Managers, Contracts and Good Faith – Challenging the Community Expectations Myth

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Abstract

Contracts represent a key device for governing and intermediating commerce. As such, a body of contract law which produces outcomes in accordance with the expectations of commercial actors is a key factor in determining the risk and thus costliness of conducting business within a particular jurisdiction. Both commercial practice and the law of contract change over time. Examples of the former include the increasing recourse to outsourcing, alliances and partnering arrangements while a topical example of the latter represents the growing debate (in Australia) about the existence and role of good faith performance obligations in contract. Proponents of the latter doctrine have asserted that the growing reliance on relational commercial forms evident in business operations means a need for good faith norms within contract. Further, they assert that the commercial community expects and desires this norm shift. This paper describes evidence which provides a contrary view. In short, it is argued that managers place a high degree of value on contractual certainty and look warily at doctrines which would appear to subvert certainty in favour of other values.

Key Words

Contract, Good Faith, Outsourcing, Alliances

1. Introduction

The environment in which commercial exchanges take place has evolved considerably over the past two decades. The embrace of market forces as a means of increasing competition and efficiency has been a global phenomenon which has resulted in significant changes to the manner in which organisations in both the private and public sectors function[1]. Faced with reduced barriers to trade, capital flows and ideas the economies of many nations have been transformed from relatively closed and protected systems to open systems subject to increasingly global market forces[2] . This upheaval at the macroeconomic level has also driven change at the microeconomic level, with organisations being forced to examine new modes of operation consistent with the objective of improving efficiency and maintaining operational sustainability [3].

One consequence of this tide of change has been the growing tendency of commercial and public sector organisations alike to adopt what would heretofore have been viewed as radical devices for governing their operations and interactions with others. Whereas traditional organisational architectures were characterised by a high degree of vertical integration[4] with external exchanges typically orchestrated in a non-cooperative adversarial fashion, more modern approaches to the conduct of "business"[5] operations have emphasised the need for greater trust and cooperation up and down the organisational supply chain[6], the importance of drawing upon external expertise and excellence as a driver of sustainability and competitive advantage[7] and the imperative of less rigid boundaries between organisations[8].

This shift in the underlying reality of organisational operations has not been without implications for contract. The relocation of activity from the internal to the external domain requires some form of governance mechanism in substitution for the bureaucratic governance model possible when as much organisational activity as possible is internalised and market exchanges are configured as one-off, arms length events. A heavy portion of the burden of this transformation has fallen on contract, yet as several authors have noted, there are apparent inconsistencies between the classical understanding of the "contract as promise" and the new, increasingly relational context in which contracts are being deployed as governance mechanisms[9].

Some authors have argued that the tendency towards the use of relational exchanges has transformed the nature of commercial dealings to the extent that relational governance mechanisms[10] have now reduced the importance of traditional formal contractual governance devices[11]. This line of thinking echoes the seminal work of relational contract theorists such as Macaulay[12] and Macneil[13] who argue that the role of contracts in practice differs materially from that which would be predicted according to the precepts of classical contract theory. Macaulay asserts that:

> *"People engaged in business often find that they do not need contract planning and contract law because of relational sanctions…Even discrete transactions take place within a setting of continuing relationships and interdependence. The value of these relationships means that all involved must work to satisfy each other"*[14]

On this approach, the requirement for and legitimacy of good faith contractual performance obligations might appear relatively uncontentious. Even through the fog of uncertainty which surrounds the definition of good faith as it pertains to

contractual performance in Australian law it seems clear that the addition of a good faith requirement[15] infuses a contract with a more "relational" quality than it would have on its face in the absence of such an obligation. In this paper however, it is argued that despite the rise and rise of relational dealings as a feature of the landscape of advanced economies, it is a mistake to leap to the conclusion that the role of contract or the expectations placed upon it by its users has in fact changed materially, or indeed, at all. In particular, It is argued that to view contracts and relationships as commingled rather than coexistent and coextensive is to lapse into analytical and empirical error. This argument is presented as follows. Sections 2 through 4 explore the increasingly important "relational" exchange forms of outsourcing, strategic alliances and partnering arrangements and why it does not follow that the rise of these techniques for governing exchanges between organisations undermines the classical foundations of contract or calls for the infusion into contracts of good faith or other similar constructs. In reinforcement of the arguments presented in these sections, part 5 of this paper presents evidence on the attitudes of Australian business people towards contracts, their interpretation and enforcement. Section 6 offers the paper's synthesis and conclusions, which suggest that notwithstanding the growth in relational interchange, commercial contract users expect that contract law must offer a last line of certainty as a means of moderating the risks associated with the high uncertainty and fluidity of modern relational interchange forms.

2. Outsourcing

The term outsourcing is used to describe a situation in which an organisation procures goods, services or processes from external vendors which it could otherwise have produced in house[16]. The origins of outsourcing activity lay in the relocation of manufacturing activities by multinational corporations into jurisdictions with lower labour costs. The first widespread examples of this were found in the U.S shoe manufacturing industry during the 1950s, when many producers relocated their productive capacity to Latin America[17] . In the 1970s and 1980s, the chief focus of outsourcing activity shifted to East Asia, with significant manufacturing activities being established in Korea, Taiwan, Malaysia and Singapore and then, via the designated Special Economic Zones (SEZs) in China[18].

From these beginnings, the outsourcing juggernaut has grown to such proportions that it is now the rule rather than the exception that large and medium sized organisations (irrespective of whether from the private or public sector) engage in this activity to at least some extent. A clear indication that this is so is found in recent survey evidence gathered by Bain & Co, which indicated that 82% of medium and large organisations across Europe, North America and Asia[19] had outsourcing arrangements of some form in place, and that 51% of medium and large organisations surveyed reported that these outsourcing providers were located offshore[20].

Further, it is by no means accurate to characterise outsourcing arrangements in the contemporary context as limited to the types of manufacturing arrangements which cemented the trend in place as early as the 1950s. Indeed, from the mid 1990s onwards, the greatest growth in outsourcing transactions flowed from services outsourcing deals, with a particular emphasis on the outsourcing of IT capabilities, many of which were not just removed from the organisations in which they had previously been resident, but moved offshore (to destinations such as India) altogether[21]. From that bridgehead, the outsourcing phenomenon penetrated further into the core of many organisations and now commonly impacts on functional areas[22] such as finance, administration, human resources, training, customer care, logistics, procurement, research and development, engineering, direct channel marketing[23] and regulatory compliance[24].

While the traditional explanation for outsourcing activity has been the cost savings associated with the adoption of such a course of action (commonly estimated as falling within the range of 25 – 40%[25] but as much as 80% in offshore IT and software engineering settings[26]), other rationales also exist. For multinational firms, the relocation of various activities into international outsourcing arrangements can assist in the management of foreign exchange risk[27]. The capacity to improve process quality beyond that which could reasonably be expected to be achieved in house[28] and the possibility of improving supply chain dependability[29] have also proved to be strong motivating factors in driving outsourcing decisions.

As outsourcing has outgrown simple contract manufacturing applications and entered the far broader realm of services, the degree to which entire business processes rather than individual components of business processes have become subject to outsourcing arrangements has also grown. Thus while in the early stages of experience with outsourcing, or what some authors have referred to as the developmental stage[30], a particular segment of a business process (e.g the payroll processing component of the finance function) might be subject to an outsourcing arrangement, in more expansive applications of the phenomenon, whole processes (e.g the entire finance department) are outsourced. This is known as business process outsourcing (BPO) and represents the highest stage of development of outsourcing arrangements[31].

The global scale and value of outsourcing arrangements is enormous, and growing at a rapid rate. Recent estimates have the global business process outsourcing (BPO) market at $US319 billion as at 2004, 11% higher than the previous year, with current forecasts for growth in 2005 at 15%[32].Further, it is presently anticipated that this high rate of growth will continue into the foreseeable future, such that by 2007, business process outsourcing arrangements in the field of logistics alone will be as large as the entire global 2004 business process outsourcing market.

In engaging in the outsourcing of entire business processes, not only do organisations expose themselves to the possibility of enjoying high order cost savings, they also have the potential to dramatically increase the responsiveness and sensitivity of their supply chains and materially increase organisational flexibility[33]. By sourcing whole capabilities from providers who have the advantage of scale or enhanced technology, buyers of outsourcing capabilities are in effect leveraging off the comparative advantage of the provider in order to improve their own business performance[34].

The world of outsourcing however, is no utopia. By breaking down the traditional barriers between a firm, its suppliers and its customers, outsourcing arrangements, particularly those at the higher end of the complexity scale (e.g business process outsourcing arrangements), have the capacity

to dramatically increase the complexity and ambiguity inherent in day to day business dealings. Thus it has been observed that in the context of arrangements such as these:

> *"On any given day, AT&T might find Motorola to be a supplier, a buyer, a competitor and a partner.*[35]*"*

Further, by their nature, outsourcing arrangements tend to be struck over medium to long term timeframes, initial time horizons often falling between three to five years[36]. This, coupled with the difficulty of fully conceptualising outcome and service level expectations ex ante and the complexity and resource consumption inherent in the tasks of monitoring and managing outsourcing arrangements mean that in practice they exhibit very high failure rates. One recent study indicates that approximately 25% of outsourcing arrangements will fail within two years, with the mortality rate reaching approximately 50% after five years[37].

The literature on outsourcing provides some useful insights into why the rate of failure of these arrangements is so high. Some of the more common explanations offered include disappointment with the level of cost savings actually achieved within the context of the arrangement[38], underestimation of the financial side effects associated with outsourcing, including the cost of transitioning to the new arrangement and the cost of monitoring the arrangement once in place, as well as failure to deliver to specification by the vendor, and the existence of disputes relating to those items within the agreed service level specifications of an outsourcing contract and those outside it[39].

One other factor which might explain a portion of the difficulties which seem on the face of the empirical record to have arisen so frequently in the context of outsourcing arrangements stems from the fact that it is by no means sound to assume that outsourcing activity is limited only to deals struck between private sector organisations. Public sector organisations in key western jurisdictions have played an enormous role in the development of the size of the outsourcing market[40], yet the nature and extent of their participation in outsourcing arrangements presents a series of challenges distinct from those faced by private sector organisations engaging in outsourcing[41].

One driver of difficulties encountered by public sector organisations engaging in outsourcing arrangements has proven to be the relative lack of commercial sophistication exhibited by those representatives of public sector agencies responsible for negotiating and managing outsourcing arrangements vis a vis the skill set of the representatives of the private sector organisations with whom they have entered into contractual relationships[42]. Further, unlike the position in private sector organisations where the evidence suggests that outsourcing arrangements have not been sought for their own sake or for their perceived symbolic value, but for hard economic reasons[43], there is growing evidence that many of the deals struck by public sector agencies have transpired because of political pressure to be seen to be engaging in activities which ought theoretically deliver better value for public money[44], outsourcing being a sound example of one means of attempting to achieve such an outcome.

Indeed, the public financial management frameworks of a range of advanced western economies (including Australia, New Zealand, the United Kingdom, the Netherlands and Sweden[45] have been characterised in recent research as producing a predisposition towards the use of outsourcing arrangements by public sector agencies[46]. One particular driver of this phenomenon has been the introduction of output based budgetary management models, which are founded on the idea that when governments expend resources, they are to be seen merely as purchasing bundles of identifiable outputs (goods and services which governments consume as a means of pursuing their desired policy outcomes)[47].

Viewed in this light, the identity of the output provider is no longer relevant, and private sector providers can participate freely in the provision of what in more traditional budgetary management systems would have been the exclusive domain of public sector agencies[48]. In practice, this has led in many jurisdictions to public financial management via the so called "yellow pages" principle, according to which any activity previously carried out internally by a public sector agency should be subject to the competitive pressure of an arranged outsourcing bid if that type of activity could theoretically be sourced from a supplier able to be located in the Yellow Pages (or local equivalent) telephone directory[49]. However, the empirical evidence on the operational and financial impact of this flurry of public sector outsourcing activity has generally suggested that the savings and other operational benefits expected ex ante to be generated as a result of the use of these structures have not in fact materialised ex post[50], and that failure rates in public sector outsourcing arrangements have been substantial[51].

The evidence then, is that while there has been enormous growth in the recourse to the use of outsourcing arrangements on a global basis in both the public and private sectors, the use of this strategy by organisations has been far from problem free. Outsourcing arrangements tend to require extensive commitment over the medium to long term. They are difficult to control in the sense that ex ante contracts defining outsourcing arrangements are likely to be incomplete. They result in traditional barriers between organisations being broken down because vendors may actually be effectively internalised in the sense that they may take over entire (often key) business processes[52]. This in turn heightens inter-party reliance (strategic capabilities being moved from purchaser to provider) and ultimately, vulnerability.

Thus, despite the emphasis often placed on the relational qualities of outsourcing arrangements, it is as well to at all times bear in mind that the relationships which may arise in the context of such arrangements represent merely a means to an end, not an end in themselves. The underlying substance of the arrangements is still sharply commercial, and the requirement to manage risk as tangible for the parties as would be the case given any other combination of forms chosen to govern their economic activities. Thus, even if in the context of the day to day realities of outsourcing arrangements notions such as trust, forbearance, flexibility and tolerance[53] substitute for formal contractual control as the essential components of inter party governance, the formal contract still represents a vital norm of final appeal[54]. That recourse may not be had to this norm on a frequent basis, or perhaps at all (in the context of a successful arrangement) does not derogate from its importance – indeed, it arguably accentuates it, as will also be the case in other non traditional governance forms, for example, strategic alliances, discussed below in section 3.

3. Strategic Alliances

If commercial activity is characterised as transpiring across a continuum of different forms, defined at one extreme by activity carried out via pure arms length market transactions and at the other by activity carried out within the boundaries of an integrated hierarchy (for example a corporate form entity), then the strategic alliance as a form for governing commercial activity lies towards the centre of the spectrum[55]. As such, a strategic alliance represents an organisational structure used to govern an incomplete contract (or series of incomplete contracts) between separate organisations each of which only has limited control over the resulting arrangement[56].

This form of governance structure resembles the common joint venture form in many ways, but also differs in significant respects, the most important of which is that in joint ventures, the contracting parties typically form a new distinct venture organisation through which to administer activities[57]. As a consequence, control rights as between joint venture parties can be argued to be more clearly delineated ex ante than in the case of strategic alliances where because the parties remain separate entities there is no tightly defined convergence of their interests or actions[58].

Thus strategic alliances are best understood as a complex hybridised governance form, incorporating design features drawn from both ends of the organisational form continuum. On the one hand, strategic alliances can be argued to resemble market based governance forms in the sense that the parties to such arrangements remain separate from one another and do not create a formalised fused entity through which to direct their activities. This separateness suggests a strong retained element of self interest on the part of the alliance's participants, and hints at the risk that alliance members might be subject to the opportunistic actions of other members[59]. On the other hand, aspects of the manner in which strategic alliances function as governance devices have been likened to the operating patterns of internal firm hierarchies in that the parties to alliances agree to coordinate their actions, participate in joint decision making and practice mutual forbearance[60].

Traditionally, economists have theorised that a key rationalisation for the existence of business firms (that is, the internalisation of activity rather than the conduct of such activity via a series of arms length open market transactions) is their efficiency as a means of resolving the incomplete contracts problem[61]. That is, in situations where it is not practical to completely specify that which a counterparty is required to do, the resulting contract renders the parties to it vulnerable to ex post opportunistic behaviour. In these situations, the removal of the transaction from the external domain (the market, governed by incomplete contracts) to the internal domain (within the boundaries of the firm) reduces the risks and costs associated with opportunism. However, while internalisation or "integration" of activity into the boundaries of a single organisation has long been regarded as an effective solution to the problem of incomplete contracts, it is by no means a unique solution to the problem.Strategic alliances represent an alternative mechanism for the governance of incomplete contracts.

While comparatively rare until the mid 1980s, the past two decades have witnessed a dramatic growth in the use of strategic alliances[62]. For example, the rate of strategic alliance formation in the United States increased fifteen fold between 1985 and 2000[63]. As such, strategic alliances have become commonplace in industries such as aviation, biotechnology, shipping, pharmaceuticals, real estate development and computing[64].

Because of their inherent flexibility, strategic alliances take on a wide variety of forms. In some cases, alliances may be characterised as vertical in form, denoting an alliance relationship between a supplier and a buyer. Successful vertical alliances have a dramatic impact on the nature and management of a buyer organisation's supply chain. Whereas traditional supply chains were characterised by adversarial relationships with multiple (redundant) suppliers[65], low trust and low transparency, supply chain alliances tend to result in the reliance by the buyer on far fewer suppliers, greater trust[66] between buyers and suppliers and far greater transparency[67]. In consequence of the radical rescripting of the relationship between buyers and sellers facilitated by vertical form strategic alliances, the boundaries between supplier and buyer organisations become considerably less well defined than in traditional supply chain settings[68].

Similar blurring effects are also seen in the context of alliances taking other forms. For example, in horizontal alliance arrangements (between organisations producing the same or similar services or products), the infrastructure and customer base of one alliance organisation also falls within the grasp of other alliance members. Airline and shipping alliances provide an excellent and highly visible example of this. The aircraft which flies a particular leg may be controlled and operated by one carrier, the ground handling arrangements by another and seats on the aircraft may be jointly and simultaneously marketed (under their own brand names) by several carriers simultaneously[69]. Under these conditions, the ownership of the "metal"[70] is not a matter of fundamental importance, and the capacity to do business and project brand visibility transcends the limits of any individual party's network and infrastructure capacities[71].

In other forms, alliances are formed to mix complementary capabilities. For example, alliances may be formed which match the technological capabilities of one organisation with the marketing or distribution capabilities of another, a very common theme in the pharmaceutical and biotechnology industries[72]. Here again, the distance between the organisations which are party to the arrangements narrows, the commonality of their risk bearing increases and their relationships becoming more symbiotic[73].

Notwithstanding the commercial benefits which can be brought about as a result of the decision to enter into strategic alliances with other organisations, as with the case of outsourcing discussed in section 2 above, the empirical evidence relating to strategic alliances shows them to suffer from "notorious instability"[74]. Part of this instability can be explained by reference to the relative lack of rigidity exhibited by governance forms such as strategic alliances when compared against similar structures such as joint ventures (the unwinding of which will generally require changes in ownership or in extremis, unwinding of formally constituted joint venture entities). Part can also be attributed to the fact that the fires of self interest are never entirely quelled in the context of a strategic alliance.

Ultimately, as in the case of outsourcing arrangements, while it may be that the parties to a strategic alliance forge closer relationships with each other than would be the case were a more adversarial, arms length approach to configuring commercial dealings adopted, the relationship itself is merely a means to an end. The empirically demonstrated instability of strategic alliance arrangements speaks volumes about the disposability of pre-existing relationships in the pursuit of enhanced business performance, the relative lack of hierarchical rigidity inherent in strategic alliance arrangements being especially convenient when the time for reformulation has come. Especially at these points of strategic inflexion, and where the fires of opportunism have risen above the quelling force of relational cooperation[75] recourse to as certain a set of norms of final appeal as possible will be of strong importance again suggesting the vital role of contract and its importance in yielding certainty and thus framing and containing risks.

Given the benefits which can flow from the adoption of less rigid transactional architectures and approaches to the execution of commercial arrangements, it is not surprising that other approaches to configuring and optimising long term business dealings have also emerged. An increasingly important exemplar of this trend is the use of partnering arrangements, discussed in section 4 below.

4. Partnering Arrangements

Unlike outsourcing arrangements and strategic alliances which have ranged across essentially every sector of the economy, partnering agreements have not been widely used outside of the construction and engineering sector in which they saw their genesis[76]. The partnering concept is said to have first visibly emerged in the mid 1950s as the result of an effort by the United States Department of Defence to better manage the complex and highly costly Fleet Ballistic Missile Program[77]. Subsequently, it was the continued high profile reliance on the partnering process by the United States defence establishment (for example by the United States Army Corps of Engineers which by the early 1990s was using partnering for all its construction projects) which saw the growth in use and recognition of the technique throughout the United States and internationally[78].

Despite its concentration within a limited range of industry settings, partnering does represent an important commercial phenomenon. Therefore, a review of its meaning and application assists in the development of a more refined understanding of how the configuration of commercial dealings has changed over the past two decades. An understanding of this phenomenon has implications for the analysis of the role to be played by contracts in moderating and facilitating commerce.

Given that partnering represents more an approach to moderating and optimising the relationships between commercial actors rather than specifically configuring their dealings, it is not surprising that attempts to provide neat and crisp formulations of the partnering concept have proved elusive[79]. Not surprisingly therefore, the relevant literature abounds with definitions. In attempting to clarify the meaning of the term, some authors have placed particular emphasis on the idea that partnering is founded on a relationship of considerable longevity which transcends the bounds of individual projects[80]. Here the chief idea appears to be that partnering orients the parties to view their dealings with each other not as discrete episodes of limited duration, but as having a deeper, longer and more textured character.

Other authors concentrate less on questions of duration, but more on issues of relationship orientation, claiming that the essence of partnering arrangements is to be found in a successful transition from a “them and us” attitude towards business counterparties to a “we” approach to dealings undertaken[81]. Some authors have attempted to render the matter less recondite by suggesting that partnering is to be best understood as a cooperative approach taken to contract management by the parties to the contract with a view to reducing conflict, the resort to formal dispute resolution mechanisms and therefore cost and stress[82]. In an Australian context, a commonly used working definition of partnering is that coined by the Construction Industry Institute of Australia which defines partnering as an explicit, voluntary, legally informal, cooperative arrangement between two or more parties involved in some common endeavours, the aim being to maximise the efficiency of resource utilisation and to minimise conflict[83].

Overall then, partnering may be seen as a management process employed to overcome an adversarial or litigious approach to the conduct of commerce. In doing so, partnering uses structured procedures involving all project participants to define mutual goals, improve communication and develop formal problem solving and dispute avoidance strategies. Though because of the informal nature of partnering arrangements when compared against the relatively more visible nature of outsourcing arrangements and strategic alliances there is a lack of systematic evidence as to the value of contracts which have been managed subject to partnering principles or the collective results of such efforts, some empirical evidence on the impact of partnering arrangements in practice has nonetheless emerged.

Evidence exists which suggests that parties who have successfully undertaken partnering arrangements have reduced the extent to which various actors engaged in construction projects have carried out redundant activities (an important consideration given that construction projects often rely heavily on the integrated and coordinated activities of a significant number of different participants), hence saving time and cost[84]. Evidence also suggests that the use of partnering arrangements can serve to reduce the frequency of relationship termination[85], reduce the incidence of cost overruns and time overruns on projects[86] and significantly reduce the incidence of litigation[87]. Still other empirical studies have concluded that partnering arrangements result in fewer lost work days, fewer instances of requests for rework, smaller claims numbers and higher client satisfaction when compared against work carried out in the absence of partnering arrangements[88].

As significant as these findings are in a commercial sense, there is no suggestion within the literature that this technique represents anything other than an evolved relationship management methodology. Where partnering fails, the implicit assumption of the literature is that the hard edges of the contract still exist, and options such as litigation remain viable.

5. Evidence on Attitudes of Business Users Towards Contracts

The discussion of outsourcing, strategic alliances and

partnering arrangements set out in sections 2 through 4 (above) demonstrate the extent to which the nature and structure of commercial interactions have evolved over the past two decades.It was demonstrated that one key result of the growth in recourse to outsourcing arrangements, strategic alliances and other commercial constructs characterised by higher relational dependence, less (planned) transience and greater external focus has been a growth in the role of contract as a governance device. Equally, it was argued that the metamorphosis in the form of commercial constructs used by organisations in the pursuit of greater efficiency, effectiveness and strategic sustainability placed contract itself in a changed context.

However, it was also contended that it did not follow that the increasingly relational context of contract lent itself to the need for a fundamental reinterpretation of contract itself. Rather, it was suggested that higher context ambiguity and fluidity accentuated the need for contract to act as a firm, estimable norm of last appeal. On this view, relational exchange arrangements and formal contractual controls are not seen as substitutes[89] and nor are formal contractual frameworks viewed as antithetical towards the development and maintenance of relational cooperation and minimisation of inter party opportunism[90]. Instead, it is posited that the capacity to have predictable recourse to well defined contractual requirements is better viewed as complementing relational exchanges and may serve to reduce rather than increase inter party opportunism[91]. If this were so, then there would be little reason to believe that the expectations of commercial actors towards contracts had, in the presence of a growing prevalence of relational interchanges, exhibited less interest in contractual certainty and more interest in fairness, forbearance, reasonableness and other similar constructs which might be argued to fall broadly within the good faith panoply.

A growing body of literature makes it evident that one of the key threads of the arguments advanced in favour of the adoption of good faith performance obligations as a feature of the Australian law of contract has been a resort to assertions that community expectations were aligned with such a requirement. Equally, however it is desirable to point out that little if any empirical evidence had been produced in support of such claims. Indeed, the Australian literature is almost devoid of systematic evidence which might profitably shine light on the question of "community attitudes" towards contract. The one identified exception to this general tendency was a paper published by Gava and Kincaid[92] in which the authors reported the results of a survey of practising barristers from NSW[93] in relation to their attitudes to aspects of the law of contract.

The Gava and Kincaid survey was based on an instrument consisting of ten pairs of propositions, one offering a traditional perspective on an element of Australian contract law, the other offering a more "modern" perspective. Respondents were asked to choose which proposition most closely represented the existing state of the law, and which proposition ought represent the law. The seventh pair of propositions put to respondents to Gava and Kincaid's survey related directly to the question of good faith performance obligations. The first proposition (which the authors used to capture the "traditional" position) in the "good faith pair" was that:

> *"In the performance of a contract, each party has a duty to carry out its obligations under the contract honestly and a right to insist on the strict performance of the duties owed to it under the contract"* [94]

The second was that:

> *"In the performance of a contract, each party is under a duty of good faith which requires it to temper its insistence upon its strict rights under the contract by taking into account the interests of the other contracting party."*[95]

When asked which of the above statements reflected the existing law, 90% of respondents chose statement one (indicating a preference for the traditional position). When asked what ought the law to be, 69% (a very clear majority) of respondents still opted for the "traditional" position by choosing statement one. The preferences expressed by the respondents to the Gava and Kincaid survey appear to contradict the assertions made by Justice Priestley with respect to community expectations in Renard. Further, though Kincaid and Gava's survey evidence was prominently published prior to the construction of Justice Finn's reasons in *Hughes Aircraft Systems International v Airservices Australia*[96], no reference was made to this evidence in the context of his Honour's comments relating to community expectations in that case. This is surprising, to say the least.

While the Gava and Kincaid survey results are of undoubted interest and importance, in the context of the current research they are also subject to two key limitations. First, they are now somewhat dated and as the empirical evidence discussed in chapter four shows, much water has flown under the good faith bridge in Australia since 1996. Second, the Gava and Kinkaid survey was directed entirely towards legal practitioners – and more specifically, barristers practising in NSW. This means that the views of other important stakeholder groups, most particularly commercial users of contracts, may not have been reflected. Arguably this represents an important omission. Though administered and framed in a legal context, contracts are tools of commerce and thus of people engaged in commerce. It is thus unwise and inappropriate for the legal community to infuse changes to the landscape of commercial contract which run contrary to the expectations and understandings of the key users of the tool. Yet to date, no systematic published evidence relating to "commercial user" attitudes towards contracts has been available to shed light on the good faith debate.

Consequently, it was thought appropriate to remedy this evidentiary gap by designing and executing a survey of the attitudes of "commercial users" towards contracts[97]. The presentation of the survey was influenced by the desire to keep the survey instrument as clear, simple and brief as possible, with a view to eliciting a better response rate and a higher degree of accuracy and meaning in answers[98]. Questions were formulated to measure, as directly as possible, the key constructs under review, to be as direct and lacking in ambiguity as possible and in such a way that specialist legal knowledge would not represent a prerequisite to the capacity of a participant to appropriately respond to each question[99].

The resulting survey instrument consisted of seven propositions relating to contracts (discussed below), with participants invited to indicate their response to each of the seven propositions by selecting a response most closely matching their degree of agreement or disagreement, chosen from a seven point Likert scale[100]. The survey participants were all Australian managers currently in full time employment across a range of industries including professional services, IT, media,

construction & engineering, health care, pharmaceuticals, manufacturing, mining and the public sector. A total of 387 survey instruments were distributed to individuals in management positions in the above industries during 2004 and 182 complete and useable responses was generated, a response rate of approximately 47%.

As indicated above, the survey instrument required participants to respond to seven propositions relating to contractual rights and obligations. The first three propositions were designed with Gava and Kincaid's good faith propositions in mind, but whereas Gava and Kincaid conflated the issue of honesty in performance and capacity to insist on strict performance of contractual duties into one question (the "traditional proposition), these two issues were dealt with discretely for the purposes of this survey. Gava and Kincaid's alternative ("modern") good faith proposition thus became the subject of the third proposition in this survey.

The first proposition in the present survey instrument read:

> *"In the performance of a contract, each party has a duty to carry out its obligations under the contract honestly".*

On a scale from 1 through 7 (where 1 indicated strong disagreement and 7 indicated strong agreement), the mean value of responses to this first proposition was 6.04, with a standard deviation of 1.08. This indicates that survey participants were of the view that honesty is an important element of the manner in which parties to contracts go about the business of performing their obligations pursuant to such agreements. An analysis of the response frequencies for each possible response to proposition one is shown in Chart 1, below. Only five of one hundred and eighty two respondents disagreed with the proposition that parties to contracts have a duty to perform their obligations with honesty.

No other recorded responses disagreed with or took a neutral view of proposition one. Twenty seven respondents indicated mild agreement with the proposition, eighty five indicated agreement and sixty five indicated strong agreement. This suggests that a good faith requirement limited to "honesty" would not be contentious among commercial contract users.

As indicated in Chart 1, the second proposition put before respondents to this survey was designed to discretely examine the question of attitude towards insistence on strict performance, something which was not achieved in the Gava and Kincaid survey by reason of the conflation of reference to honesty and strict performance in their "traditional" propositional statement relating to good faith.

For the purposes of this survey, proposition two stated that:

> *"In the performance of a contract, each party has a right to insist on the strict performance of the duties owed to it under the contract."*

On a scale from 1 through 7 (where 1 indicated strong disagreement and 7 indicated strong agreement), the mean value of responses to this proposition was 6.21, with a standard deviation of .63. The data gathered in response to this proposition displays several noteworthy features. First, as demonstrated in Chart 2, there were no recorded instances of survey participants taking either a neutral view of, or disagreeing with proposition two. Thus, all respondents agreed (twenty one mildly so, one hundred and two with no qualification and fifty nine strongly so) that each party has a right to insist on the strict performance of duties owed under the contract. The higher mean response score and lower response dispersion recorded for proposition two when compared to proposition one (mean values of 6.21 versus 6.04 and standard deviation of .63 versus 1.08) suggests a stronger preference for the certainties associated with the capacity to insist on strict performance than even for honesty in performance and suggests that commercial users would not accept good faith obligations were they to interfere with clarity of performance requirements.

The third proposition put to participants in this survey

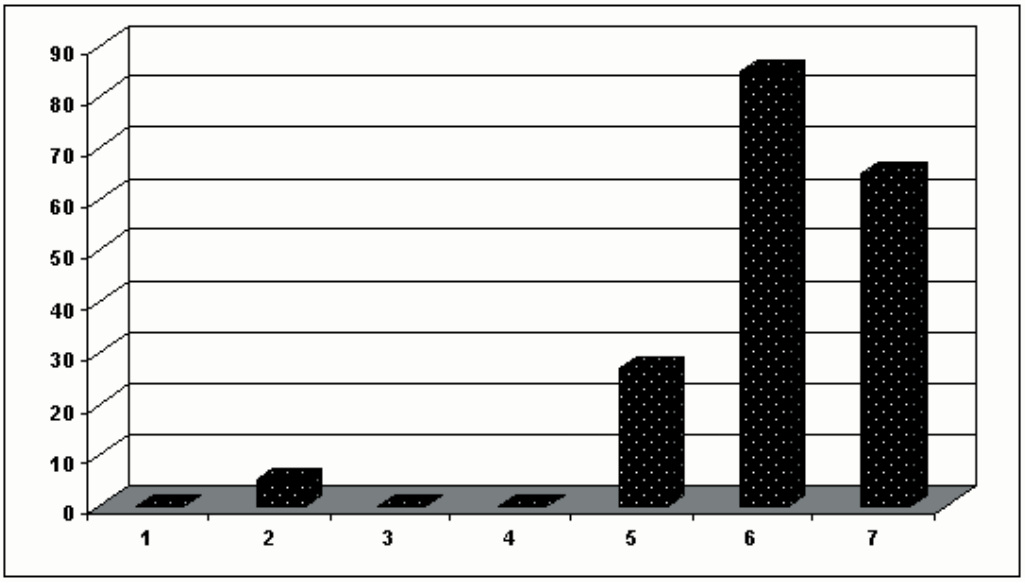

Chart 1 - Proposition 1 (Role of Honesty) – Response Frequencies

n = 182

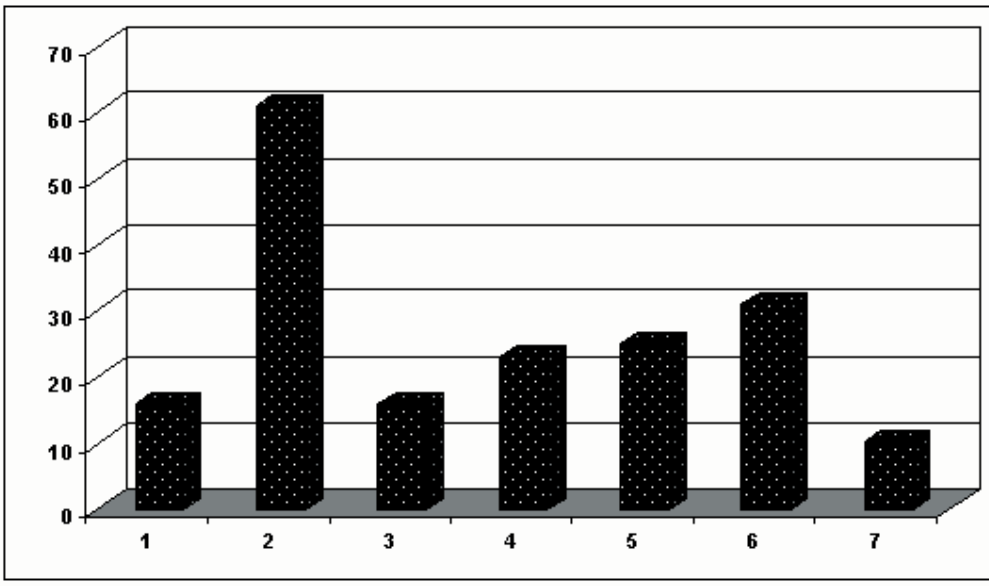

Chart 2 - Proposition 2 (Role of Strict Performance) – Response Frequencies

n = 182

was a replication of Gava & Kincaid's second good faith proposition. Response frequencies are set out in Chart 3. Proposition three read:

> *"In the performance of a contract, each party is under a duty which requires it to temper its insistence upon its strict rights under the contract by taking into account the interests of the other contracting party."*

On a scale from 1 through 7 (where 1 indicated strong disagreement and 7 indicated strong agreement), the mean value of responses to this proposition was 3.62, indicating that the attitude taken by participants lay between mild disagreement and neutrality. This broadly aligns with the response elicited to this proposition by Gava & Kincaid in their survey of legal practitioners[101]. The standard deviation of the response scores was 1.85, higher than for any other proposition contained within the survey instrument and indicating that this proposition proved somewhat controversial.

A total of 93 respondents expressed disagreement with this proposition (16 strongly so, 61 without qualification and a further 16 mildly so), but, in contrast, 66 respondents indicated their agreement (25 mildly so, 31 without qualification and 10 strongly so). Thus while the data does not suggest strident rejection by commercial contract users of the notion of tempering insistence on strict legal rights and taking account of the other party's interests, neither does it suggest that commercial contract users would welcome such a requirement as a feature of Australian contract law.

The fourth proposition put to respondents to this survey required them to weigh certainty of outcome with potential harshness of result. This proposition, the response frequencies to which are contained in Chart 4, stated that:

> *"In commercial dealings, if the parties have had every opportunity to take advice and if the terms of contracts have been carefully negotiated and are well known to the parties, the law should enforce a party's insistence on its strict rights even where the outcome might be harsh for another party."*

On a scale from 1 through 7 (where 1 indicated strong disagreement and 7 indicated strong agreement), the mean value of responses to this proposition was 5.63, indicating that the attitude taken by participants lay between mild agreement and unqualified agreement (though closer to the latter than the former). The standard deviation of the response scores recorded in relation to this proposition was 1.02, lower than for any other proposition on the survey instrument except for proposition two, which related to the right to insist on strict performance of duties owed pursuant to contract.

Indeed, it is interesting to compare the aggregated response data to propositions two and four, since the latter could be taken as a slightly qualified version of the former. Note that whereas in proposition two, respondents were asked (without more) to indicate their attitude towards the strict enforcement of contractual rights, in proposition four, they were prompted to think about the potentially harsh consequences of such a course of action[102].

The response data suggests that the addition of the "harshness of outcome" element did alter the attitudes of survey respondents to the question of the right of a party to insist on its strict rights (without regard to the interests of other parties), but not dramatically so. Whereas the mean response score to proposition two in which respondents were not prompted to weigh harshness against the capacity to insist on strict performance was 6.2 (standard deviation .63), this fell to 5.63 (with an enlarged standard deviation of 1.02) in the case of proposition four, where respondents were explicitly asked to contemplate their views in light of potentially harsh outcomes.

Overall, the data suggests that respondents did believe that harshness of outcome was a factor of potential concern, but not one which carried so much weight as to undermine a strong apparent preference for the certainty associated with enforcing the negotiated words of the agreement. If a good faith requirement were to weigh avoidance of harshness or unfairness more heavily than the capacity to require execution of contracts according to their agreed negotiated terms, this

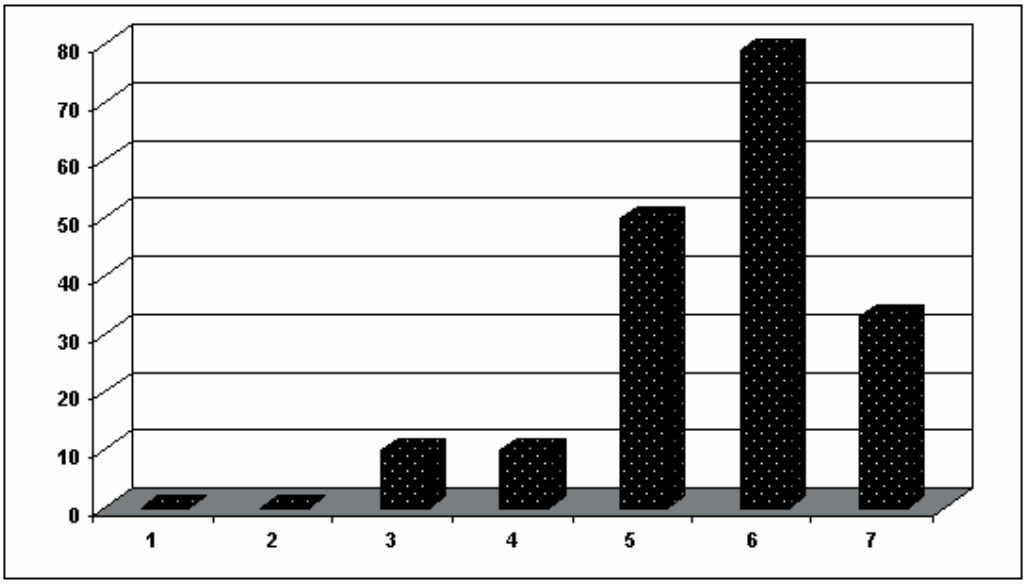

Chart 3 – Proposition 3 (Temper Strict Performance) – Response Frequencies

n = 182

would appear to contradict the expectations of commercial contract users.

The fifth proposition put to respondents to this survey required them to weigh the desirability of fairness against the desirability of the capacity to enforce strict legal rights. This proposition, the response frequencies to which are contained in Chart 5, below, stated that:

> *"In commercial dealings, irrespective of the opportunity to take advice and the advance notice of contractual terms, commercial standards of conduct suggest that considerations of fairness should prevail over the enforcement of strict legal rights."*

On a scale from 1 through 7 (where 1 indicated strong disagreement and 7 indicated strong agreement), the mean value of responses to this proposition was 3.53, indicating that the attitude taken by participants lay between mild disagreement and neutrality. The standard deviation of the response scores recorded in relation to this proposition was 1.61.

Although this question split the participant group, with 97 indicating disagreement (15 strongly so, 48 without qualification and a further 34 mildly so) against 64 in agreement (43 mildly so, 16 without qualification and a further 5 strongly so), indicating that the notion of fairness as an objective of the law of contract resonated with some, the attractiveness of this idea was insufficiently strong to outweigh a preference for the enforcement of strict legal rights.

The observed response results for proposition five are consistent with those observed for previous strongly related propositions (three and four). This provides comfort as to the construct validity of this group of propositions, the lack of apparent contradiction between the observed mean responses to these suggesting that survey respondents understood that which was being proposed to them and responded commensurately.

The sixth proposition put to respondents to this survey required them to weigh the effect of contract duration on the importance of being in a position to enforce the negotiated terms of an agreement. This proposition, the response frequencies to which are contained in Chart 6, stated that:

> *"In contracts of longer duration, an ability to have recourse to and be in a position to enforce the negotiated terms of a contract diminishes in importance."*

On a scale from 1 through 7 (where 1 indicated strong disagreement and 7 indicated strong agreement), the mean value of responses to this proposition was 3.48, indicating that the attitude taken by participants lay between mild disagreement and neutrality (though closer to the former than the latter). The standard deviation of the response scores recorded in relation to this proposition was 1.71.

This suggests that even in the context of longer term arrangements such as those likely to be encountered in relational settings such as outsourcing structures and strategic alliances, contract users still place stock in the capacity to have recourse to known negotiated contract terms.

On this view, although the relationships between actors may have been subject to numerous adjustments over time, some degree of importance is still nonetheless placed on the existence of a bedrock of contractual terms which may be referred to in cases where informal adjustments and forbearances do not represent an optimal or useful solution to a particular situation or difficulty. Were a good faith requirement to operate in a manner which reduced the capacity to have recourse to known negotiated contractual terms in part because of contextual factors such as the duration of dealings between parties, this would appear to conflict with the aggregate expectations of commercial contract users.

The seventh and final proposition put to respondents to this survey required them to weigh the desirability of certainty against the desirability for fair outcomes in the context of complexity, ambiguity and extended relational duration. This proposition, the response frequencies to which are contained in Chart 7, below, stated that:

> *"As the ambiguity, duration and complexity of contractual*

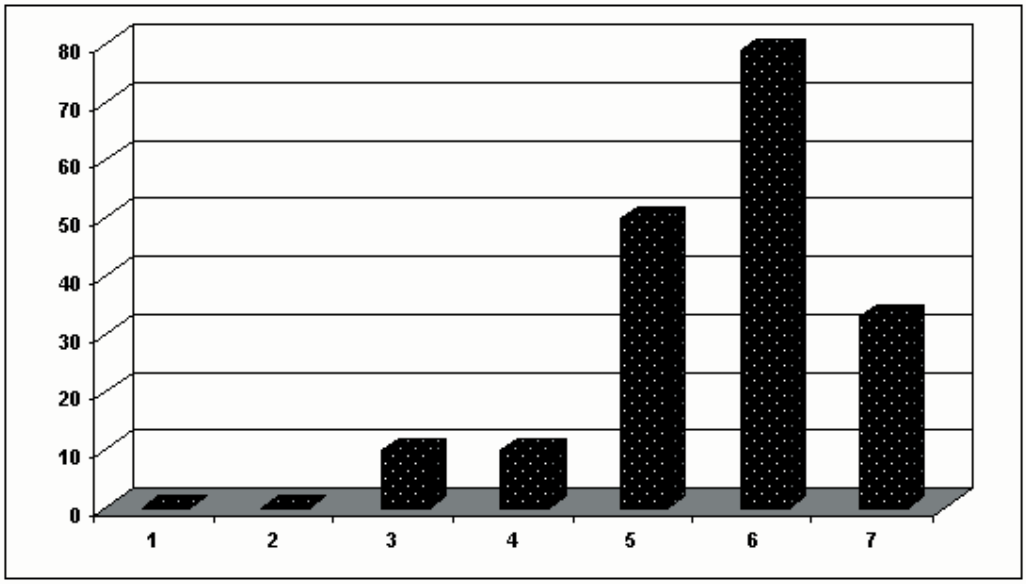

Chart 4 - Proposition 4 (Strict Performance / Harshness) – Response Frequencies

n = 182

dealings increase, considerations of fairness grow in importance while considerations of certainty diminish in importance."

On a scale from 1 through 7 (where 1 indicated strong disagreement and 7 indicated strong agreement), the mean value of responses to this proposition was 3.71, indicating that the attitude taken by participants lay between mild disagreement and neutrality (though closer to the latter than the former). The standard deviation of the response scores recorded in relation to this proposition was 1.59

The types of "relational" governance mechanisms discussed in sections 2 through 4 above could all be expected to exist within an operational environment characterised by ambiguity and complexity (hence the need for flexibility and the usefulness of not completely specifying contracts ex ante) and to be cast over medium to long timeframes. There can be little doubt that within the context of the relationships which evolve between parties to such structures, behavioural norms such as fairness and restraint are of value and importance[103] . On the other hand, because of the need to manage risks brought about as a result of heightened inter party reliance and vulnerability in the context of such relationships, the desire for certainty also represents a factor of significance.

In studying the response data to this proposition, it is instructive to note that the single largest clustering of respondents (sixty five in total, or slightly more than one third of the total number of respondents) indicated their unqualified disagreement with the notion that in the presence of the type of environmental factors one might typically associate with relational exchanges (complexity, ambiguity and long duration), notions of fairness would begin to loom larger and considerations relating to certainty would grow smaller.

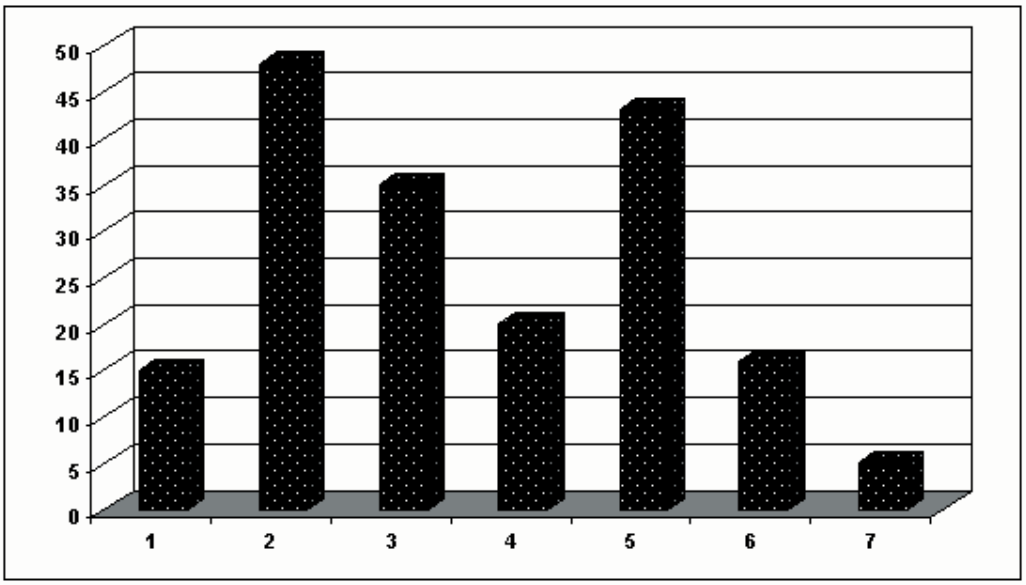

Chart 5 - Proposition 5 (Fairness / Strict Performance) – Response Frequencies

n = 182

Thus although the response data shows some sensitivity on the part of respondents to the desirability of relational attributes such as fairness, on balance, irrespective of the increasing frequency and magnitude of relational exchange transactions, the apparent preference of respondents is the capacity to have recourse to known, predictable ex ante specified norms. To the extent that concepts such as good faith performance obligations altered the orbit of contract further from the axis of certainty and closer to the axis of fairness and reasonableness, even in the context of long duration, high complexity and ambiguity, this would appear to conflict with the expectations of commercial contract users.

6. Conclusions

In this paper, it has been argued that the manner in which commercial and public sector entities have ordered their affairs and configured their "business processes" has undergone significant change over the space of the past two decades. One consistent feature of these changes was the increased external orientation of organisations engaged in the quest for greater financial and operational sustainability, a factor which in turn was argued to have significance for contract both in terms of an increased range and frequency of recourse to contract as a tool for governance as well as the changing context in which contract was being applied.

However, contrary to the suggestion evident in some literature that the shifting patterns and contexts of contract employment have resulted in a need driven partly by changing community expectations for a revision of the law of contract, for example by means of the infusion of implied good faith performance obligations (in deference to the new relational setting of contract), it has been argued in this paper that there is no reason to believe that the new relational context of contract of itself requires such a change. Indeed, a preference for certainty is a clear central theme evident in the empirical data discussed in this paper.

Further, the empirical evidence discussed above suggests that commercial users of contract do not appear to have attitudes and expectations of contract consistent with those which might be expected of a contractual regime laced with notions such as good faith. This suggests the importance of viewing business relationships and the contracts which exist in the context of those relationships as separate rather than as fused constructs, and of avoiding the analytical error of conflating the norms one might expect in one domain with those which might be demanded in the other.

Although the survey response data does demonstrate a sensitivity, on the part of respondents to the desirability of factors such as honesty in contractual dealings and to a more limited degree for some sense of fairness and restraint in the insistence on strict contractual rights, the overall sense gleaned from the data is nonetheless that on balance, certainty is the matter of paramount concern for commercial users of contract.

This view of affairs appears to be in considerable contrast with the sanguine, but apparently not empirically informed statements relating to changing community expectations relied upon by members of the Judiciary such as Justice Priestley and Justice Finn[104] as components of their arguments in favour of the broad based adoption of implied good faith performance obligations as a persistent and pervasive element of the Australian law of contract.

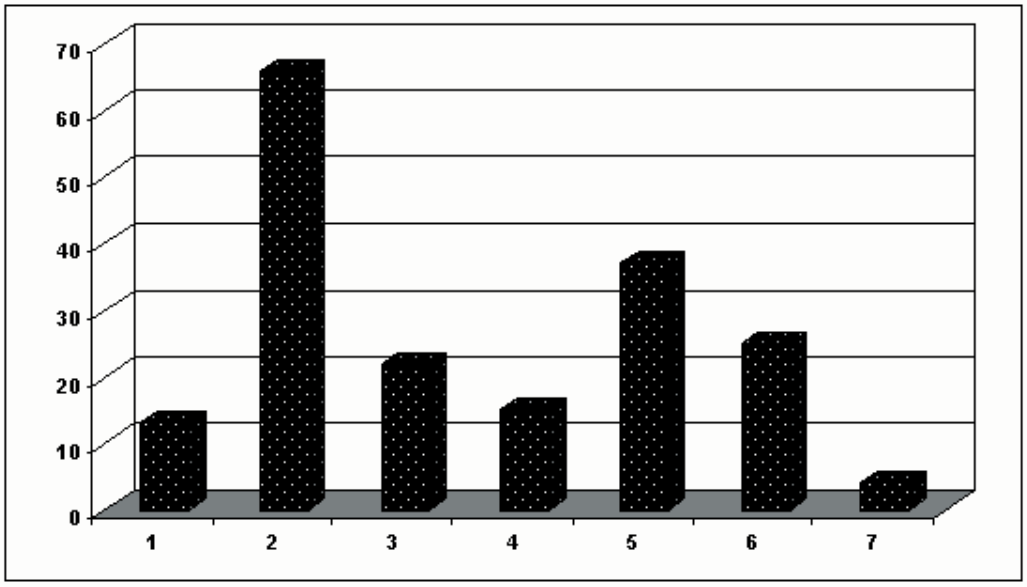

Chart 6 - Proposition 6 (Long Duration / Enforce Terms) – Response Frequencies

n = 182

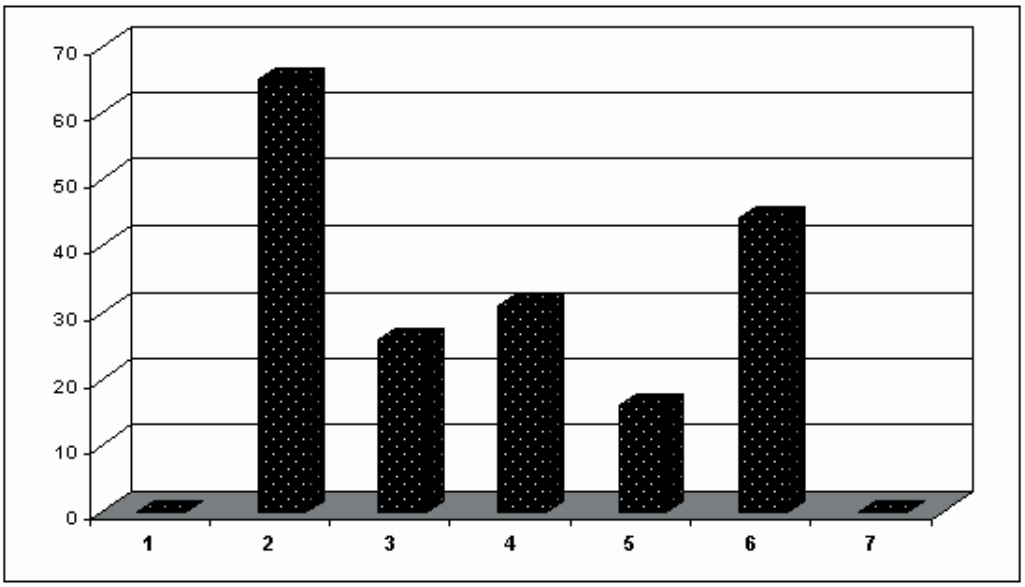

Chart 7 - Proposition 7 (Duration / Certainty) – Response Frequencies

n = 182

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66. For example suppliers rather than buyers look after quality control, replenishment and in certain cases, product design issues. In traditional contractual / adversarial supply chain systems, these functions would typically be the exclusive preserve of the buyer organisation.

67. For example, it is well documented that Wallmart's internal inventory database is open to its suppliers. The data in a retailer's inventory management system would normally be treated as highly confidential, but Wallmart provides suppliers with access to this data and then allows suppliers to carry out just in time replenishment of stock lines direct to stores. This saves all parties considerable cost, and significantly reduces the amount of inventory which Wallmart is forced to carry in order to conduct business. See; J Peters & A Hogensen, "New Directions for the Warehouse" (1999) *Supply Chain Management Review, Spring*, pp. 23-25.

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69. Airline strategic alliances also frequently encompass key areas such as procurement, maintenance and even extend to crew sharing facilities in some cases.

70. This is a common aviation industry term for the aircraft itself. Thus, in an alliance context, carrier A may market and ticket seats under its own name, but the "metal" (the aircraft) may be owned and operated by carrier B which has itself marketed and ticketed sales on the same flight under its own name. In this way, the brand and network presence of each of carrier A and B leverages not only off the infrastructure owned and controlled by A and B individually, but also by the infrastructure of A and B collectively.

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92. J Gava and P Kincaid, "Contract and Conventionalism: Professional Attitudes to Changes in Contract Law in Australia" (1996) 10 *Journal of Contract Law* 141.

93. According to the authors, the total population of barristers in NSW was 1858 at the time they undertook their study. Of these, 450 were mailed a survey instrument to complete. The authors received a total of 97 useable completed surveys, a response rate of 21.6%. See; J Gava and P Kincaid, "Contract and Conventionalism: Professional Attitudes to Changes in Contract Law in Australia" (1996) 10 *Journal of Contract Law* 141 (at 142).

94. J Gava and P Kincaid, "Contract and Conventionalism: Professional Attitudes to Changes in Contract Law in Australia", (1996) 10 J*ournal of Contract Law* 141 (at 165).

95. J Gava and P Kincaid, "Contract and Conventionalism: Professional Attitudes to Changes in Contract Law in Australia", (1996) 10 *Journal of Contract Law* 141 (at 165).

96. (1997) 146 ALR 1.

97. Following J Collis & R Hussey, *Business Research*, (2003), Second Edition, Palgrave Macmillan, New York, p.173.

98. J Gattorna, W Selen & R Ogulin, *Characteristics, Strategies and Trends for 3PL/4PL in Australia*, (2004), available at www.laa.asn.au/research_report

99. R Czaja & J Blair, *Designing Surveys, A Guide for Decisions and Procedures*, (1996), Sage, London.

100. The scale was constructed as follows: 1 = Strongly Disagree; 2 = Disagree, 3 = Mildly Disagree; 4 = Neutral, 5 = Mildly Agree; 6 = Agree; 7 = Strongly Agree.

101. Recall, as discussed above, that 90% of the respondents to the Gava & Kincaid survey thought that the traditional (non good faith) position was the law, and 69% thought that the traditional (non good faith) position ought to be the law.

102. Note that proposition four also included admonitions relating to the opportunity to take advice, the care with which the contract had been negotiated and the degree of understanding of the terms of the contract enjoyed by the parties to it. These additional matters of context were added to proposition four in a bid to crystallise in the minds of the survey respondents the idea that any "unfairness" as between the parties came not because of the existence of some imbalance as between the parties in terms of their capacity to conserve their own interests, nor through surprise or ambush. The "unfairness" if any, came through the execution of rights under a known and understood instrument.

103. J Kay, "Contracts or Relationships? The Role of Architecture in European Business", (1993) 5 *European Business Journal* 38.

104. Justice Priestley and Justice Finn are two leading Australian proponents of good faith performance obligations in contract. For more detail on this point see:, T Carlin, "The Rise (and fall?) of Implied Good Faith in Contractual Performance in Australia", (2002) *University of New South Wales Law Journal* Vol 25 (1) pp. 99-123.