

## UK Ruling Adds Clarity To Duty Of Good Faith In Contracts

By **Louise Freeman and Alan Kenny** (January 17, 2023, 2:54 PM GMT)

English law does not impose a duty of good faith on all contracting parties, unlike some other legal systems.

However, there is now a body of cases in which such duty has been implied in commercial contracts. English law also imposes some restrictions on the exercise of contractual discretion.

This article considers recent developments in the circumstances under which a duty of good faith can be implied into a commercial contract, the potential expressly to exclude such duty, and the remedies available for breach of such duty.

It also considers the practical impact of the imposition of such a duty. This has been somewhat clarified by the recent U.K. Court of Appeal decision in *Re Compound Photonics Group Ltd.; Faulkner v. Vollin Holdings Ltd.* in October last year,<sup>[1]</sup> albeit uncertainties remain.

### When a Duty of Good Faith Can Be Implied Into a Commercial Contract

In recent years, a concept has developed whereby a general duty of good faith is likely to be implied, where there is no express provision, into English law commercial contracts that are relational.

A relational contract is one that is long-term and calls for collaboration, cooperation and a greater regard for each other's interests than would ordinarily be required between contracting parties dealing with one another at arm's length.

Just because a relationship between parties is relational, it does not follow that any contract entered into in the course of that relationship must be relational. A nonexhaustive list of ingredients for a relational contract was set out in *Bates v. Post Office* in 2019:<sup>[2]</sup>

- There are no specific express terms preventing a duty of good faith being implied;
- The contract is long-term, with the parties mutually intending a long-term relationship;



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- The contract involves a high degree of communication, cooperation and predictable performance based on mutual trust, confidence, and expectations of loyalty;
- The parties intend that their respective roles be performed with integrity and with fidelity to their bargain;
- The parties are committed to collaborating in the performance of the contract;
- The spirits and objectives of the venture may not be capable of expression exhaustively in a written contract;
- The parties intend to place trust and confidence in one another, but of a different kind to that involved in fiduciary relationships;
- There may be a degree of significant investment or financial commitment by one party, or both, in the venture; and
- The relationship may be exclusive.

It is not necessary for all of these ingredients to be present; however, the more that are, the greater the likelihood that the contract will be relational.

It is important to remember that an implied duty of good faith is no different from any other implied term. For the duty to be implied, it must be:

- Either:
  - Necessary to give business efficacy to the contract, so that no term will be implied if the contract is effective without it (the business efficacy test); or
  - So obvious that "it goes without saying" — the officious bystander test; and
- Capable of clear expression and not contradict any express term — the cardinal rule.

Increasingly, contracts may include express terms that refer to positive requirements to exercise good faith. These terms may be linked to specific defined contractual obligations. Where this is the case, it may make it more difficult to argue that other terms, which do not refer to such requirements, ought to be subject to an implied duty of good faith.

### **Good Faith Limitations on Contractual Discretions: the Braganza Duty**

Separately, the courts have found that where a commercial contract requires one party to exercise a contractual discretion, they must do so rationally.

In summary, this means reasonably and in good faith and not arbitrarily or capriciously — known as the Braganza duty, stemming from the 2015 case of *Braganza v. BP Shipping Ltd.*[3]

Reasonableness here does not have its colloquial meaning. Rather, it is defined by a test with two limbs:

- First, the court will assess whether the right matters have been taken into account by a party in reaching a decision in the exercise of its discretion; and

- Second, the court will assess whether the result of this exercise of discretion is so outrageous that no reasonable decision maker could have reached it.

If the right matters have been taken into account and the result is not outrageous, the discretion will be deemed to have been exercised rationally.

### **Expressly Excluding an Implied Duty of Good Faith**

In principle, it is possible to expressly exclude an implied duty of good faith when drafting a contract. This is a further consequence of the duty's basis in the contracting parties' presumed intentions.

As such, it is open to the parties to modify the scope of the duty by express contractual terms and to exclude it altogether.

In practice, however, it may be commercially difficult to suggest excluding a duty of good faith at the outset of a contractual relationship.

It may be more acceptable to expressly identify those obligations that are to be subject to a duty of good faith, thereby implicitly evidencing the contracting parties' intention for other obligations not to be, or to state expressly that a good faith duty only arises where expressly specified in the contract.

As regards the Braganza duty, this is now well established and will be presumed to apply in the absence of very clear and unequivocal language to oust it and ensure that a contractual discretion is treated as an absolute contractual right.

Further, in certain factual circumstances even clear language may not be enough. For example, in recent cases concerning employment and consultancy contracts purporting to provide employers with absolute discretion whether to award bonuses, the courts have consistently held that such wording did not in fact provide an absolute discretion, but rather one subject to the Braganza duty.

A party may, in certain circumstances, want to consider including wording to specify the extent to which any contractual rights are discretions, or as to exactly how any discretions are to be exercised, e.g., by outlining examples of conduct that will fall in and out of scope, in defined circumstances.

### **Additional Obligations a Duty of Good Faith May Impose**

There is no single definition of good faith, or universally applicable minimum standards that a duty of good faith entails.

To the contrary, in *Compound Photonics Group*, which concerned express good faith provisions but nonetheless provides guidance relevant to an implied duty of good faith, the court warned against a formulaic approach that may detract from examination and interpretation of the context in which a specific good faith provision exists.

Instead, courts should try to identify the shared intention of the parties from the express and implied contractual terms, applying ordinary principles of construction.

As such, any analysis of what additional obligations may be imposed by a duty of good faith, whether express or implied, is necessarily very fact-dependent.

That said, Compound Photonics Group does provide some guidance on what it means generally to act in good faith: The core duty imposed is one of honesty, assessed objectively.

However, good faith is not simply another term for honesty; the court recognized that there might well be "commercially unacceptable behavior" that breaches the requirement of performing the contract in good faith, but which it would be difficult to characterize definitively as dishonest.

The court provided little further guidance on what specific behavior would fall into this category, so there remains scope for argument in this regard.

The court was clearer in dismissing suggestions arising in prior cases that a duty of good faith imposes generalized process duties in all circumstances, such as a duty to observe reasonable commercial standards of fair dealing and openness, or to consider or act consistently with the interests or justified expectations of a counterparty.

Similarly, it questioned dicta from prior cases suggesting that a duty of good faith imports a generalized obligation of fidelity to the bargain, or one to act in the spirit of the contract, warning against attempts to use contractual references to such vague concepts as imposing additional substantive obligations or restrictions.

In prior cases, good faith provisions have been variously interpreted as imposing the following practical requirements on parties:

- Providing full and frank disclosure of material facts;
- Not lulling a counterparty into a false belief or pursuing an ulterior purpose;
- Not engaging in deception or the knowing provision of false information;
- In the context of a joint venture, not participating in undisclosed negotiations with third parties;
- Not knowingly commencing or persisting in a groundless dispute;
- Transparently reporting shortfalls in contractual performance;
- Cooperative and even-handed investigation of causes of failure to perform obligations; and
- Transparency as to problems encountered with performing obligations.

In addition, the courts have been clear in finding that good faith is not a fiduciary duty.

Relational contracts subject to an implied duty of good faith involve trust and confidence but of a different kind from that involved in fiduciary relationships.

Specifically, they do not require that one party subordinates its interests to those of another.

### **Remedies for Breach of an Implied Duty of Good Faith**

If the effect of the breach deprives the nondefaulting party of the substantial benefit of the contract, they will have the right to terminate the contract and claim damages, including loss of bargain damages<sup>[4]</sup>, or affirm the contract, i.e., treat it as persisting irrespective of the breach, and claim damages, excluding loss of bargain damages.

If the effect of the breach does not deprive the nondefaulting party of the substantial benefit of the contract, they will not have the right to terminate but will be entitled to claim damages, excluding loss of bargain damages.

Damages are awarded on the same basis as for breach of contract generally and are subject to the same rules around causation, mitigation, reasonableness and remoteness.

Equitable remedies may also be available, depending on the circumstances, including specific performance, injunctive relief and an account of profits.

### **Commentary**

While other common law jurisdictions now imply a general duty of good faith into all commercial contracts regardless of their type or underlying facts, English law is unlikely to go this far.

Where a commercial contract is classified as relational, a general duty of good faith may be implied. Further, commercial contracts purporting to give parties discretion when exercising contractual rights may be subject to the Braganza duty, requiring discretion to be exercised rationally.

Prior cases provide some guidance on what a duty to act in good faith may mean in practice, but the courts are reluctant to set out a list of minimum standards that will apply in all circumstances.

As such, any assessment will necessarily be very much dependent on the wider contractual and factual context.

When drafting commercial contracts, parties should consider their intentions and the nature of the contract.

They should evaluate whether it is likely to be considered a relational contract or involve the exercise of contractual discretions and, if so, whether further steps are required to protect their interests.

Where disputes arise, obligations to act in good faith or exercise discretions rationally can be additional strings to the bow of a claimant. Contracting parties should continue to monitor developments in this evolving area of the law.

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[1] Re Compound Photonics Group Ltd.; Faulkner v. Vollin Holdings Ltd. [2022] EWCA Civ 1371.

[2] *Bates v Post Office Ltd (No.3)* [2019] EWHC 606 (QB), at [725].

[3] Referring to the case in which this principle was developed: *Braganza v. BP Shipping Ltd. & anr* [2015] UKSC 17.

[4] To compensate the non-defaulting party for the full loss of the expected benefit it would have obtained under the contract, had it been performed.