ARTICLE

CLARITY STILL NEEDED ON EXERCISING CONTRACTUAL DISCRETIONS IN NEW ZEALAND

BUDDLE FINDLAY

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The extent to which a party's discretions under a contract are fettered by standards of reasonableness has long been a source of debate. A New Zealand Court of Appeal judgment last year, together with a couple of subsequent judgments, have suggested that New Zealand law on this issue may be evolving. In this article, we take a look at the recent judgments and what they may mean in the future for contracting parties.

The *Woolley* appeal – what was the case about?

On 29 June 2023, the New Zealand Court of Appeal published its decision on *Woolley v Fonterra Co-Operative Group* [2023] NZCA 266 (*Woolley*). The appeal concerned a 2021 High Court decision that Fonterra had properly exercised a contractual discretion to suspend collection of milk under its Milk Supply Agreement with Marlborough dairy farmer Phillip Woolley.

In this appeal, Mr Woolley accepted that Fonterra did initially have grounds to exercise its contractual discretion to suspend milk collection prior to 5 September 2014. He argued, however, that those grounds no longer existed after 5 September because by that date, he was able to discharge a Council enforcement order that had triggered Fonterra's contractual discretion to suspend milk collection.

Mr Woolley's primary argument on appeal was that the High Court erred in making its own

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determination as to whether the enforcement order was discharged (rather than relying on an Environment Court decision). However, this argument (which failed to convince the Court of Appeal) was not the only pillar on which Woolley sought to rely.

Mr Woolley's amended statement of claim also asked the Court of Appeal to find that the Milk Supply Agreement contained an implied term that Fonterra would exercise its discretionary suspension power to a particular standard of reasonableness, which Mr Woolley alleged had not been satisfied in this case.

So why is the *Woolley* appeal interesting?

It is this second argument that is of most interest to legal practitioners eager to see how competing overseas doctrines relating to the exercise of contractual discretions will be reconciled and applied in New Zealand. While the judgment neither endorses nor rejects the view that the courts have a wide ability to review the reasonableness of an exercise of contractual discretions, it did deliver a summary of the offshore precedents, with some hints at where New Zealand might be headed.

For much of the past 30 years, jurisprudence in other Commonwealth jurisdictions has generally favoured the "default rule" that was first developed in the judgment of Leggatt LJ in *Abu Dhabi National Tanker Co. v Product Star Shipping Ltd (No 2)* [1993] 1 Lloyd's Rep 397 (CA) (***Product Star Shipping***). Premised on limiting judicial intervention where the dispute is between commercial counterparties (as opposed to decisions of administrative bodies), the "default rule" essentially requires that, "*having regard to the provisions of the contract by which it is conferred, [the discretion] must not be exercised arbitrarily, capriciously, or unreasonably*", in the sense that no reasonable party could rationally have so acted.

The "default rule" essentially reflects the "second limb" of the public law standard of reasonableness commonly referred to as Wednesbury reasonableness, from the case of *Associated Provincial Picture Houses v Wednesbury Corporation* [1948] 1 KB 223 (***Wednesbury***). In that case, the Court held that it could not quash the decision of a public body simply because it disagreed with it. In order for the court to intervene, it needed to find that it had given undue consideration to irrelevant factors, or not enough weight to relevant factors (the so called "first limb" of *Wednesbury*) or that the decision-maker had made a decision that was so unreasonable that no reasonable decision-maker could have made it (the so called "second limb").

This means that to date, the courts when considering the exercise of contractual discretions in commercial contracts, have tended to focus on the question of whether the substance of the party's decision to exercise a discretion was arbitrary, capricious or essentially irrational and not the process by which that decision was reached. The Court of Appeal in the *Woolley* judgment expressly noted that to date, the New Zealand legal literature has been largely silent on the application of the "default rule" in commercial contracts, though it has been referred to in a number of High Court decisions.

However, more recently, a case in the UK suggested that the "default rule" was insufficient, and that an "expanded default rule" should apply which included consideration of the first limb of the . test. The "expanded default rule" was espoused by the UK Supreme Court in *Braganza v BP Shipping Ltd*. [2015] UKSC 17, [2015] 1 WLR 1661 (***Braganza***).

In *Braganza*, the family of a sailor that disappeared at sea challenged a conclusion made by his employer, BP Shipping, that he had most likely committed suicide. The consequence of that conclusion was that the employee's widow was not entitled to a death-in-service payment under the employment contract. The Supreme Court was of the view that:

- BP Shipping had **not** taken into account all relevant considerations; but
- Setting aside that BP Shipping had not taken into account all relevant considerations, the resulting decision was not arbitrary, unreasonable, or capricious based on the inputs that BP Shipping had actually taken into account.

Whether the default rule applied, or should be expanded, was therefore material to the outcome.

If the Supreme Court could make its own assessment as to which evidence ought to have been before the decision maker, and then assess

BP Shipping's conclusion based on that information, the Supreme Court could (and in this case, did) find that BP Shipping had not exercised its discretion in accordance with the requisite standard of reasonableness.

The leading judgment (authored by Lady Hale DP) acknowledged the "understandable reluctance" of prior courts to apply the full rigor of administrative judicial review principles in a commercial context but considered that those prior courts had nonetheless failed to articulate precisely what the difference should be between the commercial and administrative contexts.

The Supreme Court did not itself identify a hard-and-fast boundary, acknowledging that the sheer diversity of potential contractual contexts could mean a precise answer is impossible. However, the Supreme Court did identify certain contractual contexts where it may be preferable for a court to look beyond the purely outcome-focused analysis of the "default rule", and to instead apply a test that utilises both limbs of the "reasonableness" test proposed in *Wednesbury*.

The Supreme Court reasoned that the additional rigor introduced by the first (procedural) limb could be justified in certain contractual contexts on the basis that, if the court never permitted itself to examine the scope of inputs to a decision, it runs the risk of repeating "unreasonable" errors made by the primary decision-maker, or of perpetuating the warping effect of any power imbalance between the contracting parties. Lady Hale DP identified the role of the court in this context by stating that "*where the decision will affect the rights and obligations of both parties, there is a clear conflict of interest, and the courts seek to ensure that the power is not abused*".

Specifically, the Supreme Court identified contracts with a "special relationship", or uneven power balance between the contracting parties (for example, a contract for employment) as examples where it may be more justifiable to examine the inputs of a decision made, even where a contract ostensibly confers discretion on a single party. This broader judicial licence may not be as justified in contexts of robust commercial dealings entered at arm's length, where preserving the benefits of contractual certainty and autonomy of the parties necessarily remains the focus.

So did the Court of Appeal in *Woolley* follow Braganza?

While the judgment in the *Woolley* appeal in fact neither endorses or rejects the expanded default rule, it did deliver a summary of the offshore precedents, with some hints at where New Zealand might be headed.

In *Woolley*, the parties agreed on two key points:

- That Fonterra's power to suspend collection of milk was a contractual discretion, not an absolute contractual right. This distinguished the facts at hand from *Bathurst Resources Ltd v L&M Coal Holdings Ltd* [2021] NZSC 85, where the Supreme Court found it was not appropriate to imply any reasonableness requirement.
- That, at a minimum, Fonterra was obliged to comply with the "default rule" as set out in *Product Star Shipping* in the exercise of its discretion.

The parties' consensus on the latter point led the Court of Appeal to note that its judgment "*assumes (without expressly deciding) that the default rule applies in New Zealand*". What the parties disagreed on was whether the "expanded default rule" applies.

The Court of Appeal noted that the issue of whether the "expanded default rule" recognised in *Braganza* applies in New Zealand had not previously been addressed by the New Zealand senior courts, and that "*nor, like the traditional default rule, does it appear to have been the subject of academic discourse here*". (NB the judgment did note elsewhere that Stephen Kós had examined the traditional default rule in his article "Constraints on the Exercise of Contractual Powers" (2011) 42 VUWLR 17).

The High Court in *Woolley*, for its part, concluded that *Braganza* had charted a new approach to the review of contractual discretions but considered that, in the light of some post-*Braganza* decisions, it remained questionable whether the new approach could apply to more strictly commercial contexts (as opposed to those relational contracts mentioned in *Braganza*, such as employment relationships).

Woolley's amended pleading argued that an expanded default rule similar to that applied in *Braganza* ought to apply in this case, and that Fonterra›s

decision to suspend milk collection after 5 September 2014 was not «reasonable» because it had failed to take actions to ensure that it was making its decision with all relevant information to hand (ie pointing to a failure of the first limb of the *Wednesbury* reasonableness test). What Fonterra lacked, argued Woolley, was a reasonably settled understanding of whether or not the enforcement order had been discharged, as at the date that Fonterra "decided" to continue to act as though the enforcement order was still in force (ie 5 September 2014).

It was not disputed that Fonterra fully understood the grave financial consequences for Mr Woolley of its continued suspension of milk collection. Further, some of the hallmarks of *Braganza's* "special relationship" were arguably present in the factual matrix here. This included the fact that Fonterra was Woolley's only potential buyer for the milk (which was Woolley's farm's sole revenue stream), as well as the unique obligations that Fonterra owed, under both the Milk Supply Agreement and under applicable statute, to act in the interest of farmer shareholders. Woolley argued that, in the context of this special relationship, there were further measures that Fonterra should have taken, but did not take, to satisfy itself that the enforcement order remained in force. In particular, Fonterra could have made its own urgent application for an Environment Court to determine whether the enforcement order was discharged.

Critically, Woolley failed to convince the court that these steps were practical or required. There was no compelling reason for Fonterra to make an urgent application essentially on Mr Woolley's behalf. In fact, as Mr Woolley was a party to the previous Environment Court proceedings while Fonterra was not, it was more appropriate for Mr Woolley to be the party to do so. Therefore, Fonterra was reasonably entitled to assume that it could wait for Mr Woolley to confirm the status of the enforcement order, and act in the meantime on the basis that the status of the enforcement order remained unknown.

Similarly, the court found little merit in Mr Woolley's other claims that there were procedural flaws underpinning Fonterra's "decision" to continue the suspension after 5 September 2014. With no viable procedural issue upheld that would cause Fonterra to have breached the first limb of the *Wednesbury* unreasonableness test, the Court of Appeal noted that the *Woolley* appeal was "*not suitable for further development of the law on constraints on the exercise of contractual discretions as, whatever the test might be, we agree with the [High Court] that it was satisfied in this case*".

It was not controversial that Fonterra's actions did not breach the second *Wednesbury* limb (the "default rule"). Faced with the information available to Fonterra at the time, the decision to keep the suspension in place was, according to the court, "not only rational but unsurprising". Fonterra had been expressly advised by the Marlborough District Council

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that it risked prosecution for aiding Woolley in a breach of an enforcement order if it resumed milk collection, and as Brown J also noted, "*it was necessary for Fonterra to consider the implications of its actions for itself and for all its co-operative members*". The risk of reputational harm to the dairy industry from Fonterra flouting a council enforcement order to collect milk from a troubled farm was self-evident.

New Zealand decisions following *Woolley*

Since the *Woolley* judgment, there have been several New Zealand decisions that have considered the exercise of contractual discretions with reference to the "default rule" and the "expanded default rule".

In *The Christian Church Community Trust v Bank of New Zealand* [2023] NZHC 2523 (***Gloriavale v BNZ***) the High Court considered a request for an interim injunction against BNZ's unilateral decision to de-bank one of the entities operated by the Gloriavale religious community.

For an interim injunction to be granted, the court must be satisfied that the party seeking the injunction has established that there is a serious question to be tried and that the balance of convenience favours the granting of relief. Consequently, the court was not required to, and did not, give a clear view as to whether the expanded default rule should apply in New Zealand. However, Cull J did expressly note that both the substantive and procedural reasonableness of BNZ's decision-making process was relevant to establishing whether it was arguable that BNZ exercised its discretion reasonably in the circumstances. Cull J also noted that a "seriously arguable" sub-question to be tried was whether BNZ's termination decision was "reasonable, **procedurally and/or substantively**" (emphasis added).

It is worth noting that Cull J devoted some time to considering whether a banking service is an "essential service" that imports public interest obligations, or in other words, whether a banking relationship might be similar to the "relational" contracts referenced in *Braganza.* Ultimately, Cull J decided that Gloriavale had established a seriously arguable case and granted the interim injunction on the basis that "*either the default rule (or the Braganza extension) applies*".

In October 2023, a month after the release of the decision in *Gloriavale v BNZ*, the question of whether the expanded default rule applies in New Zealand was again raised in proceedings by Three Hills Group, a rural delivery contractor, against New Zealand Post, in *Three Hills Group Limited v New Zealand Post Limited* [2023] NZHC 3156. Whilst discussion of the expanded default rule was limited, Gault J did note (with reference to *Woolley*) the enduring uncertainty of the *Braganza* approach in New Zealand.

What can we learn?

The *Woolley* judgment and the cases that have followed are evidence of real uncertainty as to the appetite of the courts to enquire into the exercise of contractual discretions (in particular, the process of decision-making).

The question of whether or not the expanded default rule is applied is not the only source of uncertainty - the manner in which it would be applied is also very unclear. For example, if the expanded default rule were endorsed in New Zealand for "relational contracts", it would be unwise to assume that the meaning of the term "relational contracts", as used in *Braganza*, would be interpreted by courts in New Zealand in the same way as it is interpreted in the UK.

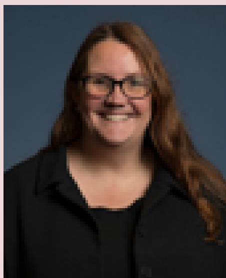
Perhaps curiously, the Court of Appeal in Woolley notes that "[Woolley] is not an employment case which, as the Supreme Court's judgments recognised, involves a relational contract of a different character from an ordinary commercial contract." If this rather narrow reference to just the employment context was intended to be a signal that the Court of Appeal was reluctant to apply the expanded default rule beyond employment contracts in New Zealand, then the subsequent judgment in *Gloriavale v BNZ* provides an indication to the contrary. In that case, the High Court arguably hints that a relationship between a bank and an organisation customer might have a sufficiently "special" character as to also warrant the application of the expanded default rule.

While the confused state of the law does introduce a layer

of difficulty for lawyers in New Zealand when advising clients that have specific questions about their exercise of certain contractual discretions, there are steps that can be taken when drafting contracts to help reduce future uncertainty. For example, if a contract is express about how the contracting parties intend for discretions under the contract to be exercised (either through a general clause or by specifying whether each discretion is fettered or unfettered), then the courts may not see fit to imply a competing term that applies the default rule or expanded default rule to the exercise of such discretions. For example, contracting parties can, and regularly do, stipulate that a decision to be made under a contract is in a particular party's "sole and absolute discretion".

As Brown J recognised in the *Woolley* appeal, any endorsement of the *Braganza* approach in New Zealand would be "*a significant development in contract law*". While the *Woolley* appeal and subsequent cases continue to leave us in an uncertain «watch this space» position, one thing is sure: any expansion of the test in New Zealand is likely to lead to more litigation of commercial disputes, potentially by a considerable degree, by significantly increasing the scope for a party to argue that a discretion has been unreasonably exercised.

About the authors



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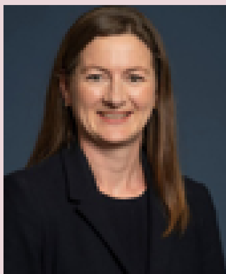

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