

Good faith – is there a new implied duty in English contract law?

Background

English law does not currently recognise a universal implied duty on contracting parties to perform their obligations in good faith. This differs from the position in many other countries, including France, Germany, the United States and Australia, which, to some extent or another, recognise some form of overriding principle that, in agreeing and performing contracts, the parties should act in good faith.

A couple of recent cases have reignited discussion about whether English law might imply a similar duty. It does not look like this will happen any time soon. But we expect the law on this area to develop further. Why? First, because parties continue to enter into long term, “relational” contracts relying on frequent communication and co-operation to operate effectively. These relationships are being put to the test in the current financial climate. Second, the growing use of express duties of good faith in English law contracts seem bound to attract further judicial interpretation. Pressure to change may also come as European law continues to creep into English law through the implementation of European Directives.

Is there a universal implied duty on contracting parties to perform their obligations in good faith?

No. English courts have been reluctant to recognise a universal implied duty of good faith other than for certain categories of contract – such as employment and fiduciary relationships. This is in part due to concerns that it could create too much uncertainty – deciding what the actual obligation entails can be vague and subjective. It also goes contrary to freedom of contract – why interfere with a contract where the parties have freely negotiated the terms? Rather than enforcing broad, overarching principles of good faith in contracts, English law has evolved by developing

particular solutions in response to particular problems, including dealing with specific situations which may be unfair.

In a recent case, the court said a duty of good faith *could* be implied into a contract but only as a term in fact, based on the presumed intention of the parties. Instead, on the facts, the court implied a term that the parties would not act dishonestly in the provision of information.

Can you impose an express duty of good faith on contracting parties?

Many commercial contracts specifically require a party to perform particular obligations or exercise specified discretions acting “in good faith”. It is less common but also possible to impose an express duty to perform the whole contract in good faith. Any express term will be interpreted carefully, in the context of the entire contract and the commercial relationship between the parties.

What does performing in good faith mean?

Under English law, there is no generally applicable definition of “good faith” in performing contracts. It is clear from the authorities that the content of a duty of good faith is heavily conditioned by its context. There may be a core meaning of honesty but, put into context, the meaning of the phrase will call for further elaboration. Examples of different interpretations by the courts include: faithfulness to an agreed common purpose, acting within the spirit of the contract, observing reasonable commercial standards of fair dealing and acting consistently with the justified expectations of the parties. In a recent case, the Court of Appeal found an express obligation to co-operate in good faith meant the parties would work together honestly endeavouring to achieve the stated purposes expressly linked to the duty.

Finally, cases seem to suggest that lack of good faith entails bad faith. Whilst good faith has a core meaning of honesty, not all bad faith involves dishonesty. Bad faith conduct could include behaviour which is seen as commercially unacceptable, improper or unconscionable, but which is not actually dishonest. So, a failure to act in good faith (or not to act in bad faith) does not necessarily require fraud or other dishonesty.

When drafting an express obligation to act in good faith, think about what this involves in the context of the contract. The drafting should be clear and precise, with no room for different interpretations – consider including a non-exclusive list of examples of “good faith” behaviour.

How does English law compare to other jurisdictions?

Most civil law jurisdictions recognise some form of duty on contracting parties to perform their obligations in good faith, although the actual obligation varies between countries. In Germany, under the German Civil Code, contracting parties have to observe good faith in both negotiation and performance of the contract. This is a key provision of German civil law, and involves more than just acting reasonably – it requires a relationship of trust based on the commercial dealing of the parties in a particular transaction. Despite a wealth of case law, there is no established definition of what good faith requires under a German law contract – although this case law does give guidance on the legal consequences of good faith in certain situations. The French Civil Code also contains a requirement that agreements must be performed in good faith.

Many common law jurisdictions also recognise some form of good faith duty on contracting parties. In the United States, every contract or duty falling under The Uniform Commercial Code (adopted by many States) imposes “an obligation of good faith in its performance or enforcement.” Good faith is defined as “honesty in fact in the conduct or transaction concerned”. For a merchant, good faith has a higher standard, and means

“honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade”. But, even with these statutory definitions, the meaning of the doctrine in the US and its exact scope is not black and white.

What should contracting parties bear in mind when exercising contractual discretions?

Parties should take care when exercising a contractual discretion even where they are not subject to a good faith obligation in doing so. If it involves making an assessment or choosing from a range of options, taking into account the interest of both parties, case law suggests there is likely to be an implied term that parties will not exercise the discretion in an arbitrary, capricious or irrational manner.

Here is a closer look at the two recent decisions involved:

YAM SENG V ITC¹

In this case, Leggatt J considered whether English law does - or should - recognise a duty to perform contracts in good faith.

Yam Seng PTE Limited (a Singapore based distributor) and International Trade Corp Limited (an English supplier) entered into a distribution agreement, with ITC agreeing to supply Yam Seng with Manchester United branded toiletries. The relationship turned sour for a number of reasons and ended up before the English courts. Yang Seng argued it was an implied term of the contract that the parties would deal with each other in good faith.

It is worth noting a couple of things about the contract itself – it was skeletal and didn’t set out the parties’ obligations in any detail. The judge noted it was evidently written by the parties themselves, without the assistance of lawyers.

Whilst Leggatt J didn’t think English law was ready to recognise a duty of good faith as a duty implied by law into all commercial contracts, he thought a duty of good faith *could* be implied into a contract as a term in fact,

¹ [2013] EWHC 111(QB)

based on the presumed intention of the parties. The two main criteria traditionally used to identify terms implied in fact are that the term (1) is so obvious that it goes without saying and (2) is necessary to give business efficacy to the contract. In a 2009 case², Lord Hoffman characterised these traditional criteria as different ways of approaching what is ultimately always a question of construction – what would the contract, read as a whole against the relevant background, reasonably be understood to mean?

Modern case law on construction of contracts recognises that contracts are made against a background of unstated shared understandings – including not only matters of fact known to the parties, but also shared values and norms of behaviour, including an expectation of honesty. These are taken for granted by the parties, rather than set out in the contract.

Using the more traditional test, a requirement for the parties to behave honestly satisfies the tests of being (1) so obvious that it goes without saying and (2) necessary to give business efficacy to commercial transactions.

As well as honesty, the judge commented that there are other standards of commercial dealing which are so generally accepted that the contracting parties would reasonably be understood to expect them without stating them in the contract – and a key aspect of good faith is to observe these standards. Another aspect of good faith is fidelity to the parties' bargain – contracts can never provide for every eventuality. To apply a contract to circumstances not specifically provided for, the language must be given a reasonable construction which promotes the values and purposes expressed or implicit in the contract.

Leggatt J noted that English law has traditionally drawn a distinction between certain types of contract where the parties owe obligations of disclosure to each other (like partnership, trusteeship or other fiduciary relationships) and other contractual relationships where they do not. He found many contracts don't fit within this model and involve a longer term relationship – these "relational" contracts may involve a high degree of co-operation, consultation and predictable performance based on mutual trust and confidence,

which are implicit rather than expressly set out in the contract, and which are necessary to give business efficacy to the contract. Joint venture agreements, franchise agreements and long term distributorship agreements are all examples of these types of "relational" contracts.

Based on his analysis, the judge felt there was nothing "novel or foreign" to English law recognising an implied duty of good faith in the performance of contracts, and the concept is already reflected in various lines of authority: courts have implied duties of co-operation in the performance of contracts, and have found that a contractual power for one party to make decisions which affect both parties to the contract must be exercised honestly and in good faith for the purpose for which it was conferred. However, despite this analysis and an apparent willingness to imply a duty to perform a contract in good faith, the duty the judge actually implied was a duty not to act dishonestly in the provision of information.

[MID ESSEX HOSPITAL SERVICES NHS TRUST V COMPASS GROUP UK AND IRELAND LTD \(TRADING AS MEDIREST\)](#)³

This case considered (amongst other things) (1) the effect of an express contractual obligation to co-operate in good faith and (2) the restrictions placed on a contractual discretion.

Medirest and the Trust entered into a long term facilities contract, with Medirest agreeing to provide catering and cleaning services to the Trust. The agreement included provisions for the Trust to award service failure points and to make deductions from payments if service levels were not met.

[Express obligation to co-operate in good faith](#)

The contract said the parties would co-operate with each other and act in good faith and take all action necessary for the efficient transmission of information and instructions and to enable the Trust to derive the full benefit of the contract.

Medirest argued that the obligation involved (1) a general obligation to co-operate in good faith and (2) an

² Attorney General for Belize v Belize Telecom Ltd [2009] 1 WLR 1988

³ [2013] EWCA Civ 200

obligation to take all action necessary for the two purposes specified in the clause. The Trust argued both obligations (i.e. to co-operate in good faith and to take all action necessary) applied to the two specified purposes only, and not to the contract as a whole. The original trial judge favoured Medirest's reading of this clause. In coming to this view, he applied the "Rainy Sky" principle – faced with a clause in a commercial contract open to different interpretations, the commercial common sense construction of the contract was that there was a general obligation of good faith. As this was a long term contract for the delivery of services, the performance demanded continuous and detailed co-operation between the parties. In these circumstances, the original judge thought it was highly likely that the parties intended there to be a general obligation to co-operate in good faith with each other in all respects, and not just for the two purposes mentioned.

The Court of Appeal took a different view. In his leading judgement, Jackson LJ found the obligation to co-operate in good faith was not a general one which qualified or reinforced all the obligations of the parties in performance of the contract – it was instead specifically focussed on the two specified purposes.

What does an obligation to act in good faith actually mean?

Jackson LJ noted that it was clear from the authorities that the content of a duty of good faith is heavily conditioned by its context. Quoting a 2004 judgement⁴, "*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*".

Jackson LJ found the obligation to co-operate in good faith in the Medirest contract meant the parties would work together honestly endeavouring to achieve the two stated purposes. Beatson LJ also made some obser-

vations on this – he considered Leggatt J's judgement in *Yam Seng v ITC*, including that "what good faith requires is sensitive to context", that the test of good faith is objective in that it depends on whether, in the particular context, the conduct would be regarded as commercially unacceptable by reasonable and honest people, and that its content "is established through a process of construction of the contract." Beatson LJ noted that the obligation to co-operate in good faith must be assessed in the light of the provisions of the relevant clause, the other provisions of the contract and its overall context. The clause was contained in a detailed contract which made specific provision for various eventualities. To construe the provision widely could conflict with other express, specific provisions (and any limitations in them).

Restrictions on the exercise of a contractual discretion

The Trust had a contractual power to make deductions from monthly payments and to award service failure points. The original trial judge found there was an implied term that, in exercising this power, the Trust would not act in an arbitrary, capricious or irrational manner. He came to this conclusion after considering various authorities where a term has been implied in a commercial contract as a restriction on the exercise of a contractual discretion: the discretion must be exercised in good faith, and not in an arbitrary, capricious or irrational manner.

The Court of Appeal came to a different conclusion. The authorities considered by the trial judge all involved a discretion which involved making an assessment or choosing from a range of options, taking into account the interests of both parties. In this case, the discretion conferred on the Trust just permitted the Trust to decide whether or not to exercise an absolute contractual right. If the Trust awards more than the correct number of service failure points or deducts more than the correct amount from a payment, the Court of Appeal felt this would be a breach of the express provisions of the contract, and there was no need to imply a term to regulate the operation of the clause in question.

⁴ *Street v Derbyshire Unemployed Workers' Centre* [2004] EWCA Civ 964

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