

Unilateral discretion in construction contracts



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Introduction

Construction contracts often give Owners 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 construction contracts give one party (usually the Owner) discretions to make decisions or exercise certain contractual rights. Such discretions are often linked to circumstances such as the approval of work, personnel or sub contractors, 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.

Owners

From an Owner'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 Owner 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 been showing 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 Owners, since it is Owners who primarily have the benefit of such discretions) often prompts Owners to try to avoid any restriction being imposed on the way in which a unilateral discretion is exercised.

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 arms' 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 Owners 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.

Owners 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 as follows:

*10.10 Whether or not the Contractor has made, or is entitled to make, a claim for an extension of time under this clause 10, the Owner may, **in its absolute, sole and unfettered discretion**, at any time from time to time by written notice to the Contractor, unilaterally extend the Date for Practical Completion.*

The Owner is not required to exercise its discretion under this clause 10.10 for the benefit of the Contractor, and has no obligation under this clause 10.10 to grant, or to consider whether it should grant, an extension of time.

Owners 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 Owner to exercise all discretions reasonably and in good faith. This can be achieved using a provision such as:

The Owner and the Owner’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

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