FINANCIAL MARKETS LAW COMMITTEE

Duties of Good Faith in Wholesale Financial Contracts

November 2022

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Registered Charity Number: 1164902.
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Introduction

The role of the Financial Markets Law Committee (the "FMLC" or the "Committee") is to identify issues of legal uncertainty or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks and to consider how such issues should be addressed.

One topic in which there is a potential for misunderstanding is in relation to the circumstances in which, in a contract governed by English law, there will be a duty to act in good faith. This is an issue that has been discussed in many court judgments in recent years and has been the subject of much extra-judicial writing by members of the senior judiciary both in England and in other jurisdictions coupled with substantial commentary from academics.

The traditional view of English law is that the scope of the duty of good faith is narrow and of limited application to the conduct of business in the wholesale financial markets. The purpose of this paper is to discuss in the light of recent case law the nature and extent of the duty in the context of wholesale financial contracts.[1] It is intended to assist the markets and practitioners in dispelling uncertainty and misunderstanding. The conclusions are expressed shortly in the Executive Summary.

1. Executive Summary

This paper starts with a high level comparative law analysis of the concept of good faith given the scope for confusion as to the role and meaning of good faith in different systems. It examines the historical and philosophical factors that resulted in good faith having a pervasive role in modern civil law systems and how that is structurally very different in its objective and effect from the common law. It goes on to discuss how duties of good faith have developed in some of the main common law systems, Australia, Canada, New York, New Zealand and Singapore, in order to give points of comparison.

This paper continues with an analysis of the position under English law. It concludes:

1. that English contract law does not apply a generally applicable duty of good faith, nor is good faith a general organising principle;

2. duties of good faith can affect a contract executed on the wholesale financial markets either by way of an implied term or by way of express contractual agreement, but an implied term is likely to be rare; and

3. in particular, the courts are only likely to imply a duty of good faith into a "relational contract". This is typically a long term contract requiring continuing trust and collaboration between the parties. Very few wholesale

[1] This paper focuses on good faith and rationality in contractual arrangements between participants in the wholesale financial markets. It does not contemplate pre-contractual negotiations in detail (which would entail examining a range of legal concepts which arguably relate to the concept of good faith such as misrepresentation and mistake) or venture into issues which arise in consumer contracts or under fiduciary duties. The paper considers contractual arrangements without reference to considerations that may arise as a function of the legal and/or regulatory implications of a participant's particular status or role. For example, financial market infrastructures perform functions to enhance safety and efficiency in payment, clearing, settlement and recording arrangements and, more broadly, to limit systemic risk and foster transparency and financial stability. Consideration of these wider "public" functions and their interaction with any possible duties of good faith and rationality are beyond the scope of this paper.

financial markets contracts are likely to be relational. This paper discusses whether such duties are implied by law or in fact and concludes that while this is still an area of developing law the difference is more likely to be theoretical than practical.

Finally, this paper considers the related duty of rationality as it applies to the exercise of contractual discretions. Known as the Braganza duty, it has been the subject of extensive judicial discussion and refinement. This paper examines a number of situations in which such a duty has been found to exist and where it has not. The duty is not however a general doctrine of abuse of rights nor is it a general duty to act reasonably. It arises where there is the potential of a conflict of interest between the parties and there is an element of confidence reposed by one party in the other to take a decision affecting those interests. Importantly, particularly for wholesale financial markets, it does not apply to the exercise of an absolute contractual right (such as, as a general matter, a termination right or acceleration right) which a party should have an unfettered right to exercise.

2. Good Faith in Contacts – Comparative Overview[2]

2.1. Preliminary

This section has two objectives. First, to give a brief comparative overview of the concept of good faith in civil law jurisdictions (with reference for illustrative purposes to France and Germany) as compared with that prevailing in England and Wales. Secondly, to consider the approach of certain other common law jurisdictions: Australia, Canada, the State of New York, New Zealand and Singapore. An awareness of comparative contract law and practice is an essential prerequisite for practitioners advising on legal risk in international markets and wishing to avoid surprises.

"Good faith" is not a term of art with a single universal meaning: in the various legal systems selected, it is used very differently and for different purposes, as a concept, as a requirement or as a phrase. Focusing on the contrasts and parallels can contribute to a better understanding of English law and to follow the topic as it evolves in different jurisdictions with different traditions.

The observations and insights into other laws are solely to give the necessary context to the discussion of the position under English law and are not intended to be definitive statements of those laws. Examples are for illustration only. Whole books have been devoted to good faith in a single legal system, let alone its comparative study. There are different civil law traditions and national differences within them. Similarly for the common law. Rules can differ substantially and hence elude broadbrush or unitary statements.

This overview draws on the broader laws of contract and obligations, it outlines how good faith has been used and developed as a concept in order to draw out themes and approaches. This necessitates looking at the underlying history and philosophy. Because of their historical influence on so many other countries' laws of obligations, the civil law focus is primarily on French and German law.

There is in any system of contract law a tension between freedom of contract and fairness of outcome. How these are addressed and where the threshold is set

[2] The FMLC is grateful to the following lawyers who kindly reviewed and commented on drafts of the comparative law section: Ewan McKendrick, Professor Stefan Vogenauer, Bertrand Andriani, Claudia Cavicchioli, Ulrich Wolff, Adrian Gebauer, Hamish Patrick, Jenna Anne de Jong, Sterling Darling, Hanwen Chan, Malcolm Stephens, Johnathan Ross, Jason Valoti, Sonia Lim and Yvonne Tan.

affects both the substance of the obligation, how rights may be exercised and the predictability of outcome.

2.2. What is "Good Faith"?

All legal systems have ways of limiting excesses of human behaviour. They may be characterised as obligations of good faith, rules of public policy, principles of interpretation, rules in relation to remedies and enforcement or simply statutory provisions or lines of case law that address particular mischiefs and which may or may not owe their origins to a more general duty of good faith. In being turned into statutory rules they may lose the formal badge of good faith. Terminology may be deceptively inconsistent: what is called a duty of good faith in one system may be analysed with different terminology in another. For example the English law on estoppel, effectiveness of exclusion clauses, exercise of discretions or liability for misrepresentation could be analysed in French or German law as manifestations of a good faith principle. Thus the idea of estoppel is similar to the German law concept of "*venire contra factum proprium*" (to contradict one's own previous conduct), which is often derived from the good faith provision of BGB §242 (see below).

A further source of potential confusion is whether in any instance the term "good faith" is a shorthand for a standard of objectively determined acceptable behaviour or is a term used (for example when faced by disingenuous behaviour or even downright bad faith or dishonesty) to comment on the subjective attitude of the party in question in relation to a specific act. A full comparison would need to consider aspects which may not be categorised as being "good faith" requirements but which are nevertheless infused by the essence of the notion.

3. Civil Systems and the Overarching Influence of Good Faith

3.1. Philosophy and historical development

The differences between civil and English systems in their approach, philosophy and objective are fundamental, even though well-advised parties may, in a properly structured and comprehensively drafted contract cumulatively deal with the same issues.

As a broad generalisation, civil law is more concerned with the behaviour of the parties throughout the process and with encouraging performance as the primary objective and remedy. As a result, in both individual and business contracts, the law and the courts may, in some circumstances, override the express terms of the contract. The result is less freedom of contract and less predictability since the outcome may depend, not on what the parties agreed but on the court's view of whether a party has complied with what the law on good faith requires.

By contrast, English law considers it fair and just, particularly in wholesale financial markets, that the parties should have much greater (albeit not completely unbounded) freedom to decide the terms of their contract and to allocate their risks without court interference. English law also considers that, despite the risk of occasional abuse of rights or hard cases, contract predictability is essential in view of the large amounts at stake and the often systemic interdependence of parties in the market with high concentrations of risk. English law does however allow the parties freely to choose to include obligations of good faith in their contracts if they wish and this is discussed more fully later in this paper. For the civil systems it is integral to contract law and is mandatory though the parties may include bespoke provisions to modify what might otherwise be required. Both solutions mark significantly different policy choices. It is not a

question of right or wrong but rather a question of differing objectives. Civil and common law are both extremely effective in achieving their different objectives.

Good faith is a fundamental and all-pervasive structural aspect of the civil law of obligations. Its origins are not in Roman law (both the law and social pressures meant that with limited exceptions contracts were to be performed strictly according to their terms) but in the writings of Aristotle (384-322 BCE) on justice and fairness, the theological and juristic observations of Thomas Aquinas (1225-1274) on both the just price (*iustum pretium*) and the effect of changed circumstances on obligations, and Enlightenment philosophies that sought to establish a more ordered and fairer society. It sought to redress the balance between the citizen and the more powerful. It was the humanising counterweight in the subsequent codes to the potential harshness of Cartesian and Leibnizian rationalism. Promotion of commerce was not the driver.

3.2. Modern Civil Law Systems Contrasted with English Common Law

The civil law systems developed through a largely top-down coherently systematised approach by the state to regulate society with codes (supplemented by court decisions and academic writing). In doing so the drafters often drew upon or had regard to existing law or, later, largely adopted and adapted what other countries had. The interaction of the codes' provisions is as of a fine clock mechanism. The law of obligations often provides general rules, specific rules for contracts and further specific default rules for different types of contract: a journey from abstraction to the specific. The often concise style of the codes has meant that academic writing has greater importance and influence in civil law systems than was traditionally the case with English law.

Having been designed as a complete system to achieve those objectives, its paradigm contract is of a citizen effecting an everyday transaction. English law, however, developed piecemeal through litigating specific disputes (in which business custom was very influential). Only cases that related to significant business transactions were heard in the royal courts and so found their way into the law reports. The custom of merchants, by definition, socially acceptable norms within their circle, was an important influence.

Both civil law systems and English common law espouse freedom of contract. Putting to one side the overlay of financial regulation, English contract law traditionally allows (at least in the context of wholesale financial contracts) parties a blank canvas on which to make more or less whatever agreements they wish. This is encouraged by the general lack of categorisation of contracts or of default rules for particular types of contract giving the parties immense flexibility.

The French Code Civil sets out a somewhat different position: Article 1102 provides *Chacun est libre de contracter ou de ne pas contracter, de choisir son cocontractant et de déterminer le contenu et la forme du contrat dans les limites fixées par la loi. La liberté contractuelle ne permet pas de déroger aux règles qui intéressent l'ordre public* (Everyone is free to contract or not contract, to choose their contracting party and to decide on the content and form of the contract within the limits fixed by law. Freedom of contract does not permit derogation from rules of public policy).

The principal inroads into that freedom are those of good faith and measures to encourage performance. The two are linked in that encouraging performance is part of encouraging respect of the obligation undertaken and of restraining potentially damaging enforcement steps.

In the modern systems the duty of good faith is enshrined in deceptively simple terms with a general duty.

Article 1104 of the French Code Civil provides "*Les contrats doivent être négociés, formés et exécutés de bonne foi"* (Contracts must be negotiated, entered into and performed in good faith). The statutory extension beyond their performance was added in 2016 but the courts had long since developed much the same concept in that regard. The provision is expressed to be one of public policy (*ordre public*) and so falls within the second sentence of Article 1102 (see above) overriding freedom of contract.

The German civil code, the *Bürgerliches Gesetzbuch* (BGB) has an equally pithy provision in §242: *Der Schuldner ist verpflichtet, die Leistung so zu bewirken, wie Treu und Glauben mit Rücksicht auf die Verkehrssitte es erfordern* (the obligor is bound to ensure performance as may be required by good faith with regard to general custom and practice).

In both France and Germany (and other civil law jurisdictions with regard to their equivalent provisions) these single sentences have evolved separately with extensive case law and academic commentary to which it is not possible to do justice here. The good faith obligation permeates everything. In the index to an English textbook on contract law, good faith has a passing mention. In the leading French textbook, *Droit Civil: Droit des Obligations* by Philippe Malaurie, Laurent Aynès and Philippe Stoffel-Munck, the index entry for *bonne foi* takes up half a page of tiny print, covering among many other things, abusive clauses, hardship clauses, exclusion clauses, grace periods for performance, unforeseen losses, formation of the contract, negotiations, information requirements, restitution of overpayment, and termination.

Good faith has been developed by civil law courts into an extensive body of law and generally requires consistent behaviour, cooperation and collaboration to work towards performance of the contract. Taking advantage of technical arguments may breach this and (if judged abusive) exercise of contractual rights may create liability in the party purporting to exercise them.

In essence, a relationship of reliance is created between the parties once negotiations have started and before the contract has been agreed and it continues through to performance of the contract.

The duty of good faith eludes definition. Its elusiveness is part of the key to its evolution. It can be expressed as including a duty not to take advantage of the reliance or trust of the other party and to show loyal behaviour in dealings with the counterparty and a duty to work together and cooperate in achieving the objectives of the contract.

Breach of the duty of good faith can result in liability. Examples would include:

- breaking off negotiations before the contract is formed without proper cause, so that, contrary to English law, the reliance of the other party in the contract being concluded is protected;

- failure to disclose material information prior to the contract, so that, for example a market form of disclaimer effective under English law might be ineffective under a civil system. The English basic view is that pre-contract disclosure is not mandatory – if it were mandatory and was not done, there might, for example, be uncertainty about the validity of guarantees and of transactions in fast-moving derivative, securities and foreign exchange

markets. By contrast, Article 1112-1 of the French Code Civil provides *"Celle des parties qui connaît une information dont l'importance est déterminante pour le consentement de l'autre doit l'en informer dès lors que, légitimement, cette dernière ignore cette information ou fait confiance à son cocontractant. Néanmoins, ce devoir d'information ne porte pas sur l'estimation de la valeur de la prestation"* (The party who knows information which is of decisive importance for the consent of the other party, must inform him of it where the latter is legitimately unaware of this information or relies on the contracting party. However, this duty to inform does not apply to the estimation of the value of the performance). The civil law systems may also have continuing disclosure obligations, which in English law depend on the agreed terms; and

- inappropriate purported exercise of termination rights potentially resulting in both damages and enforced continuation of the contract. Hence, contrary to the English position, the courts could in some jurisdictions intervene to override an agreed immediate acceleration or close-out on an express event of default though clarity and detail in the drafting of causes of termination will often reduce this risk.

Motivation for the exercise of a right may be relevant. The extent to which a party observed good faith may affect the extent to which for example an exclusion clause is upheld or, in the case of restitution, the date from which interest accrues. The practical extent and consequences of the duty in sophisticated contracts may be mitigated but not excluded by the drafting.

3.2.1. Interpretation

With contractual interpretation heavily dependent on the subjective intention of the parties, objectively construed general obligations of good faith can apply to fill in the gaps and avoid or temper what might otherwise be harsh consequences such as a nullity of contract as a result of a subjective failure to agree on the terms or contractual provisions which are intrinsically abusive or open to abuse. For example BGB §157 requires that (in addition to giving effect to the intended will of the parties pursuant to BGB §133) contracts are to be interpreted as may be required by good faith with regard to general custom and practice ("*Verträge sind so auszulegen, wie Treu und Glauben mit Rücksicht auf die Verkehrssitte es erfordern*"). This goes much further than the English rules of construction and rules about implied terms.

By contrast (and without getting into the extensive case law), English law contracts are interpreted objectively rather than by reference to what the particular parties intended. Allocation of risk is more important than intent. This method of interpretation provides a means for the courts through construction and implied terms to contain to some extent what might otherwise be wayward excesses. Objective interpretation incidentally reduces the risk of inconsistent interpretations in chains of contracts or hedging transactions and facilitates insurance, the taking of security and assignment of contracts.

3.2.2. Negotiating the contract

Obligations of good faith apply throughout the relationship. This includes duties of disclosure of hidden defects when negotiating the contract. English law addresses this by the law on misrepresentation (assuming, as is often the case, that there is a representation) and by due diligence and including representations and warranties to reverse the *caveat emptor* rule.

As mentioned above, there can also be liability for breaking off negotiations, sometimes referred to as *culpa in contrahendo* – see for example BGB §§280 I, 311 II, 241 II, Article 1112 of the French Civil Code and, in relation to the conflicts of laws issues relating to such liability, Article 12 of Regulation (EC) No 864/2007 on the law applicable to non-contractual obligations (Rome II). This does not mean that the courts will not uphold provisions expressing draft contracts to be subject to contract but that a separate non-contractual ground of liability on the grounds of reliance may arise. English law imposes no such liability. What happens if negotiations fail is dealt with, if at all, in English practice by a side agreement and the law does not generally impose any non-contractual protection of the other party's reliance on the conclusion of the intended contract.[3]

3.2.3. Performing the contract

There is a sharp contrast between English law and civil law. Under English law, subject to the proper construction of the contract (an objective exercise including consideration of implied terms) revealing the correct meaning of the contract in question, the courts will give effect to its meaning. In civil law systems, once the contract has been entered into, there will often be controls on how the contract is performed including on the unfair or abusive exercise of rights (which may be a question of construction under English law but which is not precluded if clear). Exercising for example a termination right (such as closing out a financial contract) contrary to the requirements of good faith may result in a counterclaim for damages or even for the maintenance of the contract in force.

Express obligations common in English law contracts to use reasonable endeavours (or other measures of exertion) would be subsumed in the general civil law duty of good faith, the precise extent being a question of fact as indeed in English law and dependent on whether the obligation is to achieve a result or to use means towards the achievement of a result (*obligation de résultat or obligation de moyens*). It may in some civil law jurisdictions in the event of changed circumstances in long term contracts require a willingness to renegotiate aspects of the contract.

There may also be mandatory rules in civil law jurisdictions relating to the fairness of the bargain such as imbalances in price versus value, exercise of discretion and unexpected provisions. These are discussed below.

3.2.4. Encouraging performance

Common law academics have long discussed whether a contract is an obligation to do (or not do) something or is an agreement to pay damages for not doing what you said you would do (or not do). To the civil lawyer this is a strange argument. Article 1101 of the French Code Civil provided from its creation in 1804 until the reforms of 2016 *Le contrat est une convention par laquelle une ou plusieurs personnes s'obligent, envers une ou plusieurs autres, à donner, à faire ou à ne pas faire quelque chose* (a contract is an agreement by which one or more persons obliges themselves to one or more other persons to give something or to do or not do something). It was completely rewritten in 2016 but the original form is still found in the Belgian and Luxembourg civil codes. Similarly

[3] There may be a restitutionary (*quantum meruit*) claim available to a prospective party to an anticipated (but unexecuted) contract in the circumstances examined by Robert Goff J (as he then was) in *British Steel Corporation v Cleveland Bridge & Engineering Co. Ltd*. [1984] 1 All ER 504: see further Chitty on Contracts at para. 32-085.

Titel 1 of the section of the BGB on the law of obligations (Book 2, Section 1) is headed *Verpflichtung zur Leistung* (Obligation to perform).

The prime purpose of the civil law is not only to restrain improper behaviour but to encourage performance. Respect for one's own obligations is a sign of good faith as is reasonableness in the steps taken to enforce performance. This is seen most directly in specific performance being the primary remedy for certain obligations, limitations on the abusive exercise of contractual termination rights, time being allowed for late performance – perhaps with daily fines (eg French *astreintes*) to encourage the recalcitrant party, the power (not so relevant to financial contracts) to allow for a third party to complete the contract at the expense of the defaulting party (the German concept of an obligation being *vertretbar*) and a greater tendency for courts to be able to require parties to renegotiate terms in the event of an unforeseen change of circumstances or for the court to amend the contract itself (eg the new Article 1195 in the French Code Civil which the parties can opt out of in the contract).

The amount of damages may depend on whether a party's performance was or was not consistent with good faith (covering the range from unintentional breach, degrees of negligence and wilful breach). German law allows the obligor to refuse to perform to the extent that (subject also to the terms of the contract and the possible liability of the parties) performance requires expenditure which, having regard to the subject matter and the principle of good faith is manifestly disproportionate to the counterparty's interest in performance (BGB §275). Similarly, under French law, specific performance may be requested unless such performance is impossible or unless such performance entails a clear disproportion between its cost to the debtor, who must act in good faith, and its interest for the creditor (Article 1221 of the French Code Civil). Good faith is an inherent and inseparable part of this of which some of these examples are a more systematised manifestation.

3.2.5. Specific legislative provisions

As with any system, countries have passed specific legislation dealing with specific abuses that they wanted to prevent. Some provisions have been in the codes from the beginning (such as restrictions on price and exercise of discretions). Others have grown out of the general duty of good faith, taken on a life of their own and subsequently been given their own legislative provisions. An example is the German provisions, which previously grew out of case law into having their own Act and are now in the BGB, on *Allgemeine Geschäftsbedingungen* (general business terms and standard form contracts). Concern over their effect inhibited the evolution of the German bond market as the inclusion of provisions that were not standard in that market could have been held invalid as being *überraschende Klauseln* (surprising clauses). We have taken three further examples, all of which owe their origins to the same philosophical approach.

3.2.6. Exercise of discretions

The French Code Civil (article 1304-2) and many of the codes derived from it prohibit *conditions potestatives* (though subsequent case law has in some jurisdictions significantly limited the scope of the prohibition). Essentially these are provisions where the contract allows an element of the obligation to be determined by the party who has to perform it. The theory is that it might just be tempting to take advantage of it. The prohibition originated in Roman law (Gaius, Digest 18.1.35.1). German law (BGB §319) allows the determination to be made by a third party or indeed the court, subject to various conditions. It particularly

affects determinations, decisions and exercise of discretions and so is very relevant to financial contracts. Where discretions are allowed it is not possible under French law to contract out of the good faith duty in relation to their exercise, such as the granting of consents in a reasonable manner. German law (BGB §319) provides that a determination of a performance obligation by a third party is not valid where it is unfair ("*unbillig*").

3.2.7. Change of circumstances

The challenge between the absolutist nature of the contract and allowing non-performance or variation if fair and reasonable in changed circumstances is nothing new. The Mesopotamian Hammurabi code of about 1750 BCE allowed suspension of rent and interest where harvests were ruined by storms, floods or drought. Attitudes to the effect of changed circumstances change over time. Not only do different countries (civil and common law) sit on different parts of the spectrum at any one time but they move. The Dutch and French civil codes have moved extensively in the last few decades. A restrictive view tends to prevail in times of stability. This is seen in the English rigidity of the 19th century, with frustration only coming in at the end of that century. It was also the classic French position in civil law contracts (that is to say for these purposes private law contracts as opposed to public law contracts to which different rules apply) of not allowing revision of the contract for change of circumstances resulting in financial hardship as exemplified in the 1876 *Canal de Craponne* case (Cass. Civ. 6 mars 1876) where the Cour de Cassation would not intervene in a long term contract at a fixed price that had become totally uneconomic. The 2016 amendments to the Code Civil (referred to above) however now allow for revision in certain circumstances unless contractually disapplied. This addition reflects the now discontinued work of the European Commission on a Common Frame of Reference for contract law.

A greater willingness to allow for change tends to arise in or after more troubled times. The German concept of *Wegfall* (or as it is now expressed in BGB §313, *Störung) der Geschäftsgrundlage* (collapse of (or disruption to) the basis of the transaction), developed in the period of hyperinflation in the 1920s, is that an uncontrollable and unforeseeable change in the circumstances that leads to a fundamental disequilibrium that had not been anticipated or provided for in the contract and which puts an undue burden on the party should justify amendment or termination of the obligation. The courts have applied it in relation to a number of circumstances relying on the good faith principle in BGB §242 (see above). In relation to financial contracts, despite the origins of the concept, the courts have since declared that even substantial inflation in long term contracts is not a ground to apply the principle.

In addition, most civil codes have provisions relating to events of *force majeure* that prevent performance. French law allows it as a defence to a claim for non-performance (Article 1231-1) but under Article 1218 the event must be outside the control of the obligor, must not have been reasonably foreseeable at the time of contracting and must be one whose effects could not be avoided by taking reasonable measures. Temporary suspension of the duty to perform is also permitted unless the consequent delay would justify termination. Where the threshold and consequences sit on a spectrum compared with the English law of frustration will differ from country to country.

3.2.8. Insufficiency of price

In relation to wholesale financial contracts English law has no requirement as to adequacy of price. Consideration may be nominal and is not required for

obligations created by deed. The non-culinary use of the peppercorn is a peculiarity of English law.

Thomas Aquinas' view that it was a sin to pay less than a just price gave rise to legislative provisions in the early civil codes. What was regarded as just has varied and if anything the tendency has been to move away from such provisions but different codes at different times have allowed for some contracts to be set aside if the price was less than a specified proportion of the asset's value: by way of illustration, 2/3 (Württembergische Landrechte of 1515), 1/2 (Austria and Italy) and 5/12 (sales of land in France) or where the vulnerabilities of the other party have been exploited (Germany).

4. Common Law Systems

4.1. England and Wales[4]

The modern English law on good faith is discussed in the later sections of this paper.

English contract law has very different origins, history and function. It can be summarised as legal positivism: the obligation is what is in the contract. It is largely a bottom-up casuistic approach by the courts to resolve live disputes.

The English courts' approach has to be seen in its historical context. The English economy was fast growing with its wool trade and subsequent maritime power and had a head start on the Industrial Revolution at a time when continental Europe was suffering from wars and political and social upheavals.

The vicissitudes of the theological and philosophical debates from Aquinas to the English jurist and social reformer Jeremy Bentham (1748-1832) passed by the English legal community. Its approach to training and practice, largely focused on pleadings rather than structure or substance was coupled with the national suspicion (at best) of such debates. They were not interested in devising a plan for society but in litigating the dispute in front of them.

From *Slade's Case* (1597-1602) the writ of *assumpsit* provided one form for starting a contractual lawsuit: "The defendant undertook ("*assumpsit*") to do X but hasn't." This at a stroke removed the need for categorisations of different types of contract with different procedures and rules depending on the facts. It would all depend on what had been agreed. This, plus the then rule that one couldn't give evidence in one's own case (from which derives the practice of having extensive recitals to set out the background), meant that the objective interpretation of the contract itself became more important. The courts saw themselves as there to ascertain the correct meaning and to grant the appropriate remedies for the breach.

Objectivity, legal certainty and predictability facilitated the growth and availability of credit, insurance and hedging. The contract is a mechanism for allocating risk. Unlike the civil contract it is more adversarial than collaborative. The primary remedy is damages, not performance. If the contract (once properly construed)

[4] The position under Scots law is likely to produce results similar to those described in section 5 of this paper with respect to English law, despite Scotland's mixed legal system. This is in part because codified civil law concepts of good faith in jurisdictions which had influenced the development of Scots law (for example France) were introduced after the Treaty of Union between Scotland and England in 1707, following which Scots law became more influenced by English law as commerce developed.

allows for termination, in the absence of any contrary fiduciary responsibilities, the court will allow it regardless of consequences. It is seen as enforcing the good faith obligation to perform the contract as agreed.

The Merchant of Venice was decided on a point of construction, not on philosophical or theological grounds, though it illustrates how the right result can be obtained by different legal techniques. The law on interpretation, exclusion clauses, conditions, fundamental terms and breaches is voluminous but is not expressed in terms of good faith. The law on good faith as such however is very limited beyond, usually, to deny its existence as a general duty.

The position of good faith in English contract law and controls on the exercise of discretions are dealt with separately in this paper.

4.2. Other Common Law Jurisdictions

A number of other common law jurisdictions have concepts expressed as an obligation of good faith. It is beyond the scope of this paper to discuss the other aspects of those systems that equate to concepts which are not regarded under English law as examples of good faith requirements

4.2.1. Australia

Australian courts recognise a duty to cooperate and, in some cases, a duty to act in good faith. These duties often overlap, but they are recognised as separate and distinct duties.

The duty to cooperate is a "general rule applicable to every contract that each party agrees, by implication, to do all such things as are necessary on his part to enable the other party to have the benefit of the contract" (*Butt v McDonald (1896) 7 QLJ 68*). The duty to cooperate only extends to acts required to fulfil the fundamental promises of the contract; it does not extend to being nice or even reasonable to the other party, or provide "a mechanism for alleviating the consequences of hard, even harsh or unconscionable, contractual provision" (*Council of City of Sydney v Goldspar* [2006] FCA 472).

The scope of any contractual duty of good faith has yet to be determined by the High Court of Australia. However, the Supreme and Appellate courts have held that a duty of good faith includes elements of cooperation, reasonableness and honesty. It is settled law that a duty of good faith requires discretions to be exercised reasonably and not capriciously or for an extraneous purpose (*Renard Constructions (ME) Pty Ltd v Minister for Public Works* (1992) 26 NSWLR 234). In the *Renard* case Priestley J discussed good faith and, whilst the relevant judge's comments were *obiter* and did not establish a broader concept, it has influenced the application of good faith terminology in subsequent cases. "In ordinary English usage there has been a constant association between the words fair and reasonable. Similarly, there is a close association of ideas between the terms unreasonableness and lack of good faith. Although they may not be always co-extensive in their connotations, partly as a result of the varying senses in which each expression is used in different contexts, there can be no doubt that in many of their uses there is a great deal of overlap in their content." The judge said "the kind of reasonableness I have been discussing seems to me to have much in common with the notions of good faith which are regarded in many civil law systems of Europe and in all States in the United States as necessarily implied in many kinds of contract." More recently, Australian courts have suggested that good faith and reasonableness are to be considered in a "composite and interrelated sense" (*Virk Pty Ltd (in liquidation) v Yum! Restaurants Australia Pty*

Ltd [2017] FCAFC 190). That is, if a party has acted in good faith, it follows that the party has also acted reasonably; there is no separate duty to take reasonable care to avoid an undesirable outcome.

Broadly speaking, Australian courts will imply the duty to cooperate into commercial agreements unless doing so would be inconsistent with the express terms of the agreement. Conversely, Australian courts will not imply a duty of good faith indiscriminately into all commercial agreements. Rather, and subject to the High Court considering the scope of any contractual duty of good faith, a duty may be implied as a matter of fact (in accordance with the usual principles for implying terms), or will be implied as a matter of law (e.g. the Franchising Code of Conduct and Insurance Contracts Act 1984 (Cth) imposes a duty to act in good faith on parties to a franchise agreement or insurance contract respectively).

4.2.2. Canada

In the Canadian case *Bhasin v Hrynew* (2014 SCC 71, [2014] 3 SCR 494) where the court found that one party had deliberately misled the other about the termination of the contract and the innocent party had relied on the representations, the Supreme Court of Canada noted that duties of good faith arose in contracts expressly requiring cooperation of the parties to achieve their objects; contracts involving the exercise of contractual discretion; situations where a contractual power is used to evade a contractual duty; insurance contracts and other examples not relevant for this paper. The facts did not fall within those categories but the court held that "there is a general organizing principle of good faith that underlies many facets of contract law. It is appropriate to recognize a new common law duty that applies to all contracts as a manifestation of the general organising principle of good faith: a duty of honest performance, which requires the parties to be honest with each other in relation to the performance of their contractual obligations."

The court continued: "The duty of honest performance that I propose should not be confused with a duty of disclosure or of fiduciary loyalty. A party to a contract has no general duty to subordinate his or her interest to that of the other party… But the situation is quite different, as I see it, when it comes to actively misleading or deceiving the other contracting party in relation to performance of the contract."

The court addressed the objections raised in relation to general duties of good faith in common law systems:

"The first is that "good faith" is an inherently unclear concept that will permit ad hoc judicial moralism to undermine the certainty of commercial transactions. The second is that imposing a duty of good faith is inconsistent with the basic principle of freedom of contract. I do not have to decide here whether or not these points are valid in relation to a broad, generalized duty of good faith. However, they carry no weight in relation to adopting a rule of honest performance.

Recognising a duty of honesty in contract performance poses no risk to commercial certainty in the law of contract. A reasonable commercial person would expect, at least, that the other party to a contract would not be dishonest about his or her performance…

Any interference by the duty of honest performance with freedom of contract is more theoretical than real. It will surely be rare that parties would wish to agree that they may be dishonest with each other in performing their contractual obligations."

"The principle of good faith must be applied in a manner that is consistent with the fundamental commitments of the common law of contract which generally places great weight on the freedom of contracting parties to pursue their individual self-interest. … The development of the principle of good faith must be clear not to veer into a form of ad hoc judicial moralism or "palm tree" justice. In particular, the organizing principle of good faith should not be used as a pretext for scrutinizing the motives of contracting parties."

The Canadian principle cannot be excluded by contract, noting that Cromwell J observed in *Bhasin v Hrynew* (at para 77) that he "would not rule out any role for the agreement of the parties in influencing the scope of honest performance in a particular context" and that "The precise content of honest performance will vary with context and the parties should be free in some contexts to relax the requirements of the doctrine so long as they respect its minimum core requirements."

Since the Supreme Court of Canada's decisions in *Bhasin v Hrynew* however, the scope the appellate courts have given duty of honest performance has been limited – for example see *Ontario Inc. (Louch & Louch) v. Brockville Centre Development Corp*., 2022 ONCA 610.

In the English case *MSC Mediterranean Shipping Company S.A. v Cottonex Anstalt* [2016] EWCA Civ 789, counsel was unsuccessful in their submission that *Bhasin v Hrynew* was a persuasive authority, Moore-Bick LJ holding (at para 45) "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."

4.2.3. *New York*[5]

As a matter of U.S. law, contract law is within the competency of each State except where there is a "uniquely federal interest" and a "significant conflict" between a federal policy or interest and state law. Under New York law, "all contracts imply a covenant of good faith and fair dealing in the course of performance" (*511 W. 232nd Owners Corp. v. Jennifer Realty Co.,* 98 N.Y.2d 144, 153 (2002)). This requires that "neither party shall do anything which will have the effect of destroying or injuring the right of the other party to receive the fruits of the contract" (*Kirke La Shelle Co. v. Paul Armstrong Co.*, 263 N.Y. 79, 87 (1933)). The implied covenant of good faith and fair dealing thus enables a party to argue, as a breach of contract claim, that "an implied promise was 'so interwoven in the whole writing' of a contract as to be necessary for effectuation of the purposes of the contract" (*M/A-COM Sec. Corp. v. Galesi*, 904 F.2d 134, 136 (2d Cir. 1990) (quoting *Havel v. Kelsey–Hayes Co.*, 83 A.D.2d 380, 384 (4th Dep't 1981))). Asserting a breach of the implied covenant of good faith and fair dealing often requires a party to identify an act that violates the intention of the parties, but "in some cases, the covenant may even require 'affirmative steps to cooperate in achieving' the contract's objective" (*Tractebel Energy Mktg., Inc. v. AEP Power Mktg., Inc.*, 487 F.3d 89, 98 (2d Cir. 2007) (quoting Farnsworth On Contracts § 7.17 (2d ed. 2001))).

[5] We note there is a difference between New York law and English law in their approach to agreements to negotiate in good faith. Where such an obligation exists under New York law, it may not under English law, and this difference can cause uncertainty for US parties operating in the London finance markets who expect to be negotiating and entering into agreements with parties under such an obligation. Detailed discussion of obligations to negotiate in good faith is beyond the scope of this paper.

In addition, "every contract or duty within the Uniform Commercial Code (UCC) imposes an obligation of good faith in its performance and enforcement" (UCC § 1-304). It is not however clear cut: UCC § 2-103(1)(b) expressly defines good faith in the case of a merchant who is a party to a transaction in goods as "honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade," while UCC § 1-201(19), a general provision of the UCC, defines good faith as merely "honesty in fact in the transaction or conduct concerned". Section 205 of the Restatement (Second) of Contracts also provides that every contract imposes upon each party a duty of good faith and fair dealing in its performance and enforcement.

Accordingly, the practical effects of the principle on sophisticated contracts in New York law are limited, particularly in respect of the exercise of clearly expressed contractual rights. The leading cases relate to the exercise of discretions, because "no obligation can be implied . . . which would be inconsistent with other terms of the contractual relationship" (*Murphy v. Am. Home Prod. Corp.*, 58 N.Y.2d 293, 304 (1983)). Many claims under the implied covenant of good faith and fair dealing fail on that basis. For example, a party cannot rely on the implied covenant of good faith and fair dealing to require substitute performance, where performance is forgiven by a *force majeure* clause (*Harriscom Svenska, AB v. Harris Corp*., 3 F.3d 576, 280 (2d Cir. 1993)). Nor does the implied covenant of good faith and fair dealing "extend so far as to undermine a party's 'general right to act on its own interests in a way that may incidentally lessen' the other party's anticipated fruits from the contract" (*M/A-COM*, 904 F.2d at 136 (quoting *Van Valkenburgh, Nooger & Neville, Inc. v. Hayden Publishing Co.*, 30 N.Y.2d 34, 46 (1972))). Though applying the law of a different state, one American jurist aptly commented, "even after you have signed a contract, you are not obliged to become an altruist toward the other party and relax the terms if he gets into trouble in performing his side of the bargain" (*Mkt. St. Assocs. Ltd. P'ship v. Frey*, 941 F.2d 588, 954 (7th Cir. 1991) (Posner, J.)).

Many leading cases relate to the exercise of discretions, which under the implied covenant of good faith and fair dealing must not be exercised "arbitrarily or irrationally" (*Dalton v. Educ. Testing Serv.*, 87 N.Y.2d 384, 389 (1995)).

In *Moran v Erk* (11 N.Y.3d 452 (2008) a real estate sale contract included a provision that it was contingent on the purchasers' attorney approving the contract. The purchasers developed qualms about the purchase and instructed their attorney to disapprove the contract. The New York Court of Appeals, New York's highest state court, rejected the argument that the implied covenant of good faith and fair dealing implicitly limited a discretion to disapprove the contract in bad faith. The "fruits of the contract" had not arisen as they were dependent on the attorney's approval. As there were no further limitations on approval in the contract, the purchasers were entitled to "disapprove the contract for any reason or for no stated reason".

In 2016 and 2017, the New York State Supreme Court considered the issue in two cases: in *ELBT Realty LLC v Mineola Garden City Co.* (144 A.D.3d 1083 (2nd Dep't 2016) a contract for the sale of a building allowed the purchaser to terminate the agreement "in its sole discretion" and "for any reason whatsoever". The Appellate Division, Second Department upheld the provision, holding that "the plain language of the contract makes clear that termination of the contract was a possibility and the parties, who were sophisticated, counseled business entities negotiating at arm's length over a prolonged period of time, should have understood and expected that termination of the contract could occur during that specified window of time and that such decision was the purchaser's alone and did not need to be accompanied by any specific justification." To impose a good faith

limitation on the discretion "would require adding terms to the contract and thereby make a new contract for the parties in the guise of interpreting the writing".

Shortly after that decision, the Appellate Division, First Department, came to the same conclusion in *Transit Funding Associates LLC v Capital One Taxi Medallion Finance* (149 A.D 3d 23 (1st Dep't 2017), a case where the defendant had the right to deny any loan request "in its sole and absolute discretion" which it had done with the consequence that the plaintiff was put out of business. The court held that "the covenant of good faith and fair dealing cannot negate express provisions of the agreement" and is not violated "where the contract terms unambiguously afford [the defendant] the right to exercise its absolute discretion to withhold the necessary approval". Motivation was irrelevant.

It is thus, unlike in the civil law systems, not an overriding principle and in sophisticated contracts can be made to be of minor importance.

4.2.4. New Zealand

In New Zealand, the Supreme Court in *Bathurst Resources Limited v Buller Coal Limited and L&M Coal Holdings Limited* (SC 29/2020 [2021] NZSC 85) noted the developments in other countries but declined to pronounce on whether it should follow them as the court decided the case on other grounds.

4.2.5. Singapore

In Singapore, the Court of Appeal in *Ng Giap Hon v Westcomb Securities Pte Ltd* [2009] 3 SLR(R) 518 held that there was no general implied duty of good faith in Singaporean contract law. In giving its reasons the court said in particular that it would undermine the concept of sanctity of contract unless required in exceptional circumstances and in accordance with legal principles and would generate uncertainty. It concluded that (for a doctrine of a generally implied duty of good faith) "…much clarification is required, even on a theoretical level. Needless to say, until the theoretical foundations as well as the structure of this doctrine are settled, it would be inadvisable (to say the least) to even apply it in the practical sphere…this is …the strongest reason as to why we cannot accede to the appellant's argument that the court should endorse an implied duty of good faith in the Singapore context [60]." It is noteworthy that in relation to good faith and the performance of contracts the Singapore courts have adhered to be the English position.

4.3. Comparative law conclusion

The New York, Canadian and Australian concepts are in practice largely concerned with the manner in which discretions are exercised or with examples of behaviour that amounted to deliberate bad faith (ie subjective bad faith) and not with the substantive nature of the obligations. They are so very far removed from the all-pervasive and structurally fundamental civil law concept that their differences among themselves are more of degree than substance and are not that far off the English position, albeit expressed differently. Adding a general principle such as in the BGB or Code Civil to English law and expecting it to have similar consequences is not possible without fundamentally reappraising and rewriting English contract law (and potentially equity too).

The comparison also illustrates the difficulties that can arise when the same phrase is used either as a short form tag or as a term of art differently in different

English-speaking jurisdictions and as a standard translation of highly technical terms in other languages as used in other systems.

This paper may assist in the management of risk by market participants and inform their setting of legal policies and understanding of constraints. The sharp division between common and civil law can be explained by tradition and history. There is however divergence on this topic too between common law jurisdictions with a spectrum of positions both in legal theory and practice, possibly a function of the cases that have come before them, the submissions of counsel and on occasion the civil law derived influences that have come to bear on them. It is noteworthy however that the Singapore courts have adhered to the same position as that taken by the English courts.

5. Good Faith in English Law[6]

5.1. No general duty

Unlike other legal systems (discussed above), English contract law does not have a generally applicable duty of good faith. However, this is not to say that good faith has no relevance as it can affect a financial contract in two distinct ways:

i) by way of an implied term; or

ii) by way of express contractual agreement.

These are dealt with below. Given the quantity of case law on the subject, the duties of good faith and rationality relating to the exercise of contractual discretions (often referred to as the "Braganza" duty) are dealt with separately later in this paper.

English law has specific rules in relation to matters such as estoppel and misrepresentation – which might in other jurisdictions be badged as good faith duties – and has other mechanisms and techniques to limit excesses of human behaviour (all of which are beyond the scope of this paper). However, the great weight English law places on contractual certainty has limited the wider development of duties of good faith.

As Lord Hodge recently noted in the Supreme Court in *Pakistan International Airline Corporation v Times Travel (UK) Ltd* [2021] UKSC 40, "in contrast to many civil law jurisdictions and some common law jurisdictions, English law has never recognised a general principle of good faith in contracting. Instead, English law has relied on piecemeal solutions in response to demonstrated problems of unfairness". This is because a general duty of good faith risks undermining the express terms agreed between the parties (*MSC Mediterranean Shipping Company SA v Cottonex Anstalt* [2016] EWCA Civ 789). Put differently, the elusive concept of good faith should not be used to avoid orthodox and clear principles of English contract law (*Candey Ltd v Bosheh & Anor* [2022] EWCA Civ 1103).

Therefore, despite some aspirational judicial pronouncements, the English courts have not made good faith "a general organising principle", as has been expressed in Canada. Moreover, there is no generally applicable principle of good faith,

[6] The section on Braganza duties draws on *Practice note, Contracts: good faith* written by Peter Church of Linklaters LLP (who has assisted the working group responsible for this paper on both Braganza duties and the broader English law analysis) and published by Practical Law (www.practicallaw.com). The FMLC is grateful to Practical Law for allowing its use in this way.

either at the fundamental structural level (as in civil law systems) or in the more limited, in practice, manner of New York law.

The English courts have, however, in line with the way in which English contract law evolved, developed "piecemeal solutions in response to demonstrated problems of unfairness" (*Interfoto Picture Library Ltd v Stiletto Visual Programmes Ltd* [1989] 1 QB 433). So, for example, almost all contracts would reasonably be understood as requiring honesty in their performance (*HIH Casualty and General Insurance Ltd v Chase Manhattan Bank* [2003] UKHL 6).

The most significant developments have been in relation to implied duties of good faith in "relational" contracts and to the duty of rationality that applies to the exercise of contractual discretions.

Apart from good faith, expectations of fair dealing may act as an aid to construction and to the implication of terms. Lord Steyn, writing extra-judicially, noted "A thread runs through our contract law that effect must be given to the reasonable expectations of honest men" (LQR 1997, 133 (Jul)). This manifests itself, for example, in the principles that a party may not benefit from its own wrongdoing or insist on the performance of an obligation it has prevented the other party from performing.

5.2. Continuum of Confidence

Both the "piecemeal solutions" and Lord Steyn's "thread" demonstrate on closer examination an underlying commonality of principle.

While there is no general duty of good faith that applies to all contracts, the duty can apply to particular aspects of a contract, such as the exercise of discretions in a contract to which there is not otherwise a duty of good faith and to particular situations, such as fiduciary contracts, trusteeships and contracts of agency, insurance, employment and partnership. Duties of good faith also arise under consumer legislation in relation to contracts with consumers. These particular situations are not discussed further in this paper but they illustrate the circumstances in which the duty can arise. The common feature is the existence of a relationship of trust and confidence (effectively an almost direct linguistic translation of the German "*Treu*" (trust) and "*Glaube*" (faith) but without the same legal connotations). The hallmark of a fiduciary relationship is the obligation of loyalty, a core element of which is the duty of good faith which goes to the essence of the nature of trusteeship. Trust and confidence are also the justification for the existence of a duty in a contract of employment or insurance (as the insurer is reliant on honest disclosure by the insured). It is also relevant to the question (discussed below) of when a relational contract arises.

5.2.1. Implied duties of good faith and "relational" contracts

The first point to note is that an implied duty of good faith is likely to be displaced by express obligations. Thus, where a party was subject to an obligation to use all reasonable endeavours to obtain a debt facility, there was no scope to imply a term that it must also act in good faith to obtain that facility (*Astor Management AC v Atalaya Mining plc* [2017] EWHC 425 (Comm)). Similarly, express duties to act in good faith in relation to specific obligations, or imposed on one party only, may suggest the parties have exhaustively defined the scope of that duty, so that no wider duty of good faith should be implied (*Teesside Gas Transportation Ltd v CATS North Sea Ltd* [2019] EWHC 1220 (Comm) and *Stobart Capital Limited v Esken Limited* [2022] EWHC 1036 (Ch)).

5.2.1.1. *A duty implied in fact?*

For most contracts, a duty of good faith can only be implied if it meets the strict tests for the implication of terms in fact, set out in *Marks & Spencer plc v BNP Paribas Securities Services Trust Company (Jersey) Ltd* [2015] UKSC 72. Amongst other things, this means that the implied term must be so obvious that 'it goes without saying' or be necessary for business efficacy such that the contract would lack commercial or practical coherence without it (*Monde Petroleum SA v Westernzagros Ltd* [2016] EWHC 1472 (Comm)) and *UTB LLC v Sheffield United Ltd* [2019] EWHC 2322 (Ch)). This is unlikely to be the case for the vast majority of financial contracts.

5.2.1.2. *"Relational" contracts*

In contrast, while the courts have been consistently firm in rejecting the introduction into English law of a general duty of good faith, they have developed a line of cases where such a duty may (or, according to some cases, will) arise under what have been called "relational" contracts.

The concept was first advocated by Leggatt J (as he then was) in the High Court in *Yam Seng* where the claimant had pleaded that a duty of good faith should exist. In dealing with this argument, Leggatt J said:

> "such "relational" contracts, as they are sometimes called, may require a high degree of communication, co-operation and predictable performance based on mutual trust and confidence and involve expectations of loyalty which are not legislated for in the express terms of the contract but are implicit in the parties' understanding and necessary to give business efficacy to the arrangements. Examples of such relational contracts might include some joint venture agreements, franchise agreements and long-term distributorship agreements".

The Court of Appeal initially appeared to reject the concept of relational contracts entirely (*Globe Motors v TRW* [2016] EWCA Civ 396). The case was about a long-term contract, but the court stated the "implication of a duty of good faith will only be possible where the language of the contract, viewed against its context, permits it. It is thus not a reflection of a special rule of interpretation for this category of contract". However, subsequent decisions by the Court of Appeal support the concept of a relational contract such as *Amey Birmingham v Birmingham City Council* [2018] EWCA Civ 264 in which a 25-year PFI contract was considered to be a relational contract and *Candey v Bosheh* (albeit the contract in that case was not relational).

The test for a relational contract is best described in *Bates v Post Office* [2019] EWHC 606 (QB). In that judgment, the High Court found that the Post Office's contract with its sub-postmasters was relational (and therefore had an implied duty of good faith). The Court suggested the following factors indicate a relational contract (at paragraphs 721 and 724-732): (i) It is a long-term contract or a contract the parties intend to be long-term, even though it lacks a long fixed term and allows termination by notice. (ii) The parties intend their roles to be performed with integrity and with fidelity to their bargain. (iii) The parties will be committed to collaborating with one another. (iv) The spirits and objectives of the venture cannot be expressed exhaustively in a written contract. (v) The parties each repose trust and confidence in one another. (vi) The contract involves a high degree of communication, co-operation and predictable performance based on mutual trust and confidence, and expectations of loyalty. (vii) One or both parties have made a significant investment. (viii) The

relationship is exclusive.[7] However, these factors should be treated as a sense check rather than a series of statutory requirements (*Candey v Bosheh*).

In contrast, the High Court suggested the assessment of whether a contract is relational should disregard any imbalance of bargaining power between the parties or the fact some terms were unfair. Finally, and most importantly, there must also be no specific express terms in the contract that prevents a duty of good faith being implied into the contract.

While the position of each contract will turn on its facts, it is submitted that few financial markets contracts exhibit these factors and so are unlikely to be relational contracts.[8][9]

5.2.1.3. *"Relational" contracts – A duty implied in fact or law?*

Where a contract is relational, it is unclear whether the implied duty of good faith should be implied in fact or in law.

In the High Court, Leggatt LJ (as he then was) decided that a long-term joint venture to develop hotels and an associated travel business was a relational contract subject to a duty of good faith implied in fact on the basis of the test in *Marks & Spencer v BNP*, or alternatively as a matter of law (*Al Nehayan v Kent* [2018] EWHC 333 (Comm). The Court of Appeal noted that the potential for a duty to be implied in law in *Candey v Bosheh*, but cautioned against veering too far from the test for implied terms in fact given the warning in *Globe Motors v TRW* that a duty of good faith will only be possible where the language of the contract, viewed against its context, permits it.

While this is still "an area of developing law",[10] the difference between the two is likely to be more academic than practical. In particular, the factors indicating a contract is likely to be found to be relational (such as that spirits and objectives of the venture cannot be expressed exhaustively in a written contract, that it involves a high degree of communication, co-operation and predictable performance based on mutual trust and confidence and there are no conflicting express terms) converge closely with the requirements for a term to be implied in fact. In other words, these two approaches are largely two sides of the same coin.

Implying a term in law into a "relational" contract might arguably mean the duty arises more easily that it would do if the strict test of implying terms in fact is used, and terms implied by law might be less easily displaced. However, in either case, the parties are free to disapply the duty through express terms (*Bates)* and neither approach is likely to mean a financial markets contract becomes subject to an implied duty of good faith.

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[7] The fact that a decision-maker is a public body might also be a relevant factor (at paragraph 730).

[8] This is particularly the case where the relationship between the parties is intrinsically competitive and where opportunistic behaviour is to be expected, see R Brownsword, *Contract Law: Themes for the Twenty-First Century*, (2nd Ed, Oxford University Press 2006) 119.

[9] It should be borne in mind that not all contracts to which a financial markets contract may relate or depend on will be analysed in the same way. For example, contracts in respect to longer-term infrastructure projects may be more likely to be relational.

[10] *Mackie Motors (Brechin) Ltd v RCI Financial Services Ltd* [2022] EWHC 1942 (Ch).

5.2.1.4. *Meaning of the implied duty of good faith*

In *Astor Management*, Leggatt J suggested the implied duty of good faith "is a modest requirement. It does no more than reflect the expectation that a contracting party will act honestly towards the other party and will not conduct itself in a way which is calculated to frustrate the purpose of the contract or which would be regarded as commercially unacceptable by reasonable and honest people". This is not very different from the pronouncements in the Canadian and Australian cases discussed above but is far from the civil law position.

The courts may treat the implied duty of good faith as comprising a general duty or fact-specific duties or both. As a general duty, it will require the parties to avoid conduct that would be regarded as "commercially unacceptable" by reasonable and honest people, including obligations of transparency, co-operation, and trust and confidence and not to act to undermine the bargain entered or the substance of the contractual benefit bargained for (*Bates v Post Office*). In *Bates*, the general duty was supplemented by many fact-specific duties or "incidents" of that duty of good faith. These "incidents" included obligations on the Post Office to keep proper records of transactions and to properly and fairly investigate accounting shortfalls affecting sub-postmasters.

This obligation is "not a demanding one" (*Al Nehayan v Kent*) though will vary according to the nature of the obligation and the parties concerned. Where a party is dishonest, that will almost certainly be a breach of the implied duty of good faith, though it may also extend to "sharp practice" (*Essex County Council v UBB Waste (Essex) Ltd* (costs judgment) [2020] EWHC 2387 (TCC)). Dishonesty and sharp practice are the antithesis of what is required of someone in whom the contracting party has reposed their trust and confidence.

As with implied terms more generally, it can only supplement the contract and will not operate to contradict or undermine the express terms of the contract. It is also unlikely to require a party to subordinate its own commercial interests to those of the other party (*Hamsard 3147 Ltd v Boots UK Ltd* [2013] EWHC 3251 (Pat); *Carewatch Care Services Limited v Focus Caring Services Limited* [2014] EWHC 2313 (Ch)).

5.2.2. Express obligations to act in good faith

It is of course open to parties to agree an express obligation to act in good faith, either generally or in relation to specific aspects of the contract.

Whether they have created such an obligation and what its scope and effect are will be a question of the interpretation and construction of the contract, applying the normal principles of construction (which are outside the scope of this paper). It is also important to note that an express obligation to exercise a discretion in good faith, might be subject to the Braganza duty, rather than the objectively determined duty of good faith described below.

A number of examples of express good faith obligations, taken from the ISDA Master Agreement, are set out in the Appendix to this paper.

5.2.2.1. *Meaning of an express duty of good faith*

It is also open to the parties to specify what is meant (and not meant) by such a duty. In the absence of express contractual provisions, Vos J (as he then was) said it could be described as being to: "adhere to the spirit of the contract, to observe reasonable commercial standards of fair dealing, to be faithful to the

agreed common purpose, and to act consistently with the justified expectations of [the other party]" (*CPC Group Limited v Qatari Diar Real Estate Investment Company* [2010] EWHC 1535 (Ch)).

An express duty of good faith has also been described as requiring a party, as a minimum: (i) to act honestly; (ii) to be faithful to the parties' agreed common purpose as derived from the agreement; (iii) to not use powers for an ulterior purpose; (iv) to deal fairly and openly with the other party; and (v) to consider and take into account their own interests while also having regard for the other party's interest (*Unwin v Bond* [2020] EWHC 1768 (Comm)).

However, this will often require more than generalised allegations about the other party's behaviour and instead will likely require a specific assertion that a person has acted in bad faith. For example, in *Soteria Insurance Ltd v IBM* [2022] EWCA Civ 440, the Court of Appeal stated that unless the contracting party has acted in bad faith, it is difficult to see how he can be in breach of an obligation of good faith.

Similarly, dishonest behaviour will almost certainly be a breach of an express duty of good faith (*Yam Seng*), but "unreasonable", "careless or unwise" conduct might not be so long as the party was acting honestly (*New Balance Athletics Inc v Liverpool Football Club and Athletic Grounds Ltd* [2019] EWHC 2837 (Comm)).

5.2.2.2. *Termination rights and other absolute contract rights*

As a further limitation, an express duty of good faith is unlikely to restrict clearly-drafted specific provisions such as the exercise of termination rights or other contractual options (*TSG Building Services Plc v South Anglia Housing Ltd* [2013] EWHC 1151 (TCC)).[11]

This, of course, depends on the facts. In the *Bates* judgment, duties of good faith were found to fetter the exercise of termination rights. However, in light of the Court of Appeal's warning in *Mid Essex* against construing a general and potentially open-ended obligation to act in good faith as covering the same ground addressed by other, more specific provisions, it is submitted that only in very rare circumstances would a duty of good faith fetter any termination right.

5.2.2.3. *Express obligations to negotiate in good faith*

The approach of the English courts to obligations on the parties to negotiate or agree matters (whether in good faith or otherwise) depends on the context in which they arise.

Where the parties are negotiating with a view to entering into a contract, the courts are likely to treat this as an unenforceable "agreement to agree". Lord Ackner expressed his views in trenchant terms in *Walford v Miles* [1992] AC 128. He said that "the concept of a duty to carry on negotiating in good faith is inherently repugnant to the adversarial position of the parties when involved in negotiations". The problem for the court is the lack of parameters and objectives as to what the agreement might be, which renders such purported obligation unenforceable for lack of certainty – it is not the courts' role to make the parties' bargain for them.

[11] Similarly, the Braganza duty is also unlikely to constrain a contractual right to terminate, see section 5.3.

The position is different where the obligation to negotiate or agree arises within the context of an existing agreement between the parties. In this context, the courts have long been prepared to fill in the gaps in a contract so as not to "incur the reproach of being the destroyer of bargains" (*WN Hillas & Co Ltd v Arcos Ltd* [1932] UKHL 2). Accordingly, the courts are willing to recognise an obligation to negotiate on some matter using reasonable endeavours, or in good faith, where it is found in a binding agreement if it will assist the parties to preserve rather than destroy their bargain (*Associated British Ports v Tata Steel UK Ltd* [2017] EWHC 694 (Ch) and *Brooke Homes (Bicester) Ltd v Portfolio Property Partners Ltd* [2021] EWHC 3015 (Ch)). The UK market practice on M&A financings (with commitments as to "certain funds" and agreed contracts) comes from a general distrust among practitioners of the uncertainty resulting from relying on obligations to negotiate in good faith in such circumstances.

5.3. The duty of rationality and good faith in the exercise of contractual discretions (the "Braganza" duty)

The Braganza duty has developed separately from the line of cases discussed above and is a consequence of the extraordinary autonomy English law allows to contracting parties.

Unlike some civil law systems, there is no objection in English law to one party being given the discretion unilaterally to determine the rights and obligations arising under the contract (such as by varying the interest rate attaching to a loan or definitively valuing the other party's assets); or even to amend the terms of the agreement itself. However, the English courts have developed the duty of rationality – combined with a duty of good faith – to guard against the abuse of these contractual discretions.

English law has evolved significantly in recent years such that – in the absence of clear language to the contrary – a contractual discretion must be exercised in good faith and not arbitrarily or capriciously. The discretion must also be exercised consistently with its contractual purpose (Lord Sumption in *British Telecommunications Plc v Telefónica O2 UK Ltd* [2014] UKSC 42).

The duty of rationality is, in traditional English terms, separate from, if inevitably intertwined with, the duty of good faith which accompanies it. However, viewed from a more civil law approach to what is required in those systems, the duty of rationality can be seen as a broader example of the standards required in order to satisfy a duty of good faith. For this reason, and because the case law intertwines the two concepts, the following discussion covers both aspects.

The duty of rationality is often referred to as the "Braganza" duty after the leading case, *Braganza v BP Shipping Ltd* [2015] UKSC 17. Mr Braganza, the chief engineer on a tanker, disappeared without trace, presumed to have fallen overboard at night. His employer's investigation concluded that the most likely scenario was suicide. This meant that no compensation would have been payable to his widow. The case related to the manner in which that determination had been made. Lady Hale (in para 18) said:

> "Contractual terms in which one party to the contract is given the power to exercise a discretion, or to form an opinion as to relevant facts, are extremely common. It is not for the courts to re-write the parties' bargain for them, still less to substitute themselves for the contractually agreed decision-maker. Nevertheless, the party who is charged with making decisions which affect the rights of both parties to the contract has a clear conflict of interest. That conflict is heightened where there is a significant

imbalance of power between the contracting parties as there often will be in an employment contract. The courts have therefore sought to ensure that such contractual powers are not abused. They have done so by implying a term as to the manner in which such powers may be exercised, a term which may vary according to the terms of the contract and the context in which the decision-making power is given."

She went on to say (paras 29-31):

> "If it is part of a rational decision-making process to exclude extraneous considerations, it is in my view also part of a rational decision-making process to take into account those considerations which are obviously relevant to the decision in question. It is of the essence of "*Wednesbury* reasonableness" (or "GCHQ rationality") review to consider the rationality of the decision-making process rather than to concentrate upon the outcome. Concentrating on the outcome runs the risk that the court will substitute its own decision for that of the primary decision-maker.
>
> It is clear, however, that unless the court can imply a term that the outcome be objectively reasonable – for example, a reasonable price or a reasonable term – the court will only imply a term that the decision-making process be lawful and rational in the public law sense, that the decision is made rationally (as well as in good faith) and consistently with its contractual purpose. For my part, I would include both limbs of the *Wednesbury* formulation in the rationality test. Indeed, I understand Lord Neuberger (at para 103 of his judgment) and I to be agreed as to the nature of the test.
>
> But whatever term may be implied will depend upon the terms and the context of the particular contract involved."

The Braganza duty is now "well established". It will apply in the absence of clear language to the contrary (*British Telecommunications Plc v Telefónica O2 UK Ltd* [2014] UKSC 42) and is "extremely difficult" to exclude (*Mid Essex Hospital Services NHS Trust v Compass Group UK and Ireland Ltd* [2013] EWCA Civ 200). The exact status of this implied term is unclear but appears to be implied by law such that applies automatically without the need to consider the strict requirements for implying terms in fact set out in *Marks & Spencer v BNP Paribas*.

The duty is therefore an exception to the principle that contractual rights are enforceable regardless of whether they are exercised in a reasonable or unreasonable way (*White & Carter (Councils Ltd) v McGregor* [1963] AC 413). It does not, however, amount to a general doctrine of abuse of rights nor is it a general duty to act reasonably.

The duty arises where there is the potential of a conflict of interest between the parties and there is an element of confidence reposed by one party in the other party to take a decision affecting those interests. The duty thus acts as a control mechanism to regulate that decision. Importantly, this regulates the process by which the decision is taken. The duty does not mean that the Court can substitute what it thinks would have been a reasonable decision (as might be the case where a party is under an obligation to take an objectively reasonable decision).

The duty can apply both to decisions with a range of outcomes and to simple binary decisions (*Super-Max Offshore Holdings v Malhotra* [2017] EWHC 3246 (Comm)).

The good faith element of that duty is based on similar principles to those applicable to the implication of terms of good faith in other contractual situations as discussed above. The key distinction in this context is between an absolute contractual right conferred on a party for their sole benefit (and which can be exercised regardless of the other party's interests) and a discretion that must be exercised, rationally, in good faith and for the purpose for which it was conferred. Which category a particular example falls into is a question of construction but, in the absence of an express duty, the relevant factor is essentially that one party is trusting the other to decide the matter with integrity and avoid sharp practice (for example in setting the rate of interest payable under a contract or making a genuine attempt to come up with a proper valuation). The many cases on this duty are illustrative.

5.3.1. Limitations on the duty of rationality

Importantly, the duty only applies to the exercise of certain types of discretion. As often, in order to explain what is covered, it is helpful to describe what is not covered.

5.3.1.1. *Not applicable to absolute contractual rights or powers*

It does not apply to the exercise of an "absolute contractual right" which a party should have an unfettered right to exercise (*Mid Essex Hospital Services NHS Trust v Compass Group UK and Ireland Ltd* [2013] EWCA Civ 200).

As an example, a contractual right to terminate, a partial termination right or the decision to call in a loan, will not generally be treated as a discretion but as an "absolute contractual right" (*Myers v Kestrel Acquisitions Ltd* [2015] EWHC 916 (Ch); *Lomas v JB Firth Rixson Inc* [2012] EWCA Civ 419; *TAQA Bratani Ltd v Rockrose UKCS8 LLC* [2020] EWHC 58 (Comm); *Cathay Pacific Airways Ltd v Lufthansa* [2020] EWHC 1789 (Ch); *Lombard North Central Plc v European Skyjets Ltd* [2022] EWHC 728). This depends on the circumstances (see for example *Bates v Post Office Ltd (No. 3)* [2019] EWHC 606 (QB) (paras 888 to 908)) but it is submitted that only in very rare circumstances would a termination right be subject to the *Braganza* duty. In this regard, the duty of rationality may be contrasted with the civil law concepts of abuse of right.

5.3.1.2. *Requirement for one party to be the decision-maker*

Since the purpose of the duty is to protect against a party abusing its role as decision-maker, it only applies if one party acts as the ultimate decision-maker. If a matter is to be assessed objectively, the court is the ultimate decision-maker as it can assess the validity of the decision on the basis of the evidence. For example, where a foreign exchange broker reserved the right to revoke "abusive" trades, such as those made using high-speed trading software, the court decided on the wording of the particular contract that the assessment of whether the trade was "abusive" should be made objectively and so this was a "pure contractual power" that was not subject to a duty of rationality. If the broker cancelled a trade that, assessed objectively, was not "abusive" the courts could correct that mistake (*Shurbanova v Forex Capital Markets Ltd* [2017] EWHC 2133 (QB). See also *Kwik Lets Limited v Kharira* [2020] EWHC 616 (QB)).

5.3.1.3. *Requirement for a subjective assessment of a range of factors*

The duty is only likely to arise where the decision-maker must make a subjective assessment of a range of factors. Where a determination is to be made by following a mechanical or formulaic process, there may be no discretion. In the

Mid Essex case, a hospital operated the service credit regime in its catering contract in an absurd manner. It had (among other things) claimed £84,450 because a chocolate mousse was one day over its use by date. The application of the service credits was not the product of a subjective judgment on the part of the hospital, but instead the result of the "contractual machinery". There was, therefore, no discretion to be exercised, and no need for the supplier to be protected by a duty of rationality. The hospital, however, would have been in breach of the express terms of the contract if it applied the credits incorrectly (*Mid Essex Hospital Services NHS Trust v Compass Group UK and Ireland Ltd* [2013] EWCA Civ 200). However, as always, this is highly fact dependent and, in a subsequent case, the customer could decide how large the service credit was, subject to a "maximum" value. This decision was subject to a Braganza duty (*Portsmouth City Council v Ensign Highways Ltd* [2015] EWHC 1969 (TCC)). The chocolate mousse example illustrates the point that English law is more concerned with the procedural fairness of the process than with the substantive fairness of the obligation.

5.3.1.4. *Imbalance of power*

Where there is a significant imbalance of power between the parties, there is a higher likelihood of the duty arising (*Braganza*). Conversely, the duty is less likely to apply where both parties are sophisticated and have received expert legal advice (*Cathay Pacific Airways Ltd v Lufthansa* [2020] EWHC 1789 (Ch)).

5.3.1.5. *Manifest error*

A manifest numerical or mathematical error in a calculation will not necessarily demonstrate irrationality. This is consistent with the requirement for subjectivity. However, there may well be an implied term that a calculation infected by a manifest error will not be valid (*Lomas v Burlington Loan Management* [2016] EWHC 2417 (Ch)). Manifest errors can cause difficulty, not least because while the error may be manifest, the correct answer may not be. As a matter of construction, depending on the facts, a manifest error may mean that no determination has been made as required by the contract (and so, depending on the contract, a new determination may be made) or that the determination has to be read as if the correct value had been used.

5.3.1.6. *Protection by other duties*

A lender did not owe a Braganza duty when demanding repayment of a loan. This was partly because the lender owes a different, more limited duty of good faith to the borrower and it would be inappropriate to apply additionally the Braganza duty (*UBS AG v Rose Capital Ventures Ltd* [2018] EWHC 3137 (Ch)).

5.3.2. Examples of the duty

The Braganza duty has, however, been applied in a broad range of situations. The cases are always highly dependent on the facts but the following ones which are relevant to financial markets illustrate the approach:

5.3.2.1. *Valuing a portfolio of securities after the default of a counterparty*

Under the terms of a forward sale agreement, Standard Bank had the right to value a portfolio of assets of its defaulting counterparty for the purposes of determining that counterparty's liability. That value was to "be determined by [Standard Bank] on the date of termination" and was subject to a rationality duty

(*Socimer International Bank Ltd v Standard Bank London Ltd* [2008] EWCA Civ 116). Much, however, depends on the wording of the contract (see below).

5.3.2.2. *Unilaterally setting or varying charges or interest rate*

A decision of this nature is very likely to be subject to the duty of rationality (*Nash v Paragon Finance PLC* [2001] EWCA Civ 1466*; British Telecommunications Plc v Telefónica O2 UK Ltd* [2014] UKSC 42*; BHL v Leumi ABL Ltd* [2017] EWHC 1871 (QB)).

5.3.2.3. *Awarding an option*

A service provider was entitled to exercise share options on completion of services "with the consent of a majority of the board". The board's decision as to whether to give consent was subject to a duty of rationality (*Watson v Watchfinder.co.uk Ltd* [2017] EWHC 1275 (Comm)).

5.3.2.4. *Awarding discretionary bonuses to employees*

This will normally be subject to a duty of rationality though, given the multiple and shifting factors in consideration, it may be difficult in practice to show that an award was made irrationally. Moreover, bonus awards will not be subject to this duty where there is a fixed mechanism for determining the bonus (*Commerzbank AG v Keen* [2006] EWCA Civ 1536; *Brogden v Investec Bank plc* [2016] EWCA Civ 1031. See also *Tribe v Elborne Mitchell LLP* [2021] EWHC 1863 (Ch) in relation to the discretionary allocation of profits between partners).

5.3.2.5. *Placing an employee on gardening leave*

An employer's decision to place an employee on gardening leave was found to be subject to an implied duty of rationality (*Faieta v ICAP Management Services Ltd* [2017] EWHC 2995 (QB)).

5.3.2.6. *Deciding to carry out a valuation of premises*

A bank had a right to carry out a valuation of the borrower's premises at the cost of the borrower. The decision to carry out a valuation was subject to an implied duty of rationality (*Property Alliance Group Ltd v The Royal Bank of Scotland Plc* [2018] EWCA Civ 355).

5.3.2.7. *Assessing and reclaiming overpayments*

A company had a right to assess the sums due under a contract and to reclaim, as a debt, any overpayment identified as part of that assessment. There was an implied term that the assessment had to be conducted rationally (*Everwarm Ltd v BN Rendering Ltd* [2019] EWHC 3060 (TCC)).

5.3.2.8. *Avoiding an insurance policy*

An insurance policy contained an unintentional non-disclosure clause. It stated that the insurer would not avoid the policy if the insured could establish to the insurer's "satisfaction" that the non-disclosure was innocent and free from fraud. The insurer had to make that decision rationally (*UK Acorn Finance Ltd v Markel (UK) Ltd* [2020] EWHC 922 (Comm)).

5.3.2.9. *Deciding if a force majeure event has occurred*

A franchise contract could be suspended where either party was prevented from performing its obligations by causes "which the [franchisor] designates" as a force majeure event. The power of designation was subject to the rationality duty (*Dwyer (UK Franchising) Ltd v Fredbar Ltd* [2021] EWHC 1218 (Ch) – see further below).

5.3.3. The wording is important

The proper construction of the relevant provision of the contract is essential to determine whether the power is a contractual discretion, for example, if the matter involves a subjective or objective assessment. In some cases, this is relatively straightforward, such as where a party is stated to have a right to determine a matter "in its discretion", but in others it is less straightforward.

In particular, whether a provision involves a contractual discretion involves "a process of construction which takes account of the characteristics of the parties, the terms of the contract as a whole and the contractual context … It is only possible to say whether a term conferring a contractual choice on one party represents an absolute contractual right after that process of construction has been undertaken. To say that a term provides for an absolute contractual right and therefore no term can be implied puts the matter the wrong way round" (*Equitas Insurance Ltd v Municipal Insurance Ltd* [2019] EWCA Civ 718, at para 113).

It is also important to note that it is "extremely difficult" to exclude this duty (see below) and using the term "reasonably" is not determinative of an objective test as is illustrated by two recent cases arising out of the Lehman administration.

An obligation under one ISDA Master Agreement for losses to be "reasonably determine[d] in good faith" imposed a Braganza duty (*Lehman Brothers Finance AG v Klaus Tschira Stiftung GmbH* [2019] EWHC 379 (Ch)*;* see also *Barclays Bank Plc v Unicredit Bank Ag* [2014] EWCA Civ 302 and *Goodram v Camelot UK Lotteries Ltd* [2020] EWHC 2499 (QB)).

In contrast, an obligation under another ISDA Master Agreement to "act in good faith and use commercially reasonable procedures in order to produce a commercially reasonable result", required the decision-maker to use procedures that were, objectively, commercially reasonable in order to produce, objectively, a commercially reasonable result (*Lehman Brothers Special Financing Inc v National Power Corporation* [2018] EWHC 487 (Comm)). Robin Knowles J concluded (para 96):

> "The present case may also show the value of contracting parties being clear about what they expect when they make one contracting party the decision-maker in certain events, and of thinking about the consequences. Given some of the authorities …, if contracting parties want objective criteria of reasonableness to apply, they may need to do more than just use the word "reasonable". Again, in my judgment sufficient was done in, and in the context of, the 2002 ISDA Master Agreement to achieve this."

5.3.4. Process

Process matters but in the context of financial contracts may have a lesser role than in general commercial situations.

As Lord Hodge said in *Braganza:*

> "I think that it is difficult to treat as rational the product of a process of reasoning if that process is flawed by the taking into consideration of an irrelevant matter or the failure to consider a relevant matter. While the courts have not as yet spoken with one voice, I agree that, in reviewing at least some contractual discretionary decisions, the court should address both limbs of Lord Greene's test in *Associated Provincial Picture Houses Ltd v Wednesbury Corporation* [1948] 1 KB 223, 233-234."

This is the well-known and well-established test for public law decisions. That test requires that the decision-maker must:

- Ask the right question.
- Take account of relevant matters and ignore irrelevant matters.
- Avoid a result so outrageous that no reasonable decision-maker could have reached it.

The court however made it clear (see extract earlier in this section) that the public law test is to be applied by analogy in the private law context and what it entails will depend on the context. It will not always be appropriate for a contractual decision-maker to have to meet the same high standards as are expected of a public body (*Watchfinder*). The decision-maker will be able to consider its own interests in many cases (*Property Alliance Group v RBS*) and the standard expected of the decision-maker will reflect the wider context.

The English courts are acutely aware that in wholesale financial markets decisions on matters such as the valuation of securities in the case of default must be taken without delay against a background of a potentially illiquid market with limited price transparency. For example, in *Lehman Brothers International (Europe) v Exxonmobil Financial Services BV* [2016] EWHC 2699 (Comm), Blair J recognised a close-out valuation of a repo transaction under the GMRA 2000 was urgent and related to a commercial arrangement in which one party was entitled to protect its own interests. Accordingly, it would not have been appropriate to strictly apply a public law standard to the decision-maker. More generally, the court has also indicated that establishing that a decision is irrational is a "high hurdle" (*Faieta v ICAP Management Services Ltd* [2017] EWHC 2995 (QB)).

5.3.4.1. <u>*Asking the right question*</u>

The decision-maker must ask the right question. That will determine what is relevant and irrelevant and frame the conclusion. It sets the scope of the Braganza duty and will vary according to the circumstances and the terms of the contract (*Cathay Pacific Airways Ltd v Lufthansa* [2020] EWHC 1789 (Ch)).

In *Watson v Watchfinder* [2017] EWHC 1275 (Comm) (paras 105-106), HH Judge Waksman QC (as he then was) said:

> "In order to assess whether there has been compliance with the Braganza Duty in connection with any particular contractual discretion it is necessary to know what the "target" of that discretion is, in the sense of what the decision-maker is meant to be considering when deciding whether or not to exercise it. In many cases this is straightforward and is stated as part of the discretion. That is so, for example, if the discretion relates to one party's opinion as to what is a "reasonable value" or its judgment or

> opinion as to whether a particular event has happened, for example whether the deceased in *Braganza* had committed suicide. Alternatively, the Court has explained the ambit of the discretion by reference to its ostensible purpose; so the exercise of the landlord's discretion as to whether or not to permit an assignment of the lease to a new potential tenant is not open-ended but is directed to the suitability or otherwise of that person as a tenant for the purpose of the performance of his obligations going forward, both in relation to the landlord and also other tenants."

Evidence to support the decision and to show that the decision-maker held the relevant opinion at the time of making the decision is key. As the Court of Appeal said in *Hills v Niksun Inc* [2016] EWCA Civ 115, in the absence of evidence, the court might conclude the decision had just been made "by throwing darts at a dart board – or perhaps tossing coins".

5.3.4.2. *Taking the right matters into account*

The decision-maker should also take into account all material considerations and not take into account irrelevant considerations (*Braganza*). However, again, the scope of this obligation will depend on the context. In *Lehman Brothers Finance AG v Klaus Tschira Stiftung GmbH* [2019] EWHC 379, Snowden J said:

> "I accept that the ISDA Master Agreement should not be interpreted so as to require a court to conduct the type of analysis of the discretionary decision-making process by the Non-defaulting Party that would be appropriate in a public law context. In particular, I do not think that the court should readily become involved in a detailed assessment of whether the determining party took into account all relevant factors and ignored all irrelevant factors. That would encourage challenges to be made to the determination by the Non-defaulting Party which would cut across the desire for speed and commercial certainty of determination."

The process of decision making should be consistent with any parameters within the relevant agreement (*Hills v Niksun Inc* [2016] EWCA Civ 115; *Daniels v Lloyds Bank Plc* [2018] EWHC 660) but in the absence of those parameters, the decision-maker is likely to be able to select any rational methodology (*Lehman Brothers v Klaus Tschira*).

5.3.5. The good faith limb

The Braganza duty cases mostly focus on the requirement to act rationally. However, this is separate from the requirement to exercise a discretion in good faith. So, for example, in *Abu Dhabi National Tanker Co v Product Star Shipping Co Ltd*, Leggatt LJ said:

> "The essential question always is whether the relevant power has been abused. Where A and B contract with each other to confer a discretion on A, that does not render B subject to A's uninhibited whim. In my judgment, the authorities show that not only must the discretion be exercised honestly and in good faith, but, having regard to the provisions of the contract by which it is conferred, it must not be exercised arbitrarily, capriciously or unreasonably."

Similarly, in *Ludgate Insurance Co Ltd v Citibank NA* [1998] EWHC 1144 (Comm), Brooke LJ said:

> "provided that the discretion is exercised honestly and in good faith for the purposes for which it was conferred, and provided also that it was a true exercise of discretion in the sense that it was not capricious or arbitrary or so outrageous in its defiance of reason that it can properly be characterised as perverse, the courts will not intervene."

As in other areas, it is unclear exactly what the concept of good faith means in this context. In *SNCB Holdings v UBS AG* [2012] EWHC 2044 (Comm.), [72], Cooke J said that "it connotes subjective honesty, genuineness or integrity". In *Lion Nathan Ltd v C-C Bottlers Ltd* [1996] UKPC 9, where a company's earnings had to be forecast and there was a range of possible outcomes, Lord Hoffmann said:

> "The P.R.S. had to be "calculated in good faith" and therefore had to be a bona fide estimate made without regard to whether it would have produced a higher or lower price. There is accordingly no basis for calculating the damages on the assumption that the vendor was contractually entitled to choose the highest figure."

In the context of a determination under an ISDA Master Agreement, in *Lehman Brothers Special Financing Inc v National Power*, Robin Knowles J said: "the fact that there is a range does not mean that the Determining Party can simply take the result that suits it best at one end of the range".

There is of course a significant overlap between lack of good faith and irrationality. In *BHL v Leumi ABL Limited* [2017] EWHC 1871 (QB), a receivables finance agreement allowed the bank to charge "an additional collection fee at up to 15% of amounts collected" on termination of that agreement. It also stated the customer "expressly acknowledge[d] that such fee constitutes a fair and reasonable pre-estimate of [the bank's] likely costs and expenses" in collecting the outstanding receivables. The customer went into administration and the bank terminated the agreement.

On taking over collection of the receivables, the bank imposed the maximum collection fee of 15%. "as a matter of practice". The court decided this was "wholly arbitrary, irrational, manifestly failed to take into account important relevant factors and cannot be supported". The provision was to allow the bank to recover its costs and expenses. There was no evidence the bank even considered those costs and expenses, and it had instead automatically charged the maximum amount.

As noted above, a contractual discretion must be exercised for the purposes for which it was conferred. In the context of a valuation, it seems that the duty of good faith in this context imports a requirement to make a genuine attempt to achieve that purpose, i.e. to come up with a proper valuation. If a genuine attempt is not made, it would undermine the trust that the other party has placed on the determining party to perform the role.

It follows that good faith probably goes beyond a requirement to act honestly, even by reference to the objective test that now applies in relation to that standard. This also seems to follow from *Bates v Post Office*, where the issue was one of sharp practice, albeit to an extreme extent, rather than clear dishonesty.

There is an interplay between this and the duty to act rationally. Despite the approach adopted in Braganza where the facts were very far removed from a wholesale financial contract, the courts have been reluctant to look too closely at whether the right process was followed when making certain types of

determinations (e.g. of the close-out amount payable). They have focussed on whether the outcome was one that no reasonable determining party could have reached.

It cannot, however, be right to say that there are no controls at all on the process followed by the determining party. Instead, if the process is obviously irrational, as where it has no logical connection with the purpose of the exercise, it is unlikely to be valid. Alternatively, there may be a breach of the duty of good faith in this instance, on the basis that the determining party has not made a genuine attempt to perform the task assigned to it.

5.3.6. Improperly exercised discretion

The consequence of a party breaching the *Braganza* duty varies. In practice, the outcome may be to simply reverse the original decision. For example, the judgment in *Braganza* resulted in the widow finally receiving her death benefit and the judgment in *Watchfinder* resulted in the award of the contested shares.

However, a number of outcomes are possible such as to invalidate the original decision without more, to remake the decision in a lawful manner or to award the injured party damages. This should normally reflect the principle of expectation loss and so reflect the position had the decision been made in in accordance with the requirements of the contract. In *BHL v Leumi* (paras 91-92), HH Judge Waksman QC (as he was then) said:

> "Ultimately, by the end of the trial, there was no real dispute between the parties that if I should conclude (as I do) that the discretion … was not exercised at all or improperly, then the court should, or at least is entitled to, consider the counterfactual, that is to say what percentage would or could BHL have arrived at, had it sought to apply the discretion in a lawful manner? That consensus must be correct. There is, in my judgment, no basis for saying in this case that where the discretion was not properly exercised the result is that Leumi can recover nothing by way of a collection fee."

In that case, the court had to determine what the bank, acting rationally, would have estimated its costs and expenses to be. The following factors were relevant:

- The assessment should not be made with hindsight but instead be based on the point in time at which the decision had to be made.
- Given that a range of outcomes could have satisfied the rationality requirement there was inherently scope for uncertainty. The court in this case determined the "highest percentage" that could have been rationally determined.
- This requires fact-intensive review and in this case the court conducted a detailed assessment of the evidence before it of the various costs and expenses the bank should have known about when making its assessment.

The court concluded, on the basis of the evidence, that had the bank acted rationally, the absolute maximum it could have charged was 4% of the receivables collected under the agreement. This was more than its actual costs and expenses but considerably lower than the 15% it originally sought.

5.3.7. Excluding the duty of rationality

Unlike a general duty of good faith, the rationality requirement is "extremely difficult" to exclude (*Mid Essex Hospital Services NHS Trust v Compass Group UK and Ireland Ltd* [2013] EWCA Civ 200). This is partly because of the inherent difficulty of arguing that a contract allows a party to exercise a discretion in bad faith or to act arbitrarily, capriciously perversely or irrationally (*Bates v Post Office*, paras 761 and 911).

For example, a decision might be said to be binding in the absence of "manifest error". While this point has not be tested yet, it is submitted this does not displace the *Braganza* duty but rather imposes a two-fold test to ensure (objectively) the decision is not tainted by "manifest error" and that the (subjective) decision-making process satisfies the *Braganza* duty.

Similarly, the commonly used phrase of "in its sole discretion" is unlikely to exclude the duty. That merely states who the decision-maker is. The phrase "absolute discretion" is likely to be equally ineffective. For example, the ability of a bank to assess the value of a basket of shares "in its sole and absolute discretion" did not displace the need for an honest and rational valuation (*WestLB v Nomura Bank International plc* [2012] EWCA Civ 495). The fact the directors had "absolute discretion" over the amount of maturity bonuses did not prevent the House of Lords implying a term that prevented the directors paying lower bonuses to policyholders with guaranteed annuity rates (*Equitable Life Assurance Society v Hyman* [2000] UKHL 39).

APPENDIX

Examples of express duties of good faith in the ISDA Master Agreement

Some examples taken from the 2002 ISDA Master Agreement are:

> *Determination of Close-out Amount:* "Any Close-out Amount will be determined by the Determining Party (or its agent), which will act in good faith and use commercially reasonable procedures in order to produce a commercially reasonable result." (definition of Close-out Amount)
>
> *Currency conversion:* "For this purpose, either the Early Termination Amount or the Other Amounts (or the relevant portion of such amounts) may be converted by X into the currency in which the other is denominated at the rate of exchange at which such party would be able, in good faith and using commercially reasonable procedures, to purchase the relevant amount of such currency." (Section 6(f))
>
> "To the extent permitted by applicable law, any obligation to make payments under this Agreement in the Contractual Currency will not be discharged or satisfied by any tender in any currency other than the Contractual Currency, except to the extent such tender results in the actual receipt by the party to which payment is owed, acting in good faith and using commercially reasonable procedures in converting the currency so tendered into the Contractual Currency, of the full amount in the Contractual Currency of all amounts payable in respect of this Agreement." (Section 8(a))
>
> *Selection of reference banks etc:* "the rate certified by the relevant payer to be a rate offered to prime banks by a major bank in a relevant interbank market for overnight deposits in the applicable currency, such bank to be selected in good faith by the payer after consultation with the other party, if practicable, for the purpose of obtaining a representative rate that will reasonably reflect conditions prevailing at the time in that relevant market." (definition of Applicable Deferral Rate)
>
> "The foreign exchange agent will, if only one party is obliged to make a determination under Section 6(e), be selected in good faith by that party and otherwise will be agreed by the parties." (definition of Termination Currency Equivalent)
>
> *Set-off of contingent debts:* "If an obligation is unascertained, X may in good faith estimate that obligation and set off in respect of the estimate, subject to the relevant party accounting to the other when the obligation is ascertained." (Section 6(f))

Other examples may be found in the ISDA Definitions booklets. It is, however, important to assess carefully the duty placed on the decision-maker in each case.

For example, the obligation to determine the close-out amount under the 2002 ISDA Master Agreement has been held to require the decision-maker to use procedures that were, objectively, commercially reasonable to produce, objectively, a commercially reasonable result (*Lehman Brothers Special Financing Inc v National Power Corporation* [2019] 3 All E.R. 53).

In contrast, as a different formulation is used in the 1992 ISDA Master Agreement, the equivalent obligation under that Agreement is subject to the lesser standard of rationality and good faith under the *Braganza* duty (*Fondazione Enasarco v Lehman Brothers Finance SA* [2015] EWHC1307 (Ch), [53]).

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