

## **“Contractual duties of good faith”**

**Mr Justice Leggatt**

**Lecture to the Commercial Bar Association on 18 October 2016**

1. In Cantonese “Yam seng” means “drink to success”. It is a phrase used when drinking a toast – or, as a Singapore dictionary describes it: “An exclamation made before an alcoholic drink is consumed”. It was also the name of the claimant company in one of the first cases that I heard when I went on the bench. The claimant had agreed to distribute “Manchester United” fragrances produced by the defendant in territories mainly in the Far East. There was a range of *eaux de toilettes*, deodorant sprays, shower gels, boxed gift sets and so on, all packaged in the red Manchester United colours. There was also, for real *aficionados*, a second range of products packaged in black to match the team’s away strip. It is fair to say that, although the team is very popular in the Far East, the fragrances were not. The parties fell out, accusing each other of misdemeanours – some of which the claimant relied on to justify terminating the contract.
2. The claimant contended that it was an implied term of the contract that the parties would deal with each other in good faith. In my judgment in that case I questioned what seemed to be the received wisdom that there is no duty in English law to perform contracts in good faith. I suggested that hostility to such a doctrine is misplaced. And I also pointed out that such duties of good faith are increasingly being recognised in other common law jurisdictions, leaving us as an outlier in this regard. I used the metaphor of “swimming against the tide”.
3. I am not intending this evening to repeat or discuss what I said in the *Yam Seng* case.<sup>1</sup> It has tended to evoke quite strong reactions – whether positive or negative. What I would like to do in this address is to move forward from *Yam Seng* and look at where we are now. I will consider the question: to what extent does English law at present recognise duties of good faith in the performance of contracts, and how might our law develop in the future? I will also say something about why I see the concept of good faith as significant and suggest that the

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<sup>1</sup> *Yam Seng Pte Ltd v International Trade Corp* [2013] EWHC 111 (QB).

suspicion which some English commercial lawyers have about the concept may be allayed when it is better understood.

4. I should start by defining my terms and saying what I mean by “good faith”, since it has been described as a “protean” phrase and has somewhat different meanings in different contexts.

5. I am concerned with the performance of contracts, but there is an important distinction – one that I did not or did not sufficiently notice in the *Yam Seng* case – between two different conceptions of good faith in this context. One is found in civil law systems. The other has been developed in common law systems, particularly those in the United States.

6. As an example of the civil law approach, I can take the newly revised French civil code, which came into force on 1 October 2016. Article 1104 states:

*“Les contrats doivent être négociés, formés et exécutés de bonne foi. Cette disposition est d’ordre public.”*

7. Notice, if you will, three things about this. First, the French doctrine of good faith applies to the negotiation and formation of contracts, as well as to their performance. It is not therefore concerned simply with supporting contracts which the parties have made. It limits their freedom in making contracts in the first place. It does so – and this is the second point – for reasons of public policy. The phrase “*d’ordre public*” also signifies – and this is my third point – that the public policy is an overriding one which the parties cannot contract out of.

8. Contrast this with the Uniform Commercial Code in the United States, which says (in §1-304):

*“Every contract ... imposes an obligation of good faith in its performance or enforcement.”*

Similarly, the US Restatement (Second) of Contracts says (in §205):

*“Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement.”*

9. This conception of good faith differs from the civil law doctrine in all three of the ways that I mentioned. In this formulation, it is the contract which imposes a duty

of good faith. The duty does not exist, therefore, when there is no contract and the parties are merely negotiating with each other. And what the contract imposes, the contract can also exclude or limit. The underlying aim is to give effect to the intentions of contracting parties and to support their bargain, not to restrict their freedom of contract in the interests of a broader public policy that parties should deal fairly with one another.

10. It is this second, common law conception of good faith that I am interested in. I am not suggesting that English law might embrace a continental style doctrine of good faith, nor that it should. That would not be in keeping with our legal traditions and the values which underpin our commercial law – in particular, the paramount importance which our law attaches to freedom of contract.

11. The US Uniform Commercial Code defines “good faith” as “honesty in fact and reasonable commercial standards of fair dealing.”<sup>2</sup> The US Restatement (Second) of Contracts explains the meaning of good faith as follows:

*“Good faith performance or enforcement of a contract emphasizes faithfulness to an agreed common purpose and consistency with the justified expectations of the other party; it excludes a variety of types of conduct characterized as involving ‘bad faith’ because they violate community standards of decency, fairness or reasonableness.”<sup>3</sup>*

12. Understood in this way, good faith has two elements or aspects:

- (1) Adherence to reasonable commercial standards of fair dealing; and
- (2) Faithfulness to the agreed common purpose of the contract and to the reasonable expectations of the parties arising from it.

13. Of course, this explanation is still quite abstract. As with any legal concept, it acquires more concrete meaning only from its application in particular cases. In the US there is a vast body of case law which has given flesh to the duty of good faith. I do not have time to discuss the American case law, but to give you a flavour of it, let me take just one example. It is a New York case decided in 1938.<sup>4</sup>

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<sup>2</sup> See §1-201(20); §2-103(1)(b).

<sup>3</sup> See comment to §205.

<sup>4</sup> *Goldberg 168-05 Corp v Levy*, 9 NYS 2d 304 (1938).

14. The case involved a lease of business premises where the tenant operated a clothes store. The tenant had a contractual right to cancel the lease, if the total sales from the premises in any calendar year were less than a particular figure (just over \$100k). The tenant sought to cancel the lease on the basis that the last year's sales from the premises were less than that figure. The tenant also had another clothes store nearby. The landlord alleged that the tenant had deliberately diverted sales from the leased premises to its other store for the sole purpose of bringing the turnover below the specified figure and thereby laying the basis for a cancellation of the lease. The court held that the tenant's conduct, if proved, would be a violation of the duty of good faith and fair dealing which exists in every contract.
15. This doctrine of good faith performance has been recognised in the US for over a century. More recently, it has also become established in Australia. Interestingly, the inspiration for that development seems to have been a lecture given by Steyn J (as he was at the time) at Oxford in 1991 on "The role of good faith and fair dealing in contract law".<sup>5</sup> In the following year the New South Wales Court of Appeal decided the case of *Renard Constructions (ME) Pty v Minister for Public Works*. In his judgment in that case, Priestley JA referred at some length to Steyn J's lecture and concluded that good faith and fair dealing in the performance of contracts is "in these days the expected standard." "Anything less," he said, "is contrary to prevailing community expectations".<sup>6</sup> There is now a body of cases in Australia flowing from that decision.<sup>7</sup>
16. Since I wrote my judgment in *Yam Seng*, another major common law jurisdiction has recognised a doctrine of good faith in the performance of contracts. In 2014 the Supreme Court of Canada gave its decision in *Bhasin v Hrynew*.<sup>8</sup> In a unanimous judgment the Court took two steps which in its view were needed to make the Canadian law of contract more coherent and more just. The first was to acknowledge that there is a general organising principle of good faith which underpins many facets of contract law. The second was to recognise, as one

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<sup>5</sup> Sir Johann Steyn, "The role of good faith and fair dealing in contract law: a hair-shirt philosophy?" (1991) Denning LJ 131.

<sup>6</sup> (1992) 33 Con LR 72, 113.

<sup>7</sup> See eg *Hughes Aircraft Systems International v Airservices Australia* [1997] FCA 558; *Alcatel Australia Ltd v Scarcella* (1998) 44 NSWLR 349; *Burger King Corp v Hungry Jack's Pty Ltd* [2001] NSWCA 187; *Vodafone Pacific Ltd v Mobile Innovations Ltd* [2004] NSWCA 15.

<sup>8</sup> 2014, SCC 71.

manifestation of that general principle, a specific duty of honesty in the performance of contractual obligations. So I think it can be said that, since *Yam Seng*, the tide in the common law world has continued to flow in the same direction.

#### Express duties

17. Let me turn now to English law. It is my impression – I do not know whether it accords with yours – that in commercial contracts governed by English law it has become increasingly common to find clauses which use the language of good faith.

18. Such a clause was considered in *Berkeley Community Villages Ltd v Pullen* in 2007.<sup>9</sup> The claimant in that case was a property developer who agreed to assist the owners of some farmland in promoting the land and trying to get planning consent for its residential development. The agreement had a term of 13 years: only the developer, and not the landowners, could terminate it sooner. It provided that, if the land was sold with the benefit of planning consent, the developer would receive a fee of 10% of the sale proceeds. The agreement also contained a clause which said:

*“In all matters relating to this agreement the parties will act with the utmost good faith towards one another ...”*

19. The developer spent a lot of time and effort in promoting the land. As a result, the prospects of obtaining planning consent were significantly improved and the land became much more valuable. However, the landowners decided to sell the land before planning consent had been obtained, and therefore before the developer had become entitled to be paid a fee for its work. The developer applied to the court for an injunction to prevent the sale. There was no express term of the contract which prohibited the landowners from selling the land while the agreement was still continuing but before planning consent had been obtained, so that the developer was deprived of a fee. But the developer argued that to do so would be a breach of the clause which required the parties to act with the utmost good faith towards one another. Morgan J accepted that argument and granted an injunction. He construed the good faith clause in the contract as “imposing on the defendants a

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<sup>9</sup> [2007] EWHC 1330 (Ch).

contractual obligation to observe reasonable commercial standards of fair dealing in accordance with their actions which related to the Agreement and also requiring faithfulness to the agreed common purpose and consistency with the justified expectations of the first claimant”.<sup>10</sup>

20. You may think that this explanation of what good faith requires sounds familiar and is very similar to the explanation I gave earlier based on the US Restatement of Contracts. If so, you would be right. That is not a coincidence. In deciding what the obligation to act in good faith meant, Morgan J relied on an Australian case,<sup>11</sup> which in turn cited some American sources including the Restatement of Contracts. So in this decision we can see the American concept of good faith contractual performance entering English law by a roundabout route via Australia.
21. The approach taken in the *Berkeley Community Villages* case was followed in *CPC Group Ltd v Qatari Diar Real Estate Investment Co*, a decision of Vos J.<sup>12</sup> That case was in turn cited with approval by Jackson LJ in *Compass Group UK and Ireland Ltd (t/a Medirest) v Mid Essex Hospital Services NHS Trust*,<sup>13</sup> although the clause was held not to apply on the particular facts. In the *Medirest* case the language used was simply that of “good faith” rather than “utmost good faith”. But no one suggested that anything turned on that difference and I cannot see why it should.
22. So I think it can now be said with some confidence that English law recognises and will enforce contractual duties of good faith, where they are embodied in express terms of the contract. And there are cases which tell us what good faith means in such clauses.

#### Good faith as a normal expectation

23. What of cases where there is no express obligation to act in good faith? Take *Berkeley Community Villages* as an example. The contract in that case contained an express term that the parties must act towards one another in good faith. But what if the contract had not contained such a term? Would the case have been

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<sup>10</sup> Ibid, para 97.

<sup>11</sup> *Bropho v Human Rights & Equal Opportunity Commission* [2004] FCAFC 16.

<sup>12</sup> [2010] EWHC 1535 (Ch), para 246.

<sup>13</sup> [2013] EWCA Civ 200.

decided differently, or should it have been decided differently? I would suggest that it should not make a difference. That is because the clause which required good faith did no more than express the normal expectation of contracting parties.

24. This is where I come to what I see as the real significance of the concept of good faith: why it matters. It involves what I think is quite a deep point about the nature of commerce and commercial law.
25. I simplify to make my point, but I think there is sometimes a tendency of English commercial lawyers to view commerce as if it were a kind of Darwinian struggle in which everyone is trying to gain at the expense of those with whom they do business and where, even when parties have made a contract, that does no more than set limits on the pursuit of profit at the other party's expense. This view of contracting parties as adversaries may be encouraged by the experience that we all have as lawyers of dealing with litigation. By the time parties have resorted to litigation, their relationship has often become decidedly adversarial, and the adversarial nature of our legal process may also reinforce this perception.
26. This model of commerce and of contract (as the basic legal mechanism through which commerce is conducted) does not, in my view, correspond to commercial reality. My belief about this is based on my experience when I was a barrister in advising commercial clients and trying to understand the point of view of people who actually negotiate and perform commercial contracts. As commercial barristers, you will decide for yourselves whether or not my perception accords with your own. But I believe it is a mistake to see contracting as an essentially adversarial activity. It is not what economists call a 'zero sum game' in which one party's profit is automatically the other party's loss. The essence of trade and commerce is reciprocity which benefits both parties and makes each party better off. To achieve such mutual gain, the parties agree to cooperate with each other in various ways. Contract law facilitates such cooperation by giving it legal backing.
27. If contract law is to perform that function effectively, it is necessary to recognise that not all the shared understandings and expectations which contracting parties have and which are necessary to realise their joint aims are ever spelt out, or are capable of being spelt out, in their contractual document. For example, very few, if any, contracts contain a clause by which the parties promise not to lie to one

another: that is just something which is naturally taken for granted. Furthermore, it is impossible to foresee and to provide in express terms for all the contingencies that may occur during the performance of a contract – especially when the contractual relationship is intended to endure for a long time and where the performance of the contract requires complex interactions between the parties.

28. Of course, contracts vary hugely in how much cooperation they require. At one extreme you can have a simple exchange or spot contract for the sale and purchase of a commodity. No great degree of cooperation is usually required to make a contract of that kind work. At the other extreme you may have a contract governing what is intended to be a long-term relationship requiring extensive cooperation between the parties continuing over many years. In such a case the parties may need to show flexibility and a willingness to adapt their behaviour if their joint venture is to succeed. Contracts of this second kind are sometimes referred to as “relational contracts”. That term was coined by a Scottish-American legal scholar, Ian Macneil, who wrote on this subject in the 1970s and ‘80s;<sup>14</sup> and there is now a substantial body of literature in law, economics and the social sciences about the theory of relational contracts. We can define a “relational contract” as one between parties whose relationship involves expectations of cooperation and loyalty which are not (and perhaps cannot be) completely expressed in a formal document.<sup>15</sup> In truth, there is no hard and fast distinction: the extent to which a contract has “relational” features is a matter of degree. But the term “relational contract” is a useful label to identify contracts which are towards one end of the spectrum.
29. Much of our contract law consists of default rules. Such rules simplify the process of contracting and establish a regime that is likely to reflect the expectations of reasonable parties, although the parties are free to contract out of it. Think, for example, of common law rules which govern when one party’s breach entitles the other party to terminate the contract. The parties can always override those rules and establish their own rules regulating when the contract can be terminated; and of course in many detailed, professionally drafted contracts, they do.

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<sup>14</sup> See *The Relational Theory of Contract: Selected Works of Ian Macneil*, ed David Campbell (Sweet & Maxwell, 2001).

<sup>15</sup> See Hugh Collins, “Is a Relational Contract a Legal Concept?” (forthcoming).

30. There is, I suggest, a case to be made for recognising an obligation of good faith in the performance of contracts as such a default rule. Faithfulness to the agreed common purpose of the contract, adherence to reasonable commercial standards of fair dealing – these are values which protect the integrity of the process of contracting and promote its effectiveness. There are also economic arguments that such a default rule would help to reduce the costs of contracting. Contracting parties are free to choose how much detail to put into their express contract. But negotiating and drafting a long and detailed document which tries to cover every eventuality is time-consuming and expensive. Recognising a default obligation of good faith performance may help to reduce the need for elaborate documents and make short contracts less risky.<sup>16</sup>
31. It follows also from what I have said, if you agree with it, that such a default rule is likely to have the greatest value when applied to relational contracts, because it is the hallmark of such contracts that they involve expectations of cooperation and loyalty which are not, and in practice cannot be, fully articulated in the express terms of the contractual document.

#### Developments in English law

32. So much for theory. Let me look then at where our commercial law now stands in terms of recognising implied duties of good faith in contractual performance.

#### Relational contracts

33. A paradigm example of a relational contract is a contract of employment. In an employment relationship both employer and employee typically have mutual expectations, in terms of loyalty and cooperation from the other party, which cannot be reduced to a set of contractual rules. To protect those expectations, a term is nowadays implied by law into contracts of employment that neither party will (without reasonable cause) act in a way which is likely to destroy or seriously damage the relationship of trust and confidence between employer and employee. The existence of this implied obligation was affirmed by the House of Lords in

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<sup>16</sup> See Steven J Burton, "History and Theory of Good Faith Performance in the United States", in Larry DiMatteo and Martin Hogg (eds), *Comparative Contract Law: British and American Perspectives* (OUP, 2016) 210, 219.

*Malik v BCCI*.<sup>17</sup> It has been described in later cases in the House of Lords as an obligation of good faith and fair dealing.<sup>18</sup>

34. It may be said that employment contracts are a special case. I do not see why that should be so when we are looking, not at legislation in the employment field, but at a development of the common law. The common law strives for coherence at the level of principle and, if relevant characteristics of employment relationships are also found in other contractual relationships, they should be treated similarly. In the *Yam Seng* case I gave some other possible examples of relational contracts. I suggested that some joint venture agreements, franchise agreements and long-term distributorship agreements might come into this category.<sup>19</sup>
35. That idea has been taken up in some more recent cases. I will mention two. In *Bristol Groundschool Ltd v Intelligent Data Capture Ltd*<sup>20</sup> the parties collaborated to produce training manuals for pilots. The claimant provided the content for the manuals and the defendant converted the content into an electronic application, which the parties jointly published and marketed. The parties fell out. Anticipating the end of their joint venture, the claimant secretly accessed the defendant's database and downloaded material. After the contract was terminated, the claimant used the downloaded material to continue selling the electronic training manuals.
36. One issue was whether the secret download was a breach of contract. There was no express term of the contract which prohibited it. But Mr Richard Spearman QC, sitting as a deputy High Court judge, characterised the joint venture agreement as a relational contract. He held that, in these circumstances, there was an implied term of the contract requiring good faith in its performance. The defendant had breached that term by engaging in conduct that would be regarded as "commercially unacceptable" by reasonable and honest people.

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<sup>17</sup> [1998] AC 20.

<sup>18</sup> See *Johnson v Unisys Ltd* [2003] 1 AC 518, para 24 (Lord Steyn); *Eastwood v Magnox Electric plc* [2005] 1 AC 503, para 11 (Lord Nicholls).

<sup>19</sup> [2013] EWHC 111 (QB), para 142.

<sup>20</sup> [2014] EWHC 2145 (Ch).

37. The second case is *D&G Cars Ltd v Essex Police Authority*.<sup>21</sup> In that case the Essex Police Authority used a private contractor to dispose of cars which had come into the possession of the police – for example, because they had been stolen or involved in an accident – and which were to be sold or destroyed. Under the terms of the agreement, the contractor was required to dispose of cars in compliance with instructions from the police authority. The police authority gave instructions for one particular Landrover Discovery to be completely crushed; but they later found out that, instead of sending the car to be crushed, the contractor had re-built the car, transferred the number plates from a different vehicle, and was using it as a recovery vehicle in the contractor’s own fleet. When the police authority found this out, they terminated the contract. The question was whether the termination was justified.
38. Dove J described the contract as “a relational contract *par excellence*” and held that it was an implied term that the contractor would perform the contract in good faith or – as he preferred to put it – with honesty and integrity. He concluded that, even if the contractor had not been deliberately fraudulent, there had been a breach of the implied term which amounted to a repudiatory breach of the contract.
39. There are other cases in which *Yam Seng* has been distinguished on the ground that the contract in question was not a relational contract. An example is *Hamsard 3147 Ltd v Boots UK Ltd*. In that case the parties made an interim agreement which applied while they were seeking to negotiate a long-term joint venture agreement for the claimant to supply childrenswear to Boots. Norris J found that the interim agreement could not be categorised as a relational contract and that no good faith obligation was implied in it.<sup>22</sup>
40. The judge also commented that he did not accept that there is a general obligation of “good faith” in commercial contracts. He said:
- “I readily accept that there will generally be an implied term not to do anything to frustrate the purpose of the contract. But I do not accept that there is to be routinely implied some positive obligation upon a contracting*

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<sup>21</sup> [2015] EWHC 226 (QB).

<sup>22</sup> [2013] EWHC 3251 (Pat), paras 83-85.

*party to subordinate its own commercial interests to those of the other contracting party.”*<sup>23</sup>

41. I quote that passage because I think it important to dispel the notion that an obligation of good faith requires a party to subordinate its own commercial interests to those of the other party to the contract. Good faith is not altruism. It does not require one party to put the other party’s interests before its own. That is the nature of a fiduciary duty. Good faith is different. Good faith demands loyalty, not to the other party, but to the agreement itself – to the bargain the parties have made through which each has sought to advance its own commercial interests by mutual collaboration. Norris J was in fact recognising one important aspect of good faith when he expressly accepted that “there will generally be an implied term not to do anything to frustrate the purpose of the contract”.
42. In a judgment handed down in the Commercial Court in August, Blair J found that an aircraft lease was not a relational contract.<sup>24</sup> That does not seem a surprising conclusion. But he also rejected an attempt to cast general doubt on the approach suggested in *Yam Seng*. He pointed out that it has recently been cited with approval by the Court of Appeal in *Globe Motors v TRW Lucas Varity Electric Steering Ltd*, as well as by the Singapore Court of Appeal.<sup>25</sup> In *Globe Motors*, decided in April this year, Beatson LJ endorsed the view that, in certain categories of long-term contract such as I described in *Yam Seng*, courts may be more willing to imply a duty of good faith – which he saw essentially as a duty to cooperate.<sup>26</sup>
43. This line of authority still has quite shallow roots. But those roots may be taking hold. There is now some support for the idea that, where a contract can properly be categorised as a relational contract, obligations of good faith or of a similar nature can readily be implied.

#### Contractual discretions

44. So that is the first development that I see taking place – though it is still at an early stage. The second line of cases that I want to highlight is much more firmly

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<sup>23</sup> Ibid, para 86.

<sup>24</sup> *National Private Air Transport Services Co v Windrose Aviation Co* [2016] EWHC 2144 (Comm), paras 133-136.

<sup>25</sup> See *The One Suites Pte Ltd v Pacific Motor Credit (Pte) Ltd* [2015] SGCA 21, para 44.

<sup>26</sup> [2016] EWCA Civ 396, para 67.

established. But I foresee that it could develop further and could, in time, evolve into a doctrine of the kind I envisaged earlier which treats performance in good faith as an obligation which applies to every contract, except to the extent that the parties have expressly or by necessary implication excluded it. The cases I have in mind that could lead in that direction are the growing body of cases about the exercise of contractual discretions.

45. This line of authority starts with *Abu Dhabi National Tanker Co v Product Star Shipping Ltd (The 'Product Star')(No 2)*. In that case a time charterparty gave the owners of the ship a right to refuse to obey the charterers' orders to load or discharge at a port if in their discretion the owners or the master considered it dangerous. The owners refused to proceed to a particular port in the Gulf. The Court of Appeal upheld the judge's finding that this was a breach of contract. The judgment of the Court of Appeal was given by one Leggatt LJ, who said in a passage which has quite often been quoted:

*"Where A and B contract with one another to confer a discretion on A, that does not render B subject to A's uninhibited whim. ... [N]ot only must the discretion be exercised honestly and in good faith, but, having regard to the provisions of the contract by which it was conferred, it must not be exercised arbitrarily, capriciously, or unreasonably."*<sup>27</sup>

On the facts it was found that the shipowners had not honestly believed that the port in question was dangerous and that such a belief would in any event have been unreasonable and capricious.

46. That decision was followed in *Paragon Finance plc v Nash*, where mortgage loan agreements gave the lenders a power to vary the rate of interest on the loan. The Court of Appeal held that there was an implied term of the agreements which required the lenders, in exercising that power, not to act dishonestly, for an improper purpose, arbitrarily, capriciously or unreasonably.<sup>28</sup>
47. There are many further cases in this line of authority. Another case often cited is *Socimer International Bank Ltd v Standard Bank London Ltd*, where a bank had the right to value a portfolio of securities when they were brought into account after the other party defaulted on the transaction. The Court of Appeal held that

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<sup>27</sup> [1993] 1 Lloyd's Rep 397, 404.

<sup>28</sup> [2002] 1 WLR 685, paras 30-42.

the contract gave the bank a discretion in valuing the assets limited, as a matter of necessary implication, by “concepts of honesty, good faith, and genuineness, and the need for the absence of arbitrariness, capriciousness, perversity and rationality”.<sup>29</sup>

48. Last year, the Supreme Court confirmed the applicable principles in *Braganza v BP Shipping Ltd.*<sup>30</sup> In another case in the Supreme Court, in 2014, Lord Sumption summarised the effect of the cases in this way:

*“As a general rule, the scope of a contractual discretion will depend on the nature of the discretion and the construction of the language conferring it. But it is well established that, in the absence of very clear language to the contrary, a contractual discretion must be exercised in good faith and not arbitrarily or capriciously. This will normally mean that it must be exercised consistently with its contractual purpose.”*<sup>31</sup>

49. I would like to raise, and try to answer, three questions about this line of authority. The first is: what is the **legal basis** for the restrictions on the exercise of contractual discretion which the cases recognise? Often it is left unstated. When it is stated, it is said to be an implied term. But there are of course two types of implied term. There are terms implied in fact to give effect to what the parties must be taken to have intended in the circumstances of the particular case. Lord Steyn described implied terms of this type as “*ad hoc* gap fillers”.<sup>32</sup> There are also terms implied by law as a legal incident of the contract. Such standardised terms were described by Lord Steyn as “general default rules”.<sup>33</sup> And they are in truth just one form of default rule.

50. In earlier cases such as *Paragon Finance*, the implication of a term restricting the exercise of discretion was treated as one of fact. But it seems to me that the implication has now hardened into one of law. True it is that courts regularly state that whether a term will be implied and the nature of the term implied to restrict the exercise of a discretion will depend on the terms of the particular contract and the contractual context. Yet in this line of cases we see courts implying exactly the

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<sup>29</sup> [2008] 1 Lloyd's Rep 558, 577.

<sup>30</sup> [2015] 1 WLR 1661.

<sup>31</sup> *British Telecommunications Plc v Telefónica O2 UK Ltd* [2014] UKSC 42, para 37 (citations omitted).

<sup>32</sup> *Equitable Life Assurance Society v Hyman* [2002] 1 AC 408, 458-9.

<sup>33</sup> *Ibid.*

same restrictions on the exercise of contractual discretions time and again. I quoted just now Lord Sumption's statement: "it is well established that, in the absence of very clear language to the contrary, a contractual discretion must be exercised in good faith" etc. That is language used to state a rule of law. To be sure, the rule is one which the parties may contract out of, as Lord Sumption's statement and other statements of the test make clear. In other words, it has become a general default rule.

51. The second question is: what is the **rationale** for the rule? I would suggest that it is the principle that contracts must be performed in good faith. A party which has a contractual discretion must exercise it honestly, rationally and for purposes which are within the justified expectations of the parties arising from their agreement. This is very close, if not identical, to the concept of good faith that I have described.
52. The third question is: what is the **scope** of the rule? It applies to the exercise of contractual discretions, but what counts as a contractual discretion for this purpose? As the late Professor Ronald Dworkin observed, "discretion is like the hole in a doughnut" – he evidently had in mind an American donut: "it does not exist except as an area left open by a surrounding belt of restriction".<sup>34</sup>
53. In *Paragon Finance* the contract conferred an express power on one party to take decisions on a matter which affected the rights of both parties (the rate of interest payable on the loan). The contract did not specify any criterion which the lender had to apply in fixing the rate of interest. On the face of it, the choice was open-ended. But it was held to be subject to implied restrictions. In other cases the contract has specified a criterion but the application of the criterion involved an exercise of judgment. An example is the *Product Star* – where the right of the shipowner to refuse to proceed to a particular port depended on a judgment about whether the port was dangerous, and the contract entitled the shipowner to make that judgment. It is clear that the rule constraining the exercise of discretion applies in both these situations. As I put it in a recent case, the rule applies "not only when a contract confers a duty or power on one party to take a decision which affects the interests of both parties, but whenever the contract gives responsibility

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<sup>34</sup> See R Dworkin, 'Taking Rights Seriously' (Harvard, 1977), p.31.

to one party to make an assessment or exercise a judgment on a matter which materially affects the other party's interests and about which there is room for reasonable differences of view".<sup>35</sup>

54. In all the cases where the default rule has so far been applied, the power to make a decision or the responsibility to make a judgment on a matter which affects the other party's interests has been expressly conferred by the terms of the contract. What about a case where a party has freedom to act in a way that affects the other party's rights, not because the contract expressly says so, but because the contract is silent on the point? Take the *Berkeley Community Villages* case again. The contract in that case did not say anything about whether the landowners could sell the farmland during the period of the contract and before planning consent had been obtained. So on the face of it, the landowners were free to do so. Suppose the contract had not contained an express duty to act in good faith. It does not seem to me to be a big step to take to see the case as involving the exercise of a discretion (to sell the land), but one that is constrained by a requirement that it must be exercised in good faith.
55. I therefore pose the question to you: is there any principled distinction between the exercise of an express contractual power and the exercise of a freedom which exists because the contract does not exclude it? Both are equally cases, I suggest, where a hole has been left open in the middle of the doughnut.
56. In the American case law, such as the 1938 New York case that I mentioned earlier, situations where a party acts in a way left open by the express terms of the contract so as to affect the other party's contractual rights are treated as situations in which there is a discretion which must be exercised in good faith.<sup>36</sup> By taking a similar approach, English law could evolve towards recognising a default rule that contracts are to be performed in good faith.

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<sup>35</sup> *Novus Aviation Ltd v Alubaf Arab International Bank* [2016] EWHC 1575 (Comm), para 65.

<sup>36</sup> See Steven J Burton, "History and Theory of Good Faith Performance in the United States", in Larry DiMatteo and Martin Hogg (eds), *Comparative Contract Law: British and American Perspectives* (OUP, 2016) 210, 215.

### A general principle?

57. It may well be that English law will not evolve in this way. Some of our most eminent judges remain what I might call “good faith sceptics”. An expression of that attitude can be seen in a recent judgment of the Court of Appeal on an appeal from a decision of mine.<sup>37</sup> It was a case about containers full of cotton discharged at a port in Bangladesh. The containers belonged to the shipowner and, if they were not returned to the shipowner within a certain time after the cargo had been unloaded, a daily fee was payable as liquidated damages until the containers were returned, referred to as “container demurrage”. Title to the goods passed to the consignee but the consignee refused to collect the containers and they were impounded by the customs authorities. Meanwhile, the shipper was liable for the container demurrage which was accruing from day to day, but had no power to return the containers so as to stop the payments running. By the time of the trial, the containers had been stuck in the port for some 3½ years and the demurrage claimed by the shipowner had snowballed to over US\$1m – some 10 times more than the cost of buying replacement containers.
58. It is an example of a case where it is obvious what the answer ought to be, but where the legal analysis is far from obvious. There had clearly come a time (although the Court of Appeal disagreed with me about exactly when it was) when the failure and inability of the shipper to return the containers amounted to a repudiation of the contract. The difficulty was that the shipowner had chosen not to accept the repudiation as bringing the contract to an end and had chosen instead to keep the contract alive and to go on claiming container demurrage from day to day – like the plaintiffs who went on sticking advertisements on litter bins in *White & Carter v Macgregor*.<sup>38</sup> Interestingly, the Court of Appeal held that this was a situation in which, contrary to the normal rule, the contract had been automatically terminated by the defendant’s repudiatory breach. At first instance I had taken a different approach and relied on an exception to the general rule identified in the *White & Carter* case itself and illustrated by later cases such as *The Aquafaith*,<sup>39</sup> which hold that the innocent party cannot exercise its power to keep the contract

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<sup>37</sup> *MSC Mediterranean Shipping Co v Cottonex* [2015] EWHC 283 (Comm); [2016] EWCA Civ 789.

<sup>38</sup> [1962] AC 413.

<sup>39</sup> *Isabella Shipowner SA v Shagang Shipping Co Ltd (The “Aquafaith”)* [2012] EWHC 1077 (Comm); [2012] 2 Lloyd’s Rep 61.

alive if to do so would be wholly unreasonable. What is relevant for today's purposes is a suggestion I made, in passing, that this constraint on the power to keep the contract alive could be seen as analogous to the now well established constraints on the exercise of contractual discretions and as a manifestation of a more general principle of good faith.<sup>40</sup>

59. That suggestion did not find favour with Moore-Bick LJ, who gave the leading judgment in the Court of Appeal. In his view:

*“the better course is for the law to develop along established lines rather than to encourage judges to look for what the judge in this case called some ‘general organising principle’ drawn from cases of disparate kinds.”*

And he went on to say:

*“There is in my view a real danger that if a general principle of good faith were established it would be invoked as often to undermine as to support the terms in which the parties have reached agreement.”<sup>41</sup>*

60. If that view prevails, then it is very unlikely that English law will come to recognise any general principle of good faith in contractual performance.
61. It is, I think, instructive to note the concern expressed here about recognising a general principle of good faith. The concern is that, if such a general principle were established, it would be used to undermine the terms of the parties' agreement rather than to support their agreement. Such a concern may explain the suspicion which some English commercial lawyers continue to feel towards the concept of good faith. It may derive from thinking of good faith in civil law terms, as a doctrine capable of overriding the parties' bargain. I have sought this evening to describe a different conception of good faith, which is a development of the common law, and to explain how it is rooted in the parties' agreement and seeks to uphold the justified expectations arising from that agreement. I venture to hope that, when this common law principle of good faith in contract performance is better understood, it may come, in time, to be accepted as a principle which reflects values that underpin commerce and gives greater coherence to our commercial law.

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<sup>40</sup> [2015] EWHC 283 (Comm), paras 97-98.

<sup>41</sup> [2016] EWCA Civ 789, para 45.