Implied Duty of Good Faith in English Contract Law

Gavin CHESNEY
international counsel at Debevoise & Plimpton LLP

Mikhail MOVSHOVICH
senior associate at Debevoise & Plimpton LLP

Charles LOW
associate at Debevoise & Plimpton LLP

This article discusses recent significant developments in English law regarding the implication of a duty of good faith in commercial contracts. It also addresses certain concerns that may arise in practice and outlines recommendations that should be considered when negotiating and performing a deal.

Introduction

In his 2013 judgment in *Yam Seng Pte Ltd v International Trade Corp Ltd*, Leggatt J. in the High Court stated that there was "nothing novel or foreign to English law in recognising an implied duty of good faith in the performance of contracts".[1]

However, there remains no generally applicable principle of good faith in English law. Instead, duties of good faith are only implied in certain types of legal relationships, such as: in employment, partnership or fiduciary relationships;[2] between parties to "relational" contracts that are premised on high levels of collaboration and expectations of predictable performance based on mutual trust and confidence; with respect to the exercise of certain forms of contractual discretion by a party (known as the *Braganza* duty); or where required by statute, such as under the *Consumer Rights Act 2015*.[3]

> There remains no generally applicable principle of good faith. However, when negotiating and performing a contract, parties should still pay careful attention to what they do or say, because the principle of good faith may be implied in certain relationships

The historical reluctance of English law towards embracing the idea of a generally applicable duty of good faith stems from two primary elements: the ethos of freedom of contract, whereby parties are free to pursue their self-interest, and the fear that the content of a duty of good faith would be vague and subjective, which may result in differing interpretations of contractual provisions, thus creating legal uncertainty. The position under English law contrasts with that of many civil law jurisdictions.[4]

Nevertheless, since *Yam Seng*, there have been significant developments in English law that have expanded implied duties of good faith.

Of the various types of contracts that may carry an implied duty of good faith, this article will focus on the implied duty of good faith in the particular context of relational contracts and the *Braganza* duty, as those two categories are most relevant and generally applicable to commercial practice. This article also addresses certain concerns arising from these recent developments and outlines practical recommendations going forward.

Relational contracts

Many contracts, such as franchise agreements, distribution agreements and joint venture agreements, are entered into for

[1] *Yam Seng Pte Ltd v International Trade Corp Ltd* [2013] EWHC 111 (QB), para 146.

[2] A fiduciary relationship is a relationship of trust and confidence that arises under English common law whereby one party (the fiduciary) is obliged to act in the best interests of another party (the beneficiary), whether by providing advice to, acting for or on behalf of, such party – e.g., relations that arise as between a trustee and beneficiary, principal and agent or attorney and client.

[3] Section 62(4) of the *Consumer Rights Act* 2015 provides that a term is "unfair" if, "contrary to the requirement of good faith, it causes a significant imbalance in the parties' rights and obligations under the contract to the detriment of the consumer."

[4] For instance, as a matter of general principle, Article 1 of the *Russian Civil Code* expressly provides that parties must act in good faith in establishing, exercising and protecting their rights and no one can benefit from its illegal or mala fide conduct. As further elaborated by the Supreme Court of Russia, the bona fide conduct of a party means a conduct that is expected of any participant in civil law relations taking into account rights and interests of the other party and assisting it, among other things, in obtaining necessary information.

long periods of time and often require high levels of collaboration between their parties. As was the case in *Kent* considered below, the high degree of communication and co-operation, and the expectation of predictable performance based on mutual trust and confidence that these contractual relationships entail has led to a growing willingness to imply a duty of good faith. A number of such commercial relationships have now been characterised as "relational contracts".

Sheikh Tahnoon Bin Saeed Bin Sakhboot Al Nehayan v Ionnis Kent[5]

The Sheikh (claimant) and Mr. Kent (defendant) entered into a joint venture to set up a brand of luxury hotels. The business was unsuccessful, the parties' relationship deteriorated into acrimony, and the parties negotiated a separation agreement and a related promissory note. When the claimant sought to enforce the separation terms, the defendant resisted. The court upheld the defendant's argument that the original joint venture agreement was a relational contract into which a duty of good faith should be implied. The court further held that the duty had been breached by the actions of the claimant's representatives during negotiations of the separation of the business as they covertly entered into parallel negotiations with a third party for the sale of the claimant's stake in the joint venture, and put the defendant under illegitimate pressure, including blackmail, to sign the deal. The claimant's action to enforce both the agreement and promissory note therefore failed.

In addition to the basic requirement that there must not be any express contractual terms that contradict the implication of a duty of good faith, the court in *Kent* considered the following factors to be material in determining the existence of a relational contract:

— the parties are committed to collaborating with each other, typically over a long-term relationship;[6]

— the relationship requires a high degree of communication, cooperation and predictable performance based on mutual trust, confidence, and loyalty, which may not fully and adequately be set out in the parties' written contract but which are implicit in the parties' understanding of their venture; and

[5] *Sheikh Tahnoon Bin Saeed Bin Sakhboot Al Nehayan v Ionnis Kent* [2018] EWHC 333 (Comm).

[6] As noted in *Alan Bates and Others v Post Office Limited* [2019] EWHC 606 (QB), para 732, notice provisions which allow parties to terminate their contractual relationships would not generally prevent a finding that a long-term relationship was intended by the parties.

Many commercial contracts, such as franchise agreements or joint venture agreements, are entered into for long periods of time and often require high levels of collaboration and may thus be characterised as "relational contracts"

— the relationship anticipated greater candour and mutual trust than would be the case in an ordinary commercial bargain between parties dealing at arm's length.

All these factors were found in the venture between the Sheikh and Kent, in addition to the finding that their venture was based on their personal friendship and both parties were content to deal with each other informally on the "mutual trust that they would pursue their common project in good faith".

Based on *Kent,* it appears that, whilst the question will always depend on the circumstances of each case, joint venture agreements, shareholders' agreements, share purchase agreements with a long pre-closing period providing for complex reciprocal covenants during that period, franchise agreements and long-term distributorship agreements may be more likely than other types of agreements to fall within the scope of relational contracts. The courts appear likely to give particular weight to close relationships of trust between the parties. That trust may be indicated, in particular, by the parties deciding that it was unnecessary to record all of the terms of their legal relationships in writing.

The concept of relational contracts was recently revisited by the English High Court in *Bates*.

Bates v Post Office Ltd[7]

Sub-postmasters ("SPMs") who were operating post offices across the UK brought claims against the Post Office. The SPMs reported their operations and revenues to the Post Office and were responsible for any losses caused by their or their staff's negligence. In 2000, the Post Office introduced a new accounting system called Horizon which, amongst other things, identified discrepancies in the revenues reported to the Post Office. Based on the findings of the Horizon system, the Post Office would, automatically and without further investigation, issue fines and pursue criminal prosecutions against allegedly delinquent SPMs. The SPMs claimed that Horizon was defective and, in any event, they were owed an implied duty of good faith by the Post Office in the administration and pursuit of claims against the SPMs regarding any alleged discrepancies.

[7] *Alan Bates and Others v Post Office Limited* [2019] EWHC 606 (QB).

The court in *Bates* found that the contract between the SPMs and the Post Office was a relational contract, but it did so on the basis of a very different set of considerations to those in *Kent*. They included:

— the provision of a public service through the Post Office branches, which entailed a relationship of trust between the SPMs, the Post Office and the public;

— the entitlement of SPMs to certain "employment-type" benefits;

— the requirement under law for the Post Office to maintain branches across the UK, even in locations that would not normally be commercially viable; and

— the significant investment of the SPMs in, amongst other things, purchasing or leasing premises for Post Office branches.

Certain legal commentators and practitioners have expressed some concern that the main common factor behind the finding of a relational contract in *Bates* and *Kent* was an envisaged long-term relationship between the relevant parties. Unlike *Kent*, in *Bates*, there was no context of "friendship" or other similar relationship to anchor a finding of a relational contract. The parties were dealing at arm's length and it appeared that their contractual relationships were governed by a comprehensively-drafted contract. This has resulted in concerns that the expectation of a long-term contractual relationship alone could found a relational contract.

Yet, such an approach is debatable. *Bates* was an exceptional case, involving a prominent public service element and a relationship between the SPMs and the Post Office that had elements typical of employee-employer relationships. The former element makes *Bates* a factually exceptional case, whilst the latter potentially re-categorises any implied duty of good faith as employment-based, or as based upon a closer relationship than would be expected in a typical commercial transaction. Accordingly, it may be that *Bates* should not be regarded as a significant expansion of the scope of relational contracts beyond the ambit of *Kent*.

Implied duty of good faith in relational contracts

Once a relational contract is identified, the scope of an implied duty of good faith must be determined. This is not entirely certain, and will depend on the particular circumstances of the relationship between the parties. Any duty will normally apply reciprocally to all parties to a relational contract.

The general principle is that an implied duty of good faith is a duty to refrain from conduct which would be regarded as "commercially unacceptable by reasonable and honest people". This means that parties in a relational contract are expected to do more than simply refrain from outright dishonest and deceptive behaviour. On the other hand, parties are not expected to hold themselves to the high standards expected of fiduciaries — they are not expected to subordinate their interests to those of another party. In practical terms, this appears to mean that parties should exercise contractual powers in good faith and transparently for the purposes for which they were conferred. In a parallel vein, they should not act in a way that would undermine the relationship of trust and confidence between the parties, which includes not exploiting one's position in the relationship at the expense of other participants.

Once a relational contract is identified, the scope of an implied duty of good faith must be determined, which will depend on the particular circumstances

By way of example, in the context of *Kent*, an implied duty of good faith was breached when the Sheikh deliberately concealed his parallel negotiations with a third party, which were contrary to the interests of Kent. That said, there is nothing wrong in a party to a relational contract pursuing its own interests, as long as it does so openly and transparently in relation to the other parties — the issue in *Kent* was not that the Sheikh had pursued negotiations with third parties in his own interest, but that he had deliberately concealed them from his business partner.

This would suggest that the following practical considerations should be taken into account when negotiating and performing a deal:

— Contracts that are comprehensively drafted and negotiated at arm's length are less likely to see a duty of good faith being implied.

— Whilst expressly excluding a duty of good faith is possible, it is unlikely to be conducive to the business relationship of the parties in practice. Alternatively, it might be advisable to draft an exclusion of any "implied duties" in the "Entire Agreements" clause.

— A duty to act in good faith can be provided for expressly in a contract, even if no such duty would be implied or required by law, but its scope should be clearly indicated. A vaguely drafted duty of good faith would erode contractual certainty, particularly if a contract simply provides for a general reciprocal undertaking of the parties to "act in good faith" or "act in a businesslike manner").

— The principles of freedom of contract mean that the courts will be reluctant, based upon a general reference to an implied duty of good faith, to override or qualify the express rights and obligations of the parties if those are clearly set out in the contract, even if there is an apparent imbalance between the positions of the parties.

Braganza duty

In 2015, the Supreme Court in the case of *Braganza v BP Shipping*[8] established a duty to not exercise a contractual discretion in a way that is arbitrary, capricious or irrational (the "*Braganza* duty").

This duty is not limited in application solely to relational contracts. It generally arises by implication where a party has a contractual discretion that affects the rights of both parties — in other words, where there is "a clear conflict of interest". It is more likely to arise where the nature of the contractual relationship reveals an unequal balance of bargaining power[9] or where parties are not dealing at arm's length or a contract is a relational one.[10] However, the parties can exclude the implication of a the *Braganza* duty to an exercise of discretion either by expressly specifying what limits (if any) should apply to such discretion, or by making it unambiguously clear that no limits are to apply whatsoever. The *Braganza* duty does not affect unilateral rights that are clearly set out in a contract.

The *Braganza* duty adopts an approach similar to that for the exercise of a statu-

[8] *Braganza v BP Shipping Ltd and another* [2015] UKSC 17.
[9] *Braganza*, para 18. See also *UBS AG v Rose Capital Ventures Limited, Dr Vijay Mallya, Mrs Lalitha Mallya, Mr Sidartha Vijay Mallya* [2018] EWHC 3137 (Ch), para 49.
[10] *UBS AG v Rose Capital Ventures Limited and ors* [2018] EWHC 3137 (Ch) (n 25), paras 49(2)-(3) and 52.

tory discretion in English public law. It focuses on both the process through which a decision is made and the outcome of the decision. On the process side, the party entitled to exercise the discretion is required to ensure that it takes into account all pertinent factors and does not take into account irrelevant factors. With respect to the outcome, the party is not necessarily required to reach any one particular decision — there is no necessary "right answer" as such — but the decision made must be within the range of those that a reasonable decision-maker could have reached, and anything beyond this range will be illegitimate.

Watson and others v Watchfinder.co.uk Ltd[11]

Mr. Watson and others (claimants) were directors and shareholders of a consultancy firm that was engaged by Watchfinder (defendant) to attract investors. Prior to services being rendered, the claimants and the defendant entered into a share option agreement under which the claimants were granted the right to acquire shares in the defendant. The option agreement contained a consent provision according to which the option could only be exercised with the consent of a majority of the board of directors of the defendant. Over the course of providing their services, the claimants introduced the defendant to several potential investors, one of which made significant financial investments in the defendant. The claimants then sought to exercise the option, but the defendant refused on the basis that the requisite board consent was not obtained.

At first glance, the consent provision in *Watson* might appear to be an unconditional right of veto for the defendant. However, such an interpretation was rejected by the court as a "commercial absurdity" — it was clear from the facts that the parties intended the option to be binding.[12] On the other hand, the court found that the option was not intended to be freely exercisable either, and the existence of the consent provision meant that the parties intended for some form of restriction to apply to the exercise of the option. In the absence of express wording in the contract to set the limits or criteria for exercise of the discretion, the court found that the restriction took the form of the *Braganza* duty.

> A contractual discretion shall not be exercised in a way that is arbitrary, capricious or irrational

The court then considered how the *Braganza* duty should apply. It began by establishing the "target" of the contractual discretion — why had the discretion been given to the relevant party? Interpreting the contract, the court found that the discretion existed to ensure that the claimants had performed their obligation to find new investors and so had "contributed to the growth, value or prospects of the defendant in some significant way". Accordingly, the discretion allowed the defendant to refuse consent to the option if the claimants had introduced no or only insignificant investors.

However, the court held that the defendant's directors had failed to follow an appropriate decision-making process, stating that the board made no considered exercise of the discretion, consent to the exercise of the option was merely mentioned in passing at a board meeting and there was no consideration by the board of the introduction by the claimants of a significant investor. In consequence, the court rejected the defendant's purported exercise of its contractual discretion to refuse consent, and instead ordered specific performance for the transfer to the claimants of the shares subject to the option.

Taking *Watson* and *Rose* as guidance, parties should bear in mind the following practical recommendations when negotiating and performing a deal that involves one or more parties being given a discretion:

— Where a contract renders the exercise of a right subject to a discretion, the parameters for the exercise of such discretion should also be clearly and specifically set out in the contract.

— The more specific and clear such parameters are, the less likely that it will be necessary for the *Braganza* duty to be implied.

— For the party entitled to exercise any discretion, proper consideration should be given to the discretion and clear records, such as detailed board minutes, should be maintained to show that all relevant matters were considered and related steps were taken.

— Contracts can be drafted so as to exclude the implication of the *Braganza* duty.

Conclusion

Where it exists in civil law systems, the principle of good faith in contractual relations cuts both ways. On the one hand, it is intended to uphold the presumed intent of contracting parties, fill up possible gaps in contractual terms, prevent abuse or arbitrary exercise of rights, restore the balance between the parties and, generally, protect a weaker party's interests. On the other hand, it may erode legal certainty by introducing a degree of subjectivity.

As discussed in this article, it remains the case that there is no generally applicable principle of good faith in English law. However, when negotiating and performing a contract, parties should still pay careful attention to what they do or say, because the principle of good faith may be implied in certain relationships, particularly in relational contracts or where a party is given a discretionary right. Further, a duty of good faith could arise from the laws of other jurisdictions even where a contractual relationship is governed by English law since, in certain jurisdictions, a duty of good faith may apply as an overriding legal principle regardless of the governing law chosen by the parties. The parties may also expressly agree in their contracts to act in good faith, but the practical effect of doing so, particularly in the context of enforcement, may be uncertain and limited.

As is frequently the case with English law contracts, care and diligence at the drafting stage to ensure that the obligations of the parties are clearly set out, the limits of any discretions are clearly defined and potential implied duties are clarified or excluded can help to ensure certainty within the contract, enabling all parties to fully understand their obligations and rights throughout the contract's life.

END

[11] *Watson and others v Watchfinder.co.uk Ltd* [2017] EWHC 1725 (Comm).
[12] The court paid attention to the fact that the claimants had insisted on its execution prior to rendering any services to the defendant.