

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

The Impact of Good Faith on Loan Agreements

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Abstract:

Il presente scritto “*The Impact of Good Faith on Loan Agreements*” costituisce la terza ed ultima parte 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.

In ultima istanza, l'autore si è prefissato di analizzare alcune delle conseguenze pratiche dell’introduzione del dovere di agire secondo la buona fede nei rapporti commerciali. Nello specifico, lo scritto prende in esame il modello contrattuale LMA per operazioni di finanziamento *Multicurrency Term and Revolving* sviluppato dalla Loan Market Association (LMA) e valuta nel merito gli effetti, reali ed ipotetici, della dottrina della buona fede nei rapporti di credito sia *bilaterali*, vale a dire fra una banca o un altro istituto finanziario ed un’impresa, che *sindacati*, ovvero fra un gruppo o consorzio di banche e/o altri istituti finanziari ed un’impresa.

Tenuto conto della frequente scelta del diritto inglese come legge applicabile ai contratti di finanziamento anche fra parti stabilite e/o le cui attività sono svolte in paesi diversi dal Regno Unito, la presente trattazione mette in luce la potenziale risonanza degli sviluppi dottrinali in materia di buona fede non solo a livello domestico ma anche a livello internazionale.

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.

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1 The impact of good faith on loan agreements

The uncertainty surrounding the meaning and scope of the doctrine of good faith raises concerns as to its possible application in a multitude of domains of English commercial law. In light of the importance of English law in international finance (Durand-Barthez, 2012) [1], this third part of the article will analyse the application of good faith to loan facility agreements with a focus on two key matters: (i) the present impact of good faith on the exercise of contractual discretions in loan facility agreements; and (ii), the more speculative question of the extent to which loan agreements may be characterised as *relational contracts* and, on that basis, potentially be subject to a general implied duty of good faith.

Where appropriate, reference will be made to the standard documentation produced by the Loan Market Association and commonly used in international finance (Loan Market Association, Multicurrency Term and Revolving Facilities Agreement (2016) (“LMA”)) [2].

1.1 Contractual discretions

Where the requirements for the implication of the duty of good faith are satisfied, the exercise of *contractual discretions* is increasingly subject to the scrutiny of the courts. It is thus necessary to identify the provisions of a loan facility agreement which confer discretions on the parties and may be challenged if exercised in a manner contrary to good faith.

In particular, the duty of good faith was held to apply where a lender has discretion under the facility agreement to determine whether the borrower has complied with the conditions precedent to the advancement of the funds. Assuming that the contract is based on the LMA, a lender’s obligation to advance the funds is triggered by its receipt from the borrower of a compliant utilisation request (LMA, Clause 5) [3]. However, before such obligation becomes enforceable, the borrower must satisfy several conditions precedent whose nature and scope is usually set out in a separate schedule (LMA, Clause 4 and Schedule 2) [4]. Such conditions normally consist in a requirement on the borrower to deliver to a lender a set of documents and information about its business and activity, which, critically, must be delivered in a “*form and substance*” satisfactory to the lender (LMA, Clause 4.1) [5].

Accordingly, while the borrower effectively controls the utilisation of a facility in the sense that it may decide when to draw the funds, lenders may not be obliged to comply with utilisation requests and usually reserve a subjective discretionary power to determine whether the documentation received from the borrower is satisfactory.

As Rawlings noted, such discretion may be particularly powerful if considered in light of the cautious language generally used in some of the required documents, such as in the legal opinions (Rawlings, 2012) [6].

Although such contractual power might be interpreted as a binary choice at first sight, in which case no restrictions would apply, Leggatt J in *Novus Aviation Ltd v Alubaf Arab International Bank* [2016] EWHC 1575 adopted a broad approach to the implication of a duty of good faith and held that that was not the case (*Novus Aviation Ltd v Alubaf Arab International Bank* [2016] EWHC 1575) [7].

In that instance, the defendant (the bank) was found to be in breach an implied duty of good faith on the basis that its refusal to advance the funds purely resided in its commercial interests rather than on the quality of the documentation provided by the claimant. In the context at hand, the duty of good faith translates in an implied obligation not to exercise the power “*capriciously, perversely, irrationally or arbitrarily*” (*Deutsche Bank (Suisse) SA v Khan and Others* [2013] EWHC 482) [8].

Furthermore, the duty to perform contractual discretions in good faith was held to apply to unilateral amendments to the interest rate permitted by the loan agreement by one of the parties (*Paragon Finance plc v Nash* [2002] 1 WLR 685) [9].

In analogy with the rulings cited above, despite the absence of judicial guidance at present, it is legitimate to foresee that good faith would also apply to a lender’s power to determinate whether a borrower observes covenants and undertakings, or to any provision requiring one of the parties to provide its consent, such as where a lender wishes to transfer its interest to another one (LMA, Clause 24) [10]. The nature of any obligation or restriction implied by the courts will depend on the circumstances of each case and, most importantly, on the express provisions of the contract.

However, a borrower wishing to rely on an implied duty of good faith will need to consider three crucial limitations. First, no obligation of good faith will be implied if inconsistent with the express terms of the facility agreement (*Duke of Westminster v Guild* [1985] Q.B. 688) [11].

Second, it will be possible for the parties to expressly exclude any such duty under the contract. Third, the courts may take into account the fact that parties to financial instruments are sophisticated parties that negotiate at arm’s length and such consideration may represent an important obstacle to the implication of the duty of good faith (*Dennis Edward Myers v Kestrel Acquisitions Limited* [2015] EWHC 916) [12].

A different approach will be adopted in relation to the exercise of *contractual rights* (as opposed to *contractual discretions*). In *Shurbanova v Forex Capital Markets Limited* [2017] EWHC 2133 (QB) [13], a contractual right entitling the defendant to terminate the agreement was held not to constitute a contractual discretion and, accordingly, not subject to a *Braganza duty* (nor a duty of good faith).

This approach was confirmed in *Monde Petroleum SA v WesternZagros Ltd* [2016] EWHC 1472 [261] [14] where it was held that the reasons for the legitimate exercise of a contractual right to terminate the agreement are irrelevant. **In light of the recent judicial developments, it emerges that the law drew a clear distinction between *contractual discretions* and *contractual rights* and, accordingly, it may be assumed that no duty of good faith will apply to the lender's right to demand the repayment of a facility on the occurrence of an event of default (LMA, Clause 23) [15].**

In summary, it clearly emerges that good faith has a precise impact on loan agreements and imposes limitations on the performance of certain contractual clauses. Although in some cases the distinction between contractual rights and discretions may become difficult to determine, it is submitted that the current judicial approach strikes the right balance between the autonomy and legitimate expectations of the parties by preventing behaviours that are inconsistent with the purpose of the contract and, at the same time, ensuring a satisfactory standard of commercial certainty.

1.2 The *relationality* of loan facility agreements

While the role of good faith in the exercise of contractual discretions is precisely confined to specific circumstances, as examined in the second part of the article, the same may not be said in regard to the distinction of *relational contracts*. Whilst Leggatt J in *Yam Seng* mentioned “*joint venture agreements, franchise agreements and long-term distributorship agreements*” (*Yam Seng Pte Ltd v International Trade Corporation Ltd* [2013] EWHC 111 [142]) [16] as examples of relational contracts, the judge later clarified that “*there is no hard and fast distinction: the extent to which a contract has “relational” features is a matter of degree*” (Leggatt, 2016 [28]) [17].

It is thus necessary to consider whether there is a risk that a loan facility agreement may be characterised as a relational contract and, as a result, become subject to a general implied duty of good faith on the parties (*Mid Essex Hospital Services v Compass Group* [2013] EWCA Civ 200; *Al Nehayan* [174]) [18].

To properly assess the nature of the relationships involved in a facility agreement, a distinction will be made between bilateral and syndicated loans. In line with the absence of uniform parameters to define relational contracts, the method for this analysis will consist in the identification and examination of the relational features in each such type of loan agreement and balance them against those that seem to conflict with them.

With reference to *bilateral facilities*, the “*relationality*” of the contract may be observed in several features. Firstly, in line with their remarkable flexibility, term loans may have a duration that ranges from one year to even thirty years, such as in the case of mortgages. Clearly, in the case of medium or long-term loans the duration may constitute a *relational* aspect. Secondly, loan agreements usually contain extensive monitoring provisions – requiring a significant and recurrent exchange of information – and covenants which, unless varied throughout the loan, may have a significant impact on the business of the borrower.

Despite these features may indicate an enhanced requirement of cooperation and communication between the parties, a different conclusion may be reached if the purpose of these clauses is considered. Indeed, they are primarily designed to enable the lender to monitor the risk underlying the loan, protect its financial position and resolve the relationship in case of the borrower’s failure to comply with them (LMA, Clause 23) [19].

Third, two main observations may be made in relation to the requirement of predictable performance and expectation of loyalty. Loan facility agreements are usually negotiated by sophisticated and well-advised commercial parties and contain detailed provisions as to the conduct required by both parties and the procedures to be followed upon the occurrence of determinate circumstances.

Furthermore, the relationship involves, in virtually all cases, a divergence of intentions: the return of a lender without incentives on the return connected to the performance of the borrower, such as equity kickers, is limited to the payment of interest, whereas the borrower is primarily concerned about the increase of the equity value. Moreover, should the borrower’s performance exceed the expectations, its opportunity to refinance at better conditions in reflection of a lower risk may represent a concern for the lender. **In light of the above analysis, despite the increasingly significant recognition of relational contracts, it is submitted that a bilateral loan may not be characterised as *relational*.**

The principal difference in the case of a *syndicated facility agreement* is that a group of lenders – as opposed to a single lender – agrees to provide the funds to the borrower under the same facility. However, as a syndicated facility may be considered a single document encompassing a number of contracts regulated by the same terms between each lender and the borrower (Paterson and Zakrzewski, 2017 p. 454) [20], the discussion in the preceding paragraph would equally apply to the borrower-lenders relationship.

One rather more complicated question is represented by the relationship between the other parties to a syndicated facility agreement, namely, the arranger or lead bank appointed by the borrower to arrange the syndication with prospective lenders, and the agent bank appointed as coordinator of the syndicated loan once the contract enters into force.

As previously anticipated, the focus of the present analysis is on the application of good faith as an implied term to relational contracts and, as such, it does not aim to examine in detail the nature of the relationships of all parties to a loan syndicated facility agreement, on which copious academic literature was produced. Four specific observations are noteworthy.

First, the relationship between members of the syndicate requires particular attention due to the concerted nature of the transaction. Specifically, although pursuant to the agreement the lenders' obligations are “*several*” and their rights “*separate and independent*” (LMA, Clauses 2.3(a)-(b)) [21], and as a result no lender is liable for the failure of another lender to advance the funds, their power to exercise contractual rights is usually restricted by voting provisions.

Some decisions may be subject to the consent of all lenders, whereas others may require majority voting. As a result, lenders are usually not entitled to unilaterally call an event of default and accelerate the facility (LMA, Clauses 26.7, 35.1) [22].

Moreover, the payments by the borrower to the lenders will be channelled through the agent bank which will distribute them *pro rata* among the lenders, and the contract will provide for any payment recovered directly by a lender to be notified and eventually repaid to the agent for equal distribution (LMA, Clause 28) [23].

These provisions may clearly suggest that the relationship involves a requirement of cooperation and non-discrimination between the members of the syndication, that may be associated to relational contracts. However, the agreement expressly documents in detail the procedures to be followed, leaving narrow scope for unstated expectations.

Furthermore, even in this case, each lender should be entitled to pursue primarily its individual commercial interest, provided that it does not act in a manifestly oppressive manner against a minority of lenders (*Redwood Master Fund Ltd and Others v TD Bank Europe Ltd and Others* [2002] EWHC 2703) [24]. In addition to that, each lender is permitted under the agreement to transfer its rights and obligations to a new lender (LMA, Clause 24) [25], and this clearly suggests the absence of a special relationship.

In summary, it emerges that a minor risk that that the agreement between lenders may be characterised as *relational* exists and, unless the contrary is expressly provided for in the agreement, a duty to act in good faith may be implied. The implication of such duty could have an impact on the exercise of voting rights.

For instance, in *Strategic Value Master Fund v Ideal Standard International Acquisition SARL* [2011] EWHC 171 [26] certain companies connected to the borrower acquired an interest in the loan becoming majority lenders and waived an event of default called by the previous lenders (Lawrence J, “Equity Cures and Waivers”, (2011) 3 JIBFL 148) [27]. The court held the companies were entitled to do so but it may be open to question whether that behaviour would be sanctioned by an implied duty to act in good faith among lenders. Similarly, any such duty might prevent majority lenders from voting in a manner that is oppressive or unfair towards the minority.

Second, relational features may be observed in the relationship between the arranger and the borrower. The arranger is appointed by the borrower primarily to assist it in the preparation of the information memorandum – a document designed to “*provide would-be participants in a given loan a summary of the loan transaction [...] together with information on the principal credit issues (...) and the details of the pricing structure*” (*Raiffeisen Zentralbank Osterreich AG v RBS* [2010] EWHC 1392 [92]) [28].

Moreover, it approaches potential lenders to assemble a syndicate and prepares the documentation of the facility. A significant degree of cooperation and communication between the arranger and the borrower is clearly present together with, to some extent, mutual trust and confidence and an expectation of loyalty. Although the contract does not always involve a long-term relationship, it is not excluded that this relationship may potentially be characterised as a *relational* and subject to a duty of good faith.

Third, for the sake of completeness, a *relational* contract is unlikely to be found between the arranger and the lenders as there is no contractual relationship between the parties. Moreover, considered that the arranger operates as agent of the borrower, it may be properly concluded that, provided that the arranger does not later become agent of the facility (*UBAF Ltd v European American Banking Corp* [1984] QB 713) [29], no *relational* feature may be detected.

Lastly, it is worth reflecting upon the relationship between the agent of the loan facility and the members of the syndication. Although a significant degree of communication, mutual trust and confidence, and an expectation of loyalty are certainly involved, the remarkably extensive detail of the contractual provisions that describe the scope of the duties and functions of the agent (LMA, Clause 26) [30], renders the implication of a duty of good faith highly unlikely [31].

That was confirmed in *Torre Asset Funding Ltd & anr v The Royal Bank of Scotland* [2013] EWHC 2670 [32], that also illustrated the narrow judicial construction of the duties of agents under the LMA standard documentation.

To conclude, it clearly emerges that in the context of syndicated loan facilities, certain relationships present relational features, and, in the absence of a precise definition of relational contracts, may potentially be characterised as “*relational*”. Such conclusion may be either interpreted as a confirmation of the unsatisfactory position of the law or a promising opportunity to introduce more flexibility and discretion in commercial contracts.

While some attempts have been made to consider the possible consequences of the implication of the duty in the instances discussed above, other possible evaluations would be purely speculative at present given the absence of a clear definition of the requirements of good faith and its facts-sensitive nature.

2. Conclusion

Although English contract law traditionally refused to introduce a general doctrine of good faith in the negotiation and performance of commercial contracts, the most recent judicial developments illustrate that the law is in a state of transition.

The Court of Appeal recently confirmed that no duty of good faith exists in the performance of commercial contracts, explaining that the introduction of such duty may undermine the certainty of the law.

However, several decisions recognised a new special class of contracts, known as “*relational*”, where the duty may apply in the future as a default rule. Furthermore, a remarkable shift towards the introduction of good faith could be observed in the context of contractual discretions.

Critically however, the effectiveness of the doctrine of good faith is seriously undermined by two major issues: first, a difficulty in determining the circumstances in which the courts are prepared to imply the obligation to perform contracts in good faith; and, second, the problem of defining the its content.

With reference to the first aspect, a particular concern is represented by the unclear definition of “*relational contracts*”. The present study, consisting in three separate articles, highlighted a lack of agreement among academics in relation to their distinctive features of such contracts as well as a judicial difficulty in developing a consistent approach. A coherent judicial guidance setting out objective parameters to distinguish such contracts would be desirable to ensure an adequate degree of certainty and predictability.

With reference to the second matter, the analysis highlighted an inherent difficulty in interpreting and defining the content of the duty. A general abstract notion of good faith is more likely to undermine than to enhance the quality of English contract law. The availability of legal alternatives to address and resolve problems of unfairness confirms the point.

***Vice versa*, this study explained that the implication of a duty to perform contractual discretions in good faith represents a sensible development, which contributes to the promotion of fairness in commercial relationships and the protection of the legitimate expectations of the parties without unduly interfering with the principle of freedom of contract.**

In light of the important role of English law in international finance, this third part of the article finally analysed the impact of the doctrine of good faith on loan facility agreements. **Despite an initial reluctance to imply a duty to perform contractual discretions in good faith in the commercial context, the most recent judicial developments illustrate an increased willingness to intervene.** Parties are entitled to pursue their commercial interests, yet they may not exercise their powers under the agreement in an abusive manner.

Lastly, the study explains that the unclear approach in respect to relational contracts may also have an impact on the relationships involved in syndicated loan agreements. Such fact confirms that the uncertain scope and content of a general duty to act in good faith may have wide-ranging and unforeseeable effects. These effects may not only undermine the principles of party autonomy and commercial predictability but also demonstrate the need for the application of notions good faith only to limited and specific questions of unfairness that escape the sanction of the ordinary rules of contract law.

Visualizza la [prima parte](#) del contributo.

Visualizza la [seconda parte](#) del contributo.

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5. LMA, Clause 4.1.
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