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IN GOOD FAITH? WHAT ARE THE IMPLICATIONS FOR COMMERCIAL CONTRACTS?

BY DOV OHRENSTEIN

*'[W]hole forests have been felled to produce judicial and academic writing on the meaning of good faith in contract law.'*¹

THE TRADITIONAL APPROACH

Historically the courts have been reluctant to adopt a general doctrine of good faith in English contract law and generally took the approach that there is no legal principle of good faith in dealings between commercial contractual parties. For example:

* Lord Steyn, wrote in 1997:

*"I have no heroic suggestion for the introduction of a general duty of good faith in our contract law. It is not necessary."*²

* Lord Justice Bingham in **Interfoto Picture Library Ltd v Stiletto Visual Programmes**³ stated:

"In many civil law systems, and perhaps in most legal systems outside the common law world, the law of obligations recognises and enforces an overriding principle that in making and carrying out contracts parties should act in good faith. This does not simply mean that they should not deceive each other, a principle which any legal system must recognise; its effect is perhaps most aptly conveyed by such metaphorical colloquialisms as 'playing fair', 'coming clean' or 'putting one's cards face upwards on the table.' It is in essence a principle of fair open dealing... English law has, characteristically, committed itself to no such overriding principle but has developed piecemeal solutions in response to demonstrated problems of unfairness."

REASONS TO OBJECT TO THE IMPLICATION OF GOOD FAITH DUTIES

Reasons to object to the implication of a general duty of good faith include:

* A desire to develop the law incrementally by fashioning particular solutions to particular problems rather than by imposing overarching principles.

¹ Per Hon Marilyn Warren AC, Chief Justice of the Supreme Court of Victoria. See 'Good faith: Where are we at?' (2010) 34 Melbourne University Law Review 344, 345.

² Contract Law: Fulfilling the Reasonable Expectations of Honest Men (1997) 133 Law Quarterly Review 433, 439.

³ [1989] QB 433 at 439

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* The idea that parties should be free to pursue their own self-interest both when negotiating and when performing the contract.

* A fear that recognition of a general requirement of good faith in the performance of contracts would create uncertainty.

WHAT DOES A DUTY TO ACT IN GOOD FAITH MEAN?

The content of an obligation to act in good faith has not been exhaustively defined. In **Street v Derbyshire Unemployed Workers' Centre**⁴ Auld LJ said:

"Shorn of context, the words "in good faith" have a core meaning of honesty. Introduce context, and it calls for further elaboration. ...The term is to be found in many statutory and common-law contexts, and because they are necessarily conditioned by their context, it is dangerous to apply judicial attempts at definition in one context to that of another. "

While some judges have taken the view that 'good faith' simply means the absence of bad faith, hallmarks of the obligation include the following:

* Compliance with honest standards of conduct

*"As a matter of construction, it is hard to envisage any contract which would not reasonably be understood as requiring honesty in its performance. The same conclusion is reached if the traditional tests for the implication of a term are used. In particular the requirement that parties will behave honestly is so obvious that it goes without saying. Such a requirement is also necessary to give business efficacy to commercial transactions."*⁵.

* Compliance with standards of commercial dealing

This requires adherence to standards of behaviour which are so generally accepted that the contracting parties would reasonably be understood to take them as read without explicitly stating them in their contractual document. Bad faith conduct which might be considered 'improper' 'commercially unacceptable' or 'unconscionable' but which is not dishonest would fall into this category. Examples might include deliberately avoiding giving an answer or giving an evasive answer to an enquiry when it is known that the other party will then rely on false information.

* Fidelity to the parties' bargain.

According to Leggatt J, the central idea here is that contracts can never be complete in the sense of expressly providing for every event that may happen. To apply a contract to circumstances not specifically provided for, the language must accordingly be given a reasonable construction which

⁴ [2004] EWCA Civ 964

⁵ See **Yam Seng** para 137

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promotes the values and purposes expressed or implicit in the contract. This can also be described in terms of co-operation to achieve contractual objectives.

* No arbitrary exercise of contractual discretion.

GOOD FAITH AND CONTRACTUAL DISCRETIONS

A power conferred by a contract on one party to make decisions which affect both parties must be exercised honestly and in good faith, for the purposes for which it was conferred and must not be exercised arbitrarily, capriciously or irrationally ⁶. This principle was applied by Leggatt J in **Broden v Investec** ⁷, a case concerning the award of bonuses under a contract of employment which is a type of contract in which the courts have regularly implied duties of good faith. That decision was upheld in October 2016 by the Court of Appeal ⁸, who said that the principles relating to the exercise of a contractual discretion were not controversial (although they decided that on the wording of the particular contract there was in fact no discretion).

Similarly see **Gan Insurance Co Ltd v Tai Ping Insurance Co Ltd** ⁹ which concerned a reinsurance contract containing a clause which provided that no settlement or compromise of a claim could be made or liability admitted by the insured without the prior approval of the reinsurers. The Court of Appeal held that

“any withholding of approval by reinsurers should take place in good faith after consideration of and on the basis of the facts giving rise to the particular claim and not with reference to considerations wholly extraneous to the subject-matter of the particular reinsurance”

The exercise of discretionary powers was considered in **Nash v Paragon Finance** ¹⁰ which concerned a lender’s ability to vary interest rates. The Court of Appeal held that the Claimant could not set rates of interest unreasonably only in the limited sense of setting rates that no lender, acting reasonably would set but this did not mean that there was an implied term that the lender would not impose unreasonable rates if, for example, its commercial circumstances required such rates. The wide discretion allowed to the lender in **Paragon Finance** contrasts with the onerous implied obligations that have been imposed on contractual fact finders.

⁶ **Abu Dhabi National Tanker Co v Product Star Shipping Ltd** [1993] 1 Lloyd’s Rep 397, 404

⁷ [2014] EWHC 2785 (Comm)

⁸ [2016] EWCA Civ 1031

⁹ [2001] Lloyd’s Rep IR 667

¹⁰ [2001] EWCA Civ 1466

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CONTRACTUAL FACT FINDERS

It is not unusual for contracts to appoint a party as a contractual fact finder. This has obvious potential for abuse unless some obligation of good faith or reasonableness is implied. As stated in **Braganza v BP Shipping Ltd**:¹¹

“The courts have therefore sought to ensure that such contractual powers are not abused. They have done so by implying a term as to the manner in which such powers may be exercised, a term which may vary according to the terms of the contract and the context in which the decision making power is given.”

Braganza concerned the death of a chief engineer of one of BP’s oil tankers who disappeared while the tanker was at sea. Contractual compensation was not payable to his widow if “*in the opinion of [BP] or its insurers, the death Resulted from the Officer’s wilful act*”. BP concluded that he had probably committed suicide and refused to compensate the widow. The majority of the Supreme Court held that although BP’s decision was not “*arbitrary, capricious or perverse*” it was unreasonable in the *Wednesbury* sense as applied in cases of judicial review (ie it ignored relevant matters or took into account irrelevant ones) and in breach of the implied obligations of trust and confidence that formed part of the contract of employment. Lady Hale (who gave the leading judgment) suggested that the *Wednesbury* test might not be limited to decisions of contractual fact finders in employment law contracts but might also apply more widely to other exercises of contractual discretions and also outside the context of employment.

THE CHANGE IN THE COURTS’ APPROACH

It has been perceived that there has been a change of approach by the Courts which flows from the decision of Leggatt J in **Yam Seng Pte Limited v International Trade Corporation**.¹² Leggatt J was influenced by the position in other jurisdictions where obligations of good faith are well established. This is not simply the case in Civil Law countries but also in Common Law jurisdictions. For example, the United States’ Uniform Commercial Code expressly imposes an obligation of good faith on parties to contracts, defined as ‘*honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade*’ and the Supreme Court of Canada has held that parties have a duty to act in good faith in contracts, requiring parties not to ‘*lie or mislead*’ or engage in ‘*active dishonesty*’, although it should be noted that Singapore’s Court of Appeal has refused to imply a duty of good faith in contracts.

Leggatt J said in **Yam Seng**:

“I doubt that English law has reached the stage, however where it is ready to recognise a requirement of good faith as a duty implied by law, even as a default rule, into all commercial contracts. Nevertheless, there seems to me to be no difficulty, following the

¹¹ [2015] UKSC 17

¹² [2013] EWHC 111 [QB]

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established methodology of English law for the implication of terms in fact, in implying such a duty in any ordinary commercial contract based on the presumed intention of the parties.”

WHEN WILL OBLIGATIONS OF GOOD FAITH BE IMPLIED?

The Courts have not introduced into all contracts a general implied obligation to act in good faith. However, there is a growing body of authority that such implied obligations can arise in what can be described as “*relational contracts*”. These are contracts which require

“a high degree of communication, cooperation and predictable performance based on mutual trust and confidence and involve expectations of loyalty which are not legislated for in the express terms of the contract but are implicit in the parties understanding and necessary to give business efficiency to the arrangements.”

Employment contracts are a form of relational contract for which it is well established that there are implied mutual good faith obligations. See for example **Malik v BCCI**¹³ where BCCI was held to be under an implied obligation not to conduct a corrupt and dishonest business, being one aspect of a general implied contractual obligation not to engage in conduct likely to undermine the relationship of confidence and trust between employer and employee.

There is debate as to the extent to which relational contracts, other than employment contracts, such as joint ventures and franchise agreements, are subject to implied good faith obligations. Such debate has been greatly influenced by the **Yam Seng** decision.

In **Yam Seng** the Defendant granted the Claimant the exclusive rights to distribute certain fragrances and toiletries bearing the brand name ‘*Manchester United*’ in various duty free shops at specified minimum prices. It was common ground that there was an industry assumption that retail prices in domestic markets would be higher than the corresponding duty free retail prices. The agreement was short and home-made. Yam Seng terminated the agreement on the grounds of the defendant’s alleged repudiatory breaches in failing to provide goods which Yam Seng had marketed, attempting to claw back rights to distribute certain products, providing misleading information and permitting non duty free sales to undercut the specified duty free prices. It was held that (despite the absence of relevant express provisions) as there was a relational contract there were implied good faith obligations on the defendant not to undercut duty free prices and not knowingly to provide false information.

¹³ [1998] AC 20

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THE RECENT CASES

Yam Seng was considered in **Mid-Essex Hospital Services NHS Trust v Compass Group UK and Ireland Ltd**,¹⁴ but this was a case not about implied terms but about a poorly drafted and ambiguous express term which provided.

“The Trust and the Contractor will cooperate with each other in good faith and will take all reasonable action as is necessary for the efficient transmission of information and instructions and to enable the Trust or, as the case may be, any Beneficiary to derive the full benefit of the Contract.”

There was no criticism by the Court of Appeal of Leggatt J’s decision but as Jackson LJ put it:

*“... this is a very detailed contract, where the obligations of the parties and the consequences of any failings have been spelt out in great detail. Commercial common sense therefore does not favour a general overarching duty to co-operate in good faith. In addressing this question, I start by reminding myself that there is no general doctrine of "good faith" in English contract law, although a duty of good faith is implied by law as an incident of certain categories of contract: : see ...**Yam Seng Pte Ltd v International Trade Corporation Ltd**. If the parties wish to impose such a duty they must do so expressly. ”*

Mid-Essex Hospital Services NHS Trust was considered and applied by Akenhead J in **TSG Building Services v South Anglia Housing Ltd**.¹⁵ Which concerned a long term building maintenance agreement including provisions that the parties would:

“work together and individually in the spirit of trust, fairness and mutual co-operation for the benefit of the Term Programme, within the scope of their agreed roles, expertise and responsibilities as stated in the Partnering Documents, and all their respective obligations under the Partnering Contract shall be construed within the scope of such roles, expertise and responsibilities, and in all matters governed by the Partnering Contract they shall act reasonably and without delay.”

Despite that language, it was held that the Housing Association could terminate the agreement in accordance with an unqualified termination notice provision without having to establish reasonable or fair grounds for termination. A similar conclusion was reached this year in **Monde Petroleum v Westernzagros Ltd**¹⁶ where it was said that a contractual right to terminate a contract is not an exercise of a contractual discretion.

Mid Essex was followed and applied in **Myers v Kestrel Acquisitions Ltd**,¹⁷ a case about whether a power conferred on the issuer of certain loan notes “to make any modification to this instrument” either with the sanction of an extraordinary resolution or without such sanction if it was “consistent in all material respects with any modification being made to the Discounted Loan Note

¹⁴ [2013] EWCA Civ 200

¹⁵ [2013] EWHC 1151 (TCC)

¹⁶ [2016] EWHC 1472

¹⁷ [2015] EWHC 916 (Ch)

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Instrument". It was held that it was impermissible to imply a duty of good faith as the relevant clause was not a discretion which involved a choice from a range of options, but was instead the exercise of a contractual right whether or not to modify without consent, which was constrained by the requirement that the modification be consistent with the modification to the Discounted Loan Notes. Sir William Blackburne said:

"The fact that Kestrel had that contractual choice does not justify subjecting it to some kind of good faith obligation."

In **Bristol Groundschool Limited v Intelligent Data Capture and others**¹⁸ Richard Spearman QC approved of the views expressed in **Yam Seng**. The case concerned provision of training manuals as part of a long term joint venture and product distribution agreement which was held to be a '*relational contract*' of the type described in **Yam Seng**. The Claimant had downloaded materials from the Defendant's computer system without consent in order to develop its own software system. Spearman QC concurred with Leggatt J, stating that "*good faith extends beyond, but at the very least includes, the requirement of honesty*". He concluded that the "*relevant test*" is whether the conduct complained of "*would be regarded as 'commercially unacceptable' by reasonable and honest people in the particular context involved*"

Last year, the High Court implied a duty of "*honesty and integrity*" into a vehicle recovery contract: **D&G Cars Ltd v Essex Police Authority**.¹⁹ Here the Claimant had a contract with the police to collect and crush vehicles. A vehicle was meant to have been crushed but instead the Claimant had used it as part of its own fleet. Further, the vehicle's number plates and identification number had been swapped with those of another vehicle owned by the Claimants. The Claimant then complained that the police had decided to terminate the contract. Dove J held that the Police had been entitled to terminate the contract for material breach. D&G should have obtained consent from the Police for anything other than disposal of the vehicle by crushing. This was a serious breach of the express terms of the contract. Significantly, the court also found that there had also been breach of an implied term to act with integrity, although there was no finding of dishonesty. Both breaches were sufficiently serious as to justify termination..

In **D&G Cars**, Dove J emphasised, in line with the approach taken in **Yam Seng**, that the existence and content of an implied term to act with integrity is sensitive to the context of the contract itself. He found that several features of the particular contract warranted an implied term that the parties would act with honesty and integrity in operating the contract. In particular, the contract was for a relatively lengthy period (initially 5 years), during which there were going to be a very large number of individual transactions undertaken under its auspices; it was, in the judge's view, a "*relational contract par excellence*". Further, it involved D&G acting on behalf of a law enforcement agency in dealing with the recovered property of members of the public, which might either require return to the public or form part of the evidence for criminal investigations and potential prosecutions.

¹⁸ [2014] EWHC 2145 (Ch)

¹⁹ [2015] EWHC 226 (QB).

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What is clear from **D&G Cars** is that there may well be acts which would breach the requirement of undertaking the contract with integrity but which it would be difficult to characterise as dishonest; those which would compromise the mutual trust and confidence between the parties without necessarily amounting to the telling of lies, stealing or other definitive examples of dishonest behaviour. In Dove J's view, such acts would amount to behaviour which the parties would, had they been asked, have identified as obvious acts which were inconsistent with the maintenance of their intended long-term relationship of fair and open dealing and therefore amount to a breach of contract.

In April 2016 Moore Bick LJ briefly considered the issue of an implied term of good faith in **Globe Motors v TRW Lucas Varity**²⁰ (a case about interpretation rather than implication of terms). He said that in certain categories of long-term contract (involving a high degree of co-operation, where the implication may be necessary for business efficacy), the court may be more willing to imply a duty to co-operate or, in the language used by Leggatt J in **Yam Seng**, a duty of good faith. He went on to say:

“an implication of a duty of good faith will only be possible where the language of the contract, viewed against its context, permits it. It is thus not a reflection of a special rule of interpretation for this category of contract.”

MSC Mediterranean Shipping Company S.A. v Cottonex Anstalt²¹ concerned MSC's claim for demurrage charges in respect of 35 containers of Cottonex's cotton. Cottonex's buyer had paid for but refused to collect the cotton and a Bangladeshi court order prevented Cottonex accessing the containers and returning them to MSC. At first instance²² Leggatt J had held that the decision of an innocent party such as MSC as to whether to terminate or affirm a contract following a counterparty's repudiatory breach must be exercised in good faith. Previous cases had established that an innocent party could not affirm a contract unless it had a *“legitimate interest”* in performing and claiming the contract price rather than claiming damages, but that was generally interpreted as setting a fairly low threshold. The decision arguably went further by applying good faith principles. The Court of Appeal decided that the contract had been frustrated so that the question of when an innocent party can insist on keeping the contract alive was not determined. Nevertheless, Moore Bick LJ commented:

“There is in my view a real danger that if a general principle of good faith were established it would be invoked as often to undermine as to support the terms in which the parties have reached agreement.”

In **National Private Air Transport Services Co v Windrose Aviation**²³, a case concerning an aircraft leasing agreement which was found not to be a relational contract Blair J held:

²⁰ [2016] EWCA Civ 396

²¹ [2016] EWCA Civ 789

²² [2015] EWHC 283 (Comm)

²³ [2016] EWHC 2144 (Comm)

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*“I do not accept that NAS is correct to doubt the authority of the decision in **Yam Seng**. Although its treatment in the cases has varied, this has reflected the very different factual circumstances in which it has been raised. So far as appellate authority is concerned, it has recently been cited with approval by the Court of Appeal in **Globe Motors Inc v TRW Lucas Varity Electric Steering Ltd**²⁴, and by the Singapore Court of Appeal in **The One Suites Pte Ltd v Pacific Motor Credit (Pte) Ltd**²⁵.”*

THE LIMITS TO THE DUTY TO ACT IN GOOD FAITH

The limits to any implied obligation to act in good faith should be noted:

* Although the duty to act in good faith may require compliance with standards of conduct that are reasonable having regard to the interests of the parties, such an obligation does not require one party to subordinate its own legitimate interests to the other party's. The suggestion that a good faith obligation involves such subordination of a party's interests has been the foundation of decisions that no obligation of good faith is to be implied. See, for example **Hamsard 3147 Ltd v Boots**²⁶

* The duty is not meant to involve the court in imposing its view of what is substantively fair on the parties. What constitutes fair dealing is to be defined by the contract and by those standards of conduct to which, objectively, the parties must reasonably have assumed compliance without the need to state them. The advantage of including reference to fair dealing is that it draws attention to the fact that the standard is objective and distinguishes the relevant concept of good faith from other senses in which the expression "good faith" is used.

CONCLUSIONS

While plenty of judges remain “*good faith sceptics*”, in the light of the recent case law it is likely that litigants will continue to argue that what might be ‘*relational contracts*’ should encompass a wide (and perhaps widening) range of circumstances in order to imply obligations of good faith. Relevant questions include:

- * What is the nature of the duty that is being alleged?
- * Is the agreement a relational contract?
- * Is the implied duty consistent with express terms?
- * How detailed are the express terms?

²⁴ [2016] EWCA Civ 396 at [67]

²⁵ [2015] SGCA 21 at [44]

²⁶ [2013] EWHC 3251 (Pat)

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* What would the officious bystander say?

Ultimately the key to successfully implying an obligation of good faith may be the extent to which the obligation can be seen as amounting to “*fidelity to the bargain*” rather than any form of obligatory altruism.

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