The duty to perform commercial contracts in good faith: a critical analysis of the recent developments and the impact on loan agreements

Is the Traditional “Hostility” of English Law towards Good Faith “Misplaced”? 12 Settembre 2019 Luca Morrone

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Abstract
Il presente scritto “Is the Traditional “Hostility” of English Law towards Good Faith “Misplaced”?”, costituisce la prima di tre parti dell’elaborato “The Duty to Perform Commercial Contracts in Good Faith: a Critical Analysis of the Recent Developments and the Impact on Loan Agreements”, il quale analizza il dovere di agire secondo buona fede nei rapporti commerciali (il cosiddetto “duty of good faith”) e, in particolare, nei contratti di finanziamento disciplinati dal diritto inglese. Questa prima parte introduce il controverso tema della dottrina della buona fede nel diritto contrattuale inglese ripercorrendo e contestualizzando storicamente le sue origini, nonché analizzando il complesso rapporto fra la stessa e le fonti della contrattualistica. Al fine di valutare il ruolo che ha assunto e che l’autore ritiene debba assumere in futuro la buona fede contrattuale, vengono inoltre individuate le due principali dottrine giurisprudenziali dalle quali si considera che la natura giuridica della buona fede traggia la sua origine: le clausole implicite (le cosiddette “implied terms”) e i principi di interpretazione contrattuale (vale a dire i principi della cosiddetta “contractual interpretation”).

Per completezza di informazione, si vuole precisare che la dottrina citata nel presente elaborato non tiene conto della recente sentenza della High Court, pronunciata in Marzo 2019, nel caso Bates v Post Office Limited - Judgment No. 3 [2019] EWHC 606 (QB).

For the sake of completeness, it is clarified that the present study does not take into account the recent High Court decision in Bates v Post Office Limited - Judgment No. 3 [2019] EWHC 606 (QB) of March 2019.

Introduction
The doctrine of good faith as a principle of private law may be first traced in Roman law where it encompassed both an objective notion of honesty in the performance of contracts and a subjective one focused on the intentions of an individual not to harm another’s right. The social and moral power of the
former was even reflected in the *iudicia bonae fidei*, a category of actions available to claimants in which judges were granted wide discretionary powers to achieve substantial justice (Gai, 168-180 AD) [1].

While the concept of good faith subsequently became part of the law of contract of most civil law jurisdictions (Cf. Article 1147 Italian Civil Code, Article 242 German BGB, Article 1134 French Civil Code) [2], assuming different connotations but still representing a fundamental contractual principle, a similar pattern could not be observed in all common law jurisdictions. Apart from the United States – where the contractual obligation to perform in good faith has a consolidated tradition (Burton, 2016) [3] – Canadian law has only recently recognised a similar duty in *Bhasin v. Hrynew* [2014] 3 SSC 71 (CanLII) [4] and the Australian courts sanctioned its existence in several decisions (cf. *Renard Constructions (ME) Pty Limited v Minister for Public Works* (1992) 26 NSWLR 23; *Coal Cliff Collieries Pty Limited v Sijehama Pty. Limited* (1991) 24 NSWLR 1) [5] but a coherent and consistent approach is still in the process of being developed (Hill, 2013) [6].

**English law instead recognised the application of the notion only in limited circumstances, such as in insurance or employment contracts, stimulating a complex debate on the extent to which a broader duty of good faith should be introduced in commercial contracts.** In that respect, the recent decision in *Yam Seng Pte Limited v International Trade Corporation Limited* [2013] EWHC 111 [7], in which Leggatt J implied a term requiring performance in good faith in a distributorship agreement, was particularly controversial and originated a significant scholar and judicial reaction that highlighted a wide divergence of opinions on the matter. While the decision might have been interpreted as an opening to the introduction of the doctrine of good faith in English commercial law, Moore-Bick LJ in the recent case *MSC Mediterranean Shipping Company SA v Cottonex Anstalt* [2016] EWCA Civ 789 [8], hearing an appeal from a judgment of Leggatt J, appeared to firmly restore the traditional position that English law does not recognise a duty of good faith in commercial matters. Nevertheless, the doctrine of good faith is becoming increasingly influential in certain ambits of contract law, albeit some uncertainty surrounds its present scope and function.

This article will shed some light on the application of the duty to perform contracts in good faith, analyse the problems of the current legal framework and evaluate the possible implications of the doctrine of good faith on loan facility agreements, contracts frequently governed by English law at an international level. The first part of this article will examine the traditional features of English contract law to understand the importance of its fundamental principles and the need to develop the doctrine of good faith in conformity with those features. The second part will assess the scope of application and content of the duty to determine the extent to which the law presently achieves adequate standards of certainty and predictability. The third and final part, building on the analysis of the previous section, will evaluate the impact of good faith on loan agreements focusing on its current function as well as at the potential future developments.

1. Is the Traditional “hostility” of english law towards good faith “misplaced”? 

One of the most significant obstacles to the recognition of a duty to perform contracts in good faith, was identified by Leggatt J in *Yam Seng* in the “traditional English hostility” towards the doctrine (*Yam Seng Pte Limited* [153]) [9]. The judge, citing Professor McKendrick, mentioned three reasons for this diffidence. Firstly, the preference of English law for an incremental development or, in other words, “an aversion to general principles” (McKendrick, 1999, ch. 3 p. 44) [10]. Secondly, the importance of the underlying values of freedom of contract and individualism. Thirdly, the uncertainty that would arise from the application of a duty to perform contracts in good faith (*Yam Seng Pte Limited* [153]) [11]. The judge,
rejecting the criticism, concluded that such reluctance was “misplaced” (Yam Seng Pte Limited [153]) [12]. Thus, as a preliminary matter, it is of central importance to explore and evaluate the legitimacy of the concerns underlying the introduction of notions of good faith in commercial contracts.

1.1. The traditional features of English contract law

To this end, the starting point for the analysis is the rise of the classical model of contract law due to its significance to the development of the foundational rules and principles of English contract law. The origins of this model may be traced to the period comprised between 1770 to 1870, and are closely related to the emergence of the new social, political and economic setting stimulated by the Industrial Revolution (Atiyah, 1979, ch. 14) [13].

New economic forces demanded the law to be suited to the business needs of the individuals operating in the market, and the law of contract of the time – which already encompassed concepts of commercial exchange (Mulcahy, 2008, p. 26) [14] but was still centrally focused on fairness and substantive justice (Atiyah, 1979, pp. 402) [15] – proved not to be adequate. New principles of law emerged whose underlying ideas consisted in the freedom of parties to create legally binding obligations and the sanctity of contracts (Printing and Numerical Registering Co v Sampson (1875) 19 EQ 462 [465]) [16]. In other words, it was paramount that parties were held to their bargains and, in that context, the primary interest of the courts was the resolution of disputes in line with the values of the free market. **Limited was the regard to questions of fairness or equality of bargaining powers; the overarching idea being that the market was capable of self-regulating** (Atiyah, 1979, pp. 404) [17]. **Judges only exercised their overriding power to interfere with the free market when its operation “outraged the judicial conscience”** (Atiyah, 1979, pp. 404) [18].

The classical model of contract law institutionalised the so-called “laissez-faire economy” embracing an ethos founded on free-will: it recognised that individuals solely rely on their own judgment and pursue their own interests, and safeguarded their intentions as expressed in the contractual documents (Atiyah, 1979, pp. 405-408) [19]. Despite the diverging views on the influence of Adam Smith’s thoughts, including Campbell’s speculative interpretation of the philosopher's works that identified an intrinsically other-regarding perspective on exchanges, it is clear that English contract law endorsed an individualist philosophy (Campbell, 2017) [20].

While freedom of contract became one of the cornerstones of English contract law, which still has a critical influence on its development (Atiyah, 1979, p. 406) [21], the effectiveness of the classical model was affected by a number of shortcomings (Mulcahy, 2008, p. 29) [22]. These crucially included the failure to cope with matters regarding competition and to take into account imbalances of power in certain contractual relationships, such as when a business party deals with a consumer (Atiyah, 1979, p. 693) [23]. **The inadequacy of the system combined with a changing legal attitude which accepted an increased public intervention in determinate contractual contexts, led to the decline of freedom of contract** (Atiyah, 1979, p. 726) [24]. The process that followed could be described as a progressive departure from the sanctity of contracts and a transition from an individualistic to a paternalistic philosophy of contract law (Mulcahy, 2008, pp. 33-35) [25], which could be observed in a growing legislative and judicial interference with contracts between private parties. **However, as explained below, it would be erroneous to assume that freedom of contract and certainty of the parties’ bargains were no longer paramount.**
1.2 The intentions of the parties in the rules of construction and interpretation

Such growing legislative and judicial interference could primarily be observed in the rules adopted by judges to ascertain the meaning of contracts, which form two distinct but interrelated processes implied terms and contractual interpretation. The implication of terms may be described as the judicial or statutory introduction of terms into private contracts, whereas the interpretation as the judicial analysis of a contractual document to objectively determine the intentions of the parties (Rainy Sky SA v Kookmin Bank [2011] UKSC 50 [21]) [26].

Leggatt J in the Yam Seng case viewed good faith as an integral part of these two processes representing a group of norms that are intrinsic to commercial relations and implicitly accepted by the parties (Yam Seng Pte Limited [135]) [27]. Accordingly, it is critical to understand their underlying rules and functions.

With reference to implied terms, the main question that divides academics relates to the source of this constructive method and may be summarised in the dichotomy between the ex-post identification of the intentions of the parties, where a gap is left by the express terms of a contract (Phang, 2014) [28], and the public concern to achieve justice. In line with the second perspective, Professor Collins supported the idea that good faith represents the real basis for the implication of terms (Collins, 2014) [29]. To assess the approach adopted by English law, it is necessary to distinguish the different methods of implication. In relation to terms implied by trade customs, while Oughton and Davies (2000, p. 243) argued that such terms cannot be regarded as reflective of the presumed intention of the parties [30], it would not be unreasonable to assume that the parties involved in a given business are aware of the incidental application of certain terms.

The same reasoning could legitimately apply to terms implied by statute. The matter becomes more controversial in relation to terms implied in law, namely where terms automatically become part of determinate categories of contract as a matter of policy. While Peden argued that such terms do not depend on the intention of the parties but on the nature of the contract (Peden, 2001) [31], as correctly analysed by Austen-Baker, that is only true where the implication arises in a new category of contractual relationship because otherwise parties ought to be aware of the application of an implied term (Austen-Baker, 2017 p.2) [32]. Lastly, with regards to the implication of terms in fact, based on the circumstances of the case, it is of critical importance to consider the test that has been applied by the courts.

While a broad approach was adopted in Attorney General of Belize v Belize Telecom Limited [2009] UKPC 10 [33], as the Supreme Court recently clarified, the test for the implication in fact requires the judge to consider whether the term is necessary to give business efficacy to the contract (Marks and Spencer plc v BNP Paribas Securities Services Trust Company (Jersey) Limited [2015] UKSC 72 [17]) [34]. Thus, as a later decision summarised, the term “must be necessary to give business efficacy to the contract; it must be so obvious that it goes without saying; it must be capable of clear expression; and it must not contradict any express term of the contract” (Hallman Holding Limited v Webster [2016] UKPC 3 [14]) [35].

This restored the traditional test for the implication in fact (Walter Lilly & Co Limited v Clin [2016] EWHC 357 [39]) [36], whereby reasonableness alone was not sufficient (Marks and Spencer Plc [23]) [37]
and the court was not rewriting the contract on behalf of the parties (Trollope and Colls Limited v Northwest Metropolitan Regional Hospital Board [1973] 1 WLR 601) [38]. The stringency of the test for the implication in fact clearly highlights the strong emphasis that the law still places on the intention of the parties and clearly aligns with the traditional approach of English contract law (Trollope and Colls Limited v Northwest Metropolitan Regional Hospital Board [1973] 1 WLR 601) [39].

In line with the above, the rigour of English law in limiting the interference with the parties’ bargains may also be observed in the preference for an incremental development of rules, focused on specific problems, as opposed to the adoption of general principles (Interfoto Picture Library Limited v Stiletto Visual Programmes Limited [1988] 1 All ER 348 Bingham LJ) [40].

With regard to the second closely related but distinct (Attorney General of Belize v Belize Telecom Limited [2009] UKPC 10) [41] tool for the construction of contracts, namely the contractual interpretation, the same tension between freedom of contract and judicial intervention translated into a division between “literal” and “purposive” (or “contextual”) approach. While the former may be associated with loyalty to the wording of the contract, the latter may be described as antithetical to it (Adams and Brownsword, 2000) [42] and, in this context, resulting in the courts trying to determine the objective business common sense of the agreement.

The courts have traditionally adopted a balanced approach between the two approaches. While historically precedence was given to the business common sense where that conflicted with the strict meaning of the wording of the contract, as it was considered to better reflect the intention of the parties (Law Land Company Limited v Consumers’ Association Limited [1980] 2 EGLR 109) [43], loyalty to the text always represented a fundamental principle of interpretation (Society of Lloyd’s v Robinson [1999] 1 All ER (Comm) 545, 551) [44]. Indeed, courts recently confirmed an unwillingness to rewrite contracts to achieve a fair result (Ilott v Williams & Ors [2013] EWCA Civ 645) [45] and stressed the primacy of the wording of a contract where it may properly be assumed that such contract had been carefully drafted (Ravennavi Spa v New Century Shipbuilding Co Limited [2007] EWCA Civ 58) [46].

As McMeel pointed out, while the Supreme Court in Arnold v Britton [2015] UKSC 36 [47] marked an important shift in the balancing exercise from a more contextualist approach towards a more textualist one (McMeel, 2017) [48], there was no introduction of additional factors in the traditional interpretative process. Rather, the Court merely reasserted the significance of party autonomy, legal certainty and predictability.

In summary, a general judicial reluctance to interfere with the parties’ intentions as expressed in their agreement clearly emerges, which largely aligns the traditional principles of English contract law of freedom of contract and commercial
In particular, three observations follow: firstly, when deciding whether to imply terms into a contract, the courts generally apply a strict test and adopt a cautious approach to limit the risk of departing from the intentions of the parties; secondly, and to the same end, courts prefer to avoid the adoption of general principles such as concepts of reasonableness (Liverpool City Council v Irwin [1977] AC 239; [2015] UKSC 72 [23]) or good faith (Interfoto Picture Library Limited) [50]; thirdly, despite minor historical changes to the rules of interpretation, judges attach significant value to the language of the agreement, which as confirmed by the Supreme Court, shall represent the starting point in the process of contractual interpretation (Arnold) [51].

1.3 What should the correct approach to good faith be?
In light of the above analysis, the complexity of reconciling a general notion of good faith with traditional features of English contract law is apparent. As observed in Street v Derbyshire (Street V Derbyshire Unemployed Workers' Centre [2004] EWCA Civ 964), “shorn of context, the words “in good faith” have a core meaning of honesty. Introduce context, and it calls for further elaboration”. The concept in itself requires qualification and, if adopted as part of the construction mechanisms as suggested in Yam Seng (Yam Seng Pte Limited) [53], it may clearly have substantial and wide-ranging effects on English commercial law. For instance, it may confer disproportionate discretion on judges and result in considerable difficulties in its practical application. It follows that the introduction of a general doctrine may clearly conflict with the traditional principles of English contract law and, thus, requires the adoption of a particularly cautious approach.

While “hostility” (Yam Seng Pte Limited [123]) [54] may not represent a proportionate response, a requirement for the doctrine of good faith to be adapted to the general features and existing rules of English contract law appears sensible.

One additional element reinforcing this conclusion may be drawn from a recent empirical study carried out by Professor Cuniberti. Analysing more than 4,400 international contracts based on data relative to the period from 2007 to 2012, he proved not only the existence of a substantial market for international contracts – represented by the 30% of all the agreements in which the parties choose to subject their agreements to the law of a state other than their own – but also that “English and Swiss contract laws were consistently preferred” (Cuniberti, 2014, p. 472) [55] and “on average three times more attractive to commercial parties than any other laws” (Cuniberti, 2014, p. 476) [56].
While the author was unable to prove any correlation between the specific rules of Swiss and English private laws, which might have indicated the precise preferences of the parties, he acknowledged that the main features of a law of contract may have an impact on the parties’ choice of the applicable law (Cuniberti, 2014, p. 507) [57]. In line with that, it seems legitimate to suggest major departures from the principles of construction and interpretation, which reflect the traditional features of English contract law, may also have implications on the long-standing privileged position of English law in the international legal market (*The Atlantic Star* [1973] QB 364, 382, Lord Denning) [58].

In seguito sarà pubblicata la seconda parte.

The second extract will than be released.

**SUGGESTED READING**

2. Article 1147 Italian Civil Code; Article 242 German BGB; Article 1134 French Civil Code
8. *MSC Mediterranean Shipping Company SA v Cottonex Anstalt* [2016] EWCA Civ 789
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30. Oughton D W and Davis M, Sourcebook on Contract Law (2nd edn, Cavendish 2000) 243
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50. Interfoto Picture Library Limited (n 40).
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53. Yam Seng Pte Limited (n 7).
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TAG:  law and economics, buona fede, contratti commerciali, contracts, diritto inglese

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