



JONES DAY
COMMENTARY

TOWARDS AN IMPLIED DUTY OF GOOD FAITH UNDER ENGLISH LAW

“I respectfully suggest that the traditional English hostility towards a doctrine of good faith in the performance of contracts, to the extent it still persists, is misplaced.” So said a High Court Judge, Leggatt J, in the recent case of *Yam Seng Pte Limited v International Trade Corporation Limited*.¹ On its face, this was a bold assertion.

Jurisdictions around the world generally recognise the principle that contracting parties owe each other a duty of good faith in the performance of their contractual obligations.

In the United States, this principle is enshrined in the Uniform Commercial Code which provides that “every contract or duty within this Act imposes an obligation of good faith in its performance or enforcement”.²

Similar provisions are found in the commercial codes of most civil law jurisdictions, and the courts

in common law jurisdictions such as Australia and Canada increasingly recognise a broad principle of good faith and fair dealing.

England stood out as one of the few jurisdictions that did not recognise an implied duty of good faith between contracting parties. A leading commentary on the issue notes that:

... in keeping with the principles of freedom of contract and the binding force of contract, in English contract law there is no legal principle of good faith of general application, although some authors have argued that there should be.³

Under English law, duties of good faith are owed by those in a fiduciary relationship and can exist as the result of an expressly agreed contractual term. A duty of good faith can be implied in specific contractual relationships (for example in partnership,

1 [2013] EWHC 111 (QB).

2 U.C.C. § 1-203. See also, Restatement (Second) of Contracts, § 205.

3 *Chitty on Contracts*, 31st Ed., Vol 1, ¶ 11-039.

agency, employment or insurance contracts) but, as a general rule, the English courts would not imply a duty of good faith into a commercial contract.

That position appears to be changing.

For a long time, commentators have suggested that a general duty of good faith would be introduced into English law as a result of efforts to standardise contract law within the European Union. Such a duty is already recognised in most EU Member States' systems of law, and the implementation of EU legislation has resulted in the concept of good faith being applied for various purposes in relation to specific kinds of contract.⁴ The further extension of the principle is widely anticipated. By way of example, the proposed Common European Sales Law provides that "Each party has a duty to act in accordance with good faith and fair dealing".⁵

Change may have come sooner than expected and from an unexpected quarter. In the recent *Yam Seng* decision, Leggatt J found that a duty of good faith could be implied into contracts as a matter of English law. Indeed, the judge's reasoning suggests that such a duty should be implied into many if not all commercial contracts.

YAM SENG V INTERNATIONAL TRADE CORPORATION

The case related to a distribution agreement for Manchester United branded fragrances, deodorants and other toiletries pursuant to which ITC granted certain distribution rights to Yam Seng, primarily in relation to 42 duty-free centres across Asia. Following a breakdown in the relationship, Yam Seng terminated the agreement and brought breach of contract and misrepresentation claims in the English High Court.

Yam Seng claimed, amongst other things, that ITC had breached an implied term that the parties would deal with

each other in good faith. Yam Seng claimed that ITC had done so, first, by providing Yam Seng with false information on which ITC knew Yam Seng would rely in marketing the products and, second, by authorising sales by third parties in the domestic markets of territories covered by the distribution agreement at a lower retail price than the agreed duty-free retail price.

Following a detailed analysis of the authorities, the judge held that a contractual duty of good faith could be implied and that the content of the duty to perform a contract in good faith is dependent on context. He also held that, in the context of the distribution agreement, it was clearly implied, first, that ITC would not knowingly provide false information on which Yam Seng was likely to rely and, second, that ITC would not authorise sales in the domestic market that undercut the agreed duty-free retail prices.⁶

The judge found that ITC had not in fact authorised undercutting of the duty-free prices but that ITC was in breach of "the implied duty of honesty". As a result of this and certain other breaches identified by the judge, Yam Seng had been entitled to terminate the distribution agreement and was entitled to claim damages. The judge also found that Yam Seng was entitled to damages for misrepresentation on the basis that ITC had induced Yam Seng to enter into the distribution agreement by making certain false representations as to the rights then owned by ITC.

LEGGATT J'S REASONING

The judge's reasoning, on the issue of good faith, was straightforward.

The judge began by implying a contractual obligation of honesty, stating that "[a]s a matter of construction it is hard to envisage any contract which would not reasonably be understood as requiring honesty in its performance" and noting that such a requirement meets the traditional tests for the implication of a term in that (i) it is so obvious that it

4 See, for example, the requirement of good faith in the test of unfair terms under the Unfair Terms in Consumer Contracts Regulations SI 1999/2083, implementing EU Directive 93/13/EC.

5 Proposal for a Regulation of the European Parliament and of the Council on a Common European Sales Law, Com (2011) 635 final, Annex 1, CESL Proposal, Annex I, art. 2(i) CESL. The Proposal also makes specific reference to the good faith principle in provisions relating to, amongst other things, contractual interpretation, implied terms, mistake and fraud.

6 The judge does not appear to have considered the question of whether such an implied term would have been lawful under any applicable competition laws (i.e., under the competition laws applicable in the domestic markets of the territories covered by the distribution agreement). In many jurisdictions, including EU Member States, such a provision might have been considered to be an unlawful resale price maintenance agreement.

goes without saying and (ii) it is necessary to give business efficacy to commercial transactions.

The judge extended this implied term to include an obligation to comply with “other standards of commercial dealing which are so generally accepted that the contracting parties could reasonably be understood to take them as read without explicitly stating them in their contractual document”. The judge noted that the observance of such standards (for example not engaging in business conduct that was “improper”, “commercially unacceptable” or “unconscionable”) is a key aspect of good faith.

The judge then explained that another aspect of good faith that can readily be implied into commercial contracts applying the traditional tests “is what may be described as fidelity to the parties’ bargain”. In this respect, the judge noted that contracts can never expressly provide for every event that might happen and that, in circumstances not specifically provided for, contractual language must, in accordance with well-established principles, be given a reasonable construction which promotes the values and purposes expressed or implicit in the contract.

The judge concluded by noting that “[t]he two aspects of good faith which I have identified [honesty and fidelity to bargain] are consistent with the way in which express contractual duties of good faith have been interpreted in several recent cases”. By applying the traditional tests for the implication of a term, the judge had reached the same position as if a contractual duty of good faith had been expressly included in the distribution agreement.

The judge clearly had at the front of his mind what are sometimes described as “relational” contracts. The judge noted that relational contracts may require a high degree of communication, cooperation and predictable performance based on mutual trust and confidence and may involve expectations of loyalty which are not legislated for in the express terms of the contract, but which are implicit in the parties’ understanding and necessary to give business efficacy to the arrangements. The contract before the court was a distribution agreement, but the principle could apply in many other contractual arrangements which go beyond a simple exchange of obligations: joint ventures, outsourcing

contracts, financing agreements, bank loans and swap contracts, to name a few.

The judge considered that he was recognising the existence in English law of an implied duty of good faith and fair dealing which was neither novel nor foreign. The term may be implied not as a matter of law but as a matter of fact, meaning that it is based on the presumed intentions of the parties. It is thus a question of construction of the contract and decided on a case-by-case basis.

BUT WHAT DOES IT MEAN?

A critical issue is what, precisely, is required by an implied contractual duty of good faith. What does it mean? Some assistance is given by case law regarding express terms to the same effect.

In *Berkeley Community Villages Ltd v Pullen*, Morgan J held that an express term requiring the parties to act with the utmost good faith towards one another imposed an 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 [other party].⁷

That approach was followed in *CPC Group Ltd v Qatari Diar Real Estate Investment Co*, where Vos J held that:

... the obligation of utmost good faith in the [contract] was to adhere to the spirit of the contract [...] and to observe reasonable commercial standards of fair dealing, and to be faithful to the agreed common purpose, and to act consistently with the justified expectations of the parties.⁸

In the *Yam Seng* case, the judge held that what good faith requires is “sensitive to context” but that it certainly includes “the core value of honesty”. The judge described the test of good faith as an objective test: whether, in the particular context, the conduct would be regarded as commercially unacceptable by reasonable and honest people.

⁷ [2007] EWHC 1330 (Ch) at [97].

⁸ [2010] EWHC 1535 (Ch) at [246].

The judge's core value of honesty poses difficult questions of scope. The judge indicated that the duty of honesty extends beyond a duty not knowingly to make untrue statements and suggested that "depending on the context" it might be dishonest to avoid answering a question, to give an evasive answer or even to fail to correct an answer which was incorrectly thought to be true at the time or which, whilst true at the time, has since become false. The judge even raised the question of whether the duty of honesty created a positive obligation to volunteer information relevant to the performance of the contract but held that, on the facts before him, it was unnecessary for him to decide.

COURT OF APPEAL APPROVAL?

Less than a month after it was handed down, Leggatt J's decision in *Yam Seng* was referred to in the Court of Appeal decision in *Mid Essex Hospital Services NHS Trust v Compass Group UK and Ireland Ltd.*⁹ While the Court of Appeal did not overturn the decision, their apparent approval of the decision should be treated with caution.

The *Mid Essex* case related to a substantial commercial contract for the provision of outsourced catering and cleaning services to two hospitals operated by a National Health Service Trust. Both parties argued that the other was in breach of its obligations under the contract.

The contract in the *Mid Essex* case included an express obligation of good faith, but the Trust argued that this duty was limited to certain specified matters. Compass argued that, particularly in light of the *Yam Seng* decision, the express clause should be given a wide interpretation and/or that a wider duty of good faith should be implied. The Court of Appeal found in favour of the Trust, holding that, on the facts of the case, the express provision was limited to the specified matters and that no general obligation of good faith arose.

Two of the Lords Justice referred to the *Yam Seng* decision in their rulings. The first, Lord Justice Jackson, referred only to the section of Leggatt J's decision that addressed the historical position under English law, stating in this regard that:

I start by reminding myself that there is no general doctrine of "good faith" in English contract law, although a duty of good faith is implied by law as an incident of certain categories of contract [...] If the parties wish to impose such a duty they must do so expressly.

This statement is at odds with the conclusion reached in *Yam Seng* that such a duty may be imposed implicitly rather than expressly.

Lord Justice Beatson focussed on Leggatt J's discussion of the content of a duty of good faith, considering that this was also relevant to the interpretation of the express obligation to act in good faith under the contract in question. Beatson LJ concluded that the express contractual duty of good faith should not be broadened and he did not imply a more general duty of good faith into the contract.

Thus, while the Court of Appeal cited *Yam Seng*, the Court of Appeal did not base its decision on the principles stated in *Yam Seng*. Whether Leggatt J's decision will be followed in the future remains unclear.

CONCLUSION

Anyone involved in long-term contractual relationships, including distribution agreements, joint ventures, outsourcing agreements and financing agreements, would be well advised to take note of the *Yam Seng* judgment and the likelihood that in future disputes relating to the performance of contracts, a duty of good faith and fair dealing may very well be an issue, at least until it is settled by the appeal courts or European legislators.

⁹ [2013] EWCA Civ 200.

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