Do Contractual Parties Have To Act in “Good Faith”? If so, What Does That Mean?

If you enter into a contract with another party, do you have an obligation to act in good faith towards them? Two recent English court decisions considered the issue.

Traditionally, a key difference between English and New York contract law is the standard implication in New York law of a requirement of “good faith”, whereas English law focuses more upon the specific contractual obligations to which each party has agreed. A couple of recent cases in the English courts have revisited this area.

In short, the High Court has sought to extend the scope of good faith in commercial relationships, while the Court of Appeal has rowed back from that position but without closing the door on it entirely. However, parties should be mindful of the possibility that under English law their conduct might be judged against that standard in the future.

Yam Seng Pte v. The International Trade Corporation Limited

The first case was that of Yam Seng Pte v. The International Trade Corporation Limited [2013] EWHC 111, a decision of Mr. Justice Leggatt in the English High Court. The case involved a distribution agreement under which the defendant had granted the claimant exclusive rights to distribute fragrances bearing the brand name “Manchester United” in various territories. A year later the relationship ended acrimoniously, with the claimant informing the defendant that it was terminating the agreement due to the defendant’s breach.

The claimant claimed damages for alleged breaches of the agreement, including breach of an implied term that the parties would deal with each other in good faith.

In considering this argument, the judge provided a helpful historic and geographic overview of whether different jurisdictions, including England, recognise a general duty to perform contracts in good faith. As he set out, commentators appear to be of the view that in English contract law there is no generally applied legal principle of good faith. However such a principle is recognised by most civil law systems, including those of Germany, France and
Italy. The United States has long since recognised such a doctrine, in particular in New York. In addition, the concept has been gaining ground in other common law jurisdictions, such as Canada, and is now well established in Australia.

As to the position under English law, a duty of good faith is implied by law into certain categories of contracts, for example employment contracts, and contracts that involve a fiduciary relationship. The judge did not think English law had reached the stage where it was ready for a duty of good faith to be implied by law into all commercial contracts. However, he saw no difficulty in implying such a duty into ordinary commercial contracts based on the presumed intentions of the parties using the established English law methodology for implying terms into contracts.

The two principal criteria used to identify whether terms should be implied into contracts are that the term is so obvious that it goes without saying, and that the term is necessary to give business efficacy to the contract. The ultimate question is what would the contract, read as a whole against the relevant background, reasonably be understood to mean?

For present purposes, the judge found that the relevant background against which contracts are made includes not only matters of fact known to the parties, but also shared values and norms of behaviour. In his view, commerce takes place against a background expectation of honesty, and that another aspect of good faith that overlaps with honesty is fidelity to the parties’ bargain.

Further, in some contractual contexts the relevant background expectations may extend further to an expectation that the parties will share information relevant to the performance of the contract, such that a deliberate omission to disclose such information may amount to bad faith. English law has traditionally drawn a sharp distinction between certain relationships — such as partnership, trusteeship and other fiduciary relationships — on the one hand, in which the parties owe onerous obligations of disclosure to each other, and other contractual relationships in which there is no duty of disclosure. The judge thought that such a distinction was arguably too simplistic. Many contracts involve a longer-term relationship between the parties in which they make substantial commitments. Such so-called “relational” contracts may require a high degree of communication, cooperation and predictable performance based on mutual trust and confidence, and involve expectations of loyalty that are not reflected in the express terms of the contract, but are implicit in the parties’ understanding and necessary to give business efficacy to the arrangements. The judge thought that examples of such relational contracts might include some joint venture agreements, franchise agreements and long-term distributorship agreements.

The judge went on to find that in this particular context, the nature of the dishonesty by the defendant was such as to strike at the heart of the trust that is vital in any long-term commercial relationship, particularly one as dependent as this relationship was on the mutual trust between the two individuals behind the parties. The judge was not asked to decide whether the requirements of good faith extended to any positive obligations of disclosure as to the products to be sold and any material changes in information, although he thought it could have been arguable. However, he did find that, in these circumstances, there was a duty not to give false information, and a duty not to allow the claimant’s prices to be undercut.
Mid-East Essex Hospital Services NHS Trust v. Compass Group UK and Ireland Ltd.

Subsequently, the Court of Appeal considered the position in Mid-East Essex Hospital Services NHS Trust v. Compass Group UK and Ireland Ltd. [2013] EWCA Civ 200.

This case involved a contract for the provision of catering and cleaning services to two NHS hospitals. From reasonably early on, relations were challenging, and soon rapidly deteriorated. Both parties purported to terminate the contract, and maintained that they had substantial financial claims against the other.

The contract contained an express provision requiring the parties to “co-operate with each other in good faith”. However, that provision also contained a number of other clauses, and it was therefore unclear whether the duty to co-operate in good faith was a duty governing the parties’ contractual relationship generally, or whether it was specific to that particular clause.

The Court of Appeal addressed this question by “reminding” itself that there is no general doctrine of good faith in English law, albeit it is implied into certain categories of contract. It found, overturning the decision of the judge at first instance, that in those circumstances, there was no general obligation to co-operate in good faith, and that the good faith obligation was specific to that particular clause. It went on to determine the scope of the relevant good faith obligation, and found that it meant that the parties would work together honestly endeavouring to achieve the two stated purposes. Further, Lord Justice Beatson considered the decision in the Yam Seng case, and highlighted that the question of good faith was sensitive to context. Given that, in the current case, a limited obligation of good faith had been specifically included, it was important not to construe a general and potentially open-ended obligation as covering the same ground.

Conclusion

At first blush it appears that the judge in the Yam Seng case sought to go further than existing English authority in implying an obligation of good faith into a contract that did not involve a fiduciary relationship, and the Court of Appeal, in the Compass case, was not inclined to go as far. However, it may have been that the key difference between the two decisions was that in the Yam Seng case, the underlying contract was a skeletal document that did not attempt to specify the parties’ obligations in any detail. In fact, the judge in the Yam Seng case thought that the result may have been different if there had been a detailed and professionally drafted contract, and so it proved in the Compass case.

In the Yam Seng case, the judge thought the duty could be better characterised as one of good faith and fair dealing, and that what constitutes fair dealing is defined both by the contract, and also by those standards of conduct that, objectively, the parties have assumed. The Court of Appeal has not entirely closed the door on that approach. Whether a duty of good faith will be imported into more contractual relationships in the future remains to be seen. Until the matter is finally clarified, parties considering their behaviour with their contractual counterparts could be well advised to tread carefully, particularly in situations where commercial relationships are strained or a party may be in breach.

Jumana Rahman