractual discretion may lead to the unrestricted exercise of that discretion, to your detriment.

# Implied ‘fetters’ on the exercise of contractual discretions

Courts in Australia have shown an increasing willingness to imply terms of good faith and reasonableness into commercial contracts. However it is uncertain whether obligations of good faith and reasonableness are to be implied into commercial contracts generally. Despite this uncertainty, it seems that, in the absence of clear words to the contrary in the contract, courts will often be keen to impose some fetter or restriction on the way in which discretions are exercised (particularly where the discretion is wider than is necessary to protect a party’s legitimate interests).

Cases in both Australia and the UK have held that contractual discretions must not be exercised unreasonably, arbitrarily, capriciously, dishonestly or for an improper purpose.

The potential uncertainty that this creates (particularly for Principals, since it is Principals who primarily have the benefit of such discretions) often prompts Principals to try to avoid any restriction being imposed on the way in which a unilateral discretion is exercised.

## Case law

NSW courts have generally held that an obligation for parties to act in good faith can be implied in all commercial contracts. On the other hand, Victorian courts have rejected the notion that good faith should be indiscriminately implied to override any express provisions of power. However, Victorian courts have not completely overruled the need for good faith in certain commercial situations, especially where balance of power heavily favours one party.

Overall, good faith will remain an important consideration for all Australian courts when determining commercial dealings. Principals should not underestimate the courts’ ability to fetter an express discretionary power if Principals choose to exercise that power ‘dishonestly’ or ‘unconscionably’. As set out below, the defining factor for finding good faith will likely ride on ‘vulnerability’ and the ‘presumed intentions’ of the parties in that situation.

### NSW

The NSW Court of Appeal has held in a series of decisions that as a matter of law it is appropriate for good faith to be implied into commercial contracts.

In the case of *Macquarie International Health Committee Pty Ltd v Sydney Local Health District* [2010] NSWCA 268, the contract gave the respondent an ‘absolute and unfettered discretion’ to set a new timetable.

Notwithstanding these clear words, the NSW Court of Appeal held that this discretion was still subject to an express, contractual obligation of good faith (even though the obligation of good faith was stated to be ‘without limiting the generality of any other provision of this deed’).

A subsequent decision of the New South Wales Court of Appeal *Bundanoon Sandstone Pty Ltd v Cenric Group Pty Ltd* [2019] NSWCA 87 held that a Principal under a construction contract who issues a ‘show cause’ notice in accordance with a termination regime must act in good faith in considering the Contractor’s response. In circumstances where a Principal had a closed mind and was not interested in the content of the response, the Principal’s subsequent termination of the contract constituted a wrongful repudiation. The NSW Court of Appeal noted that the Principal’s real motive in initiating the show cause process was to deprive the Contractor of a specific economic benefit and take that benefit for itself.

### Victoria

On the other hand, Victorian courts have been reluctant in finding any implied good faith that can substitute for express provisions of discretionary powers in commercial contracts.

The Supreme Court of Victoria Court of Appeal in *Esso Australia Resources Pty Ltd v Southern Pacific Petroleum* [2005] VSCA 228 rejected the proposition that an overarching duty of good faith should indiscriminately be applied to commercial contracts. Chief Justice Warren cited notions of ‘judicial reticence’ and ‘vulnerability’ in determining whether good faith should be implied in individual contracts:

*‘The interests of certainty in contractual activity should be interfered with only when the relationship between the parties is unbalanced and one party is at a substantial disadvantage or is particularly vulnerable in the prevailing context. Where commercial leviathans are contractually engaged, it is difficult to see that a duty of good faith will arise, leaving aside duties that might arise in a fiduciary relationship.’*

Justice Buchanan echoed the sentiment of 'vulnerability':

*'I am reluctant to conclude that commercial contracts are a class of contracts carrying an implied term of good faith as a legal incident, so that an obligation of good faith applies indiscriminately to all the rights and power conferred by a commercial contract. It may, however, be appropriate in a particular case to import such an obligation to protect a vulnerable party from exploitative conduct which subverts the original purpose for which the contract was made.'*

In the case of *David A Harris Pty Ltd v Amp Financial Planning Pty Ltd* [2019] VSC 24, the Supreme Court of Victoria considered the question of whether a contract containing an express right to terminate would be fettered by an implied term of good faith in exercising that right. The Court found that there was no implied term of good faith for three reasons:

1. there is no generally accepted term implied in law that parties must act in good faith in the performance of their contract, leaving the financial planner to argue that such a term was implied in fact
2. the implied term argued for by the financial planner could not be implied, in that it was not so obvious that it goes without saying, necessary to give business efficacy to the contract, and capable of clear expression
3. the implied term argued for was inconsistent with the comprehensive and carefully articulated regime established by the parties to regulate their termination rights.

## Federal Court

The Full Federal Court in *Virk Pty Ltd (in liq) v YUM! Restaurants Australia Pty Ltd* [2017] FCAFC 190 identified good faith in terms of conduct that can be deemed to be in bad faith. It specified that conduct that is:

- capricious
- dishonest
- unconscionable
- arbitrary
- the product of a motive which was antithetical to the object of the contractual power

will be in bad faith.



# When will the unrestricted exercise of a discretion be permitted?

Courts will assess the purpose for which a party is given a discretion under a contract according to the particular context, and the language of the contract. In addition, courts are generally unwilling to 're-write' the agreement of parties where the parties have been dealing at arm's length, and have willingly entered into the agreement.

Therefore, any implied restriction on the exercise of a contractual discretion can be avoided if it is clear from the language and nature of the contract that the parties intended that the discretion was to be exercised without restriction. The type of language required to preclude any such restriction need only be relatively simple.

# How can Principals avoid a restriction on the exercise of contractual discretions?

Unfortunately, the party exercising a discretion is unlikely to know whether exercising the discretion in a particular manner, or in particular circumstances, is unreasonable or not for a proper purpose until the other party to the contract challenges it. In addition, the party having the benefit of a discretion may not want to have to turn its attention to issues of reasonableness or proper purpose 'in the heat of the moment'. A court will never condone dishonesty or 'capricious or arbitrary' exercise of a power.

Principals should normally seek to avoid these potential uncertainties by including clear language in the contract precluding the imposition of any restriction on the exercise of a discretion. An example of such language is to use the words: 'absolute and unfettered discretion'.

Principals may also want to include a general clause in the contract seeking to exclude the implication of obligations of reasonableness and good faith generally. An example of such a provision is as follows:

*Except where it is expressly stated that a party or another person must act in good faith or reasonably, in exercising a right, power or function under this Contract, the party or person may decide whether and in what manner it does so in its own discretion and is under no obligation to consider the interests of any other person or party. To the full extent permitted by law the parties exclude any implied terms of good faith or reasonableness.*

# How can Contractors ensure that discretions must be exercised reasonably?

Obviously, the existence of absolute and unrestricted discretions in a contract may have a significant impact on the position of the other party to the contract. Contractors should therefore try to include in the contract provisions requiring the Principal to exercise all discretions reasonably and in good faith. This can be achieved using a provision such as:

*The Principal and the Principal's representative must act reasonably and in good faith in determining any matter, or exercising any discretion or contractual right or power, under or in connection with the Contract.*

## Conclusion

All parties to a contract need to consider the implications of unilateral discretions within their contracts and be mindful of the wording of such discretions. For more information on the subject of discretions and the restriction of these discretions within contracts, contact PwC Legal.

# How to contact us



If you have any questions about this paper, please contact the editor, Damian McNair, Partner, Energy Transition.

PwC Australia has a dedicated Energy Transition business, consisting of a hub of 132 multidisciplinary and highly-skilled experts helping to facilitate Australia's successful transition to a decarbonised economy by 2050. We are helping accelerate our clients through the energy transition and their related ESG priorities as Australia moves to a net zero economy.

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