

In good faith?

What is the impact of the good faith doctrine on commercial contracts, asks **Dov Ohrenstein**



IN BRIEF

► Obligations to act in good faith or of fair dealing are not to be implied into every contract.

► However, in the light of the recent case law, it is increasingly likely that litigants will try to imply such obligations into commercial contracts particularly into what might be described as “relational contracts”.

As the Hon Marilyn Warren AC, Chief Justice of the Supreme Court of Victoria, wrote: “Whole forests have been felled to produce judicial and academic writing on the meaning of good faith in contract law” (see “Good faith: Where are we at?” (2010) 34 *Melbourne University Law Review* 344, 345).

Historically, the courts have been reluctant to adopt a 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” (“Contract Law: Fulfilling the Reasonable Expectations of Honest Men” (1997) 133 *Law Quarterly Review* 433, 439).
- Lord Justice Bingham stated in *Interfoto Picture Library Ltd v Stiletto Visual Programmes* [1989] QB 433, [1988] 1 All ER 348: “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...English law has, characteristically, committed itself to no such overriding principle but has developed piecemeal solutions.”

Reasons to object to the implication of a duty of good faith

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.
- The idea that parties should be free to pursue their own self-interest when negotiating and performing contracts.
- A fear that recognition of a general requirement of good faith in the performance of contracts would create uncertainty.

The change in the courts’ approach

There has been a change of approach by the courts since *Yam Seng Pte Limited v International Trade Corporation* [2013] EWHC 111 (QB), [2013] 1 All ER (Comm) 1321 where 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 US’s Uniform

Commercial Code imposes an obligation of good faith on contracting parties, defined as “honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade”.

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* [2004] EWCA Civ 964, [2004] 4 All ER 839 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...it is dangerous to apply judicial attempts at definition in one context to that of another.”

Hallmarks of the obligation include:

- 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” (see *Yam Seng*, para 137).
- 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 have accepted them without saying so expressly. Conduct which is “improper”, “commercially unacceptable” or “unconscionable”, but would fall into this category. Examples might include deliberately avoiding giving an answer to an enquiry when it is known that the other party will then rely on false information.
- Fidelity to the parties’ bargain. As contracts cannot provide expressly for every event that may happen, the language must be given a reasonable construction which 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. 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 (*Abu Dhabi National Tanker Co v Product Star Shipping Ltd* [1993] 1 Lloyd’s Rep 397, (1992) *Times*, 29 December). Similarly where the consent of one party is needed to an action of the other and a term is implied that such consent is not to be withheld unreasonably: see for example *Gan v Tai Ping (Nos 2 & 3)* [2001] EWCA Civ 1047, [2001] 2 All ER (Comm) 299.

The limits to the obligation 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 duty is not meant to involve the court imposing its view of what is 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.

When will an obligation of good faith be implied?

The courts have not introduced a general obligation to act in good faith. 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, Leggatt J held that the obligation to act in good faith may be implied in "relational contracts" and said that these 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."

Yam Seng was considered in *Mid-Essex Hospital Services NHS Trust v Compass Group UK and Ireland Ltd* [2013] EWCA Civ 200, [2013] All ER (D) 200 (Mar), a case 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...If the parties wish to impose such a duty they must do so expressly."

Andrews J in *Greenclouse Ltd v National Westminster Bank plc* [2014] EWHC 1156 (Ch), [2014] All ER (D) 127 (Apr) considered the implication of a duty of good faith and said: "So far as the 'good faith' condition is concerned, there is no general doctrine of good faith in English contract law and such a term is unlikely to arise by way of necessary implication in a contract between two sophisticated commercial parties negotiating at arms' length."

In *Bristol Groundschool Limited v Intelligent Data Capture and others* [2014] EWHC 2145 (Ch), [2014] All ER (D) 117 (Jul) the case concerned provision of training manuals as part of a long term joint venture which was held to be a "relational contract". Spearman QC 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".

This year, the High Court implied a duty of "honesty and integrity" into a vehicle recovery contract: *D&G Cars Ltd v Essex Police Authority* [2015] EWHC 226 (QB), [2015] All ER (D) 85 (Mar). 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 used it in its own fleet. The claimant then complained that the police had terminated the contract. Dove J held that the police had been entitled to terminate for material breach. Significantly, the court also found that there was "a relational contract par excellence" giving rise to an implied term to act with integrity that had been breached despite the absence of a finding of dishonesty. Dove J said: "By the use of the term 'integrity', rather as Leggatt J uses the term 'good faith', the intention is to capture the requirements of fair dealing and transparency which are no doubt required (and would, to the parties, go

without saying) in a contract which creates a long-standing relationship."

What is clear is that there is conduct which would breach a requirement to act with integrity or in good faith but which falls short dishonesty.

The question of an implied duty to act in good faith arose again this year in *Myers v Kestrel* [2015] EWHC 916 (Ch), [2015] All ER (D) 11 (Apr) which concerned the extent of a contractual right to unilaterally amend the terms of certain vendor loan notes (VLNs) so as to subordinate those notes to other notes and to postpone the redemption date the effect of which was said to make the VLNs worthless. It was not in dispute that the exercise of such a discretion had to be limited by concepts of "honesty, good faith, and genuineness, and the need for the absence of arbitrariness, capriciousness, perversity and irrationality". However, it was argued that the implied terms went further so that the right to modify the terms of the VLNs had to be exercised in good faith and for the benefit of note holders as a whole so that the majority note holder should not be free to commit an act of economic self-harm to further some other agenda. The court rejected the implication of such a term. It held that it had no power to introduce terms simply to make the contract fairer or more reasonable particularly where the overall contractual documentation is extensive and detailed and has been negotiated at arms' length between commercial parties.

Conclusions

Obligations to act in good faith or of fair dealing are not to be implied into every contract. However, in the light of the recent case law, it is increasingly likely that litigants will try to imply such obligations into commercial contracts particularly into what might be described as "relational contracts". These are likely to encompass a wide (and perhaps widening) range of circumstances. Parties have the option of expressly excluding such duties, although often it may be impractical to do so. **NLJ**

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