

## Good faith and rationality – A growing contractual trend?

As we look to emerge from the COVID-19 pandemic and deal with the resultant economic environment, businesses' behaviour in relation to their contractual counterparties will come under sharper focus. This will particularly be the case where contractual provisions give businesses contractual discretion. More generally, businesses may also need to act in good faith.

### Is there a general obligation of good faith in contracts and what does it mean?

The starting point is the contract – what it says and what the parties intended. Any obligation of good faith must either be express or implied.

#### *Express terms*

- A contract governing the relationship between the parties can include an express provision of good faith.
- What the obligation means will depend on the circumstances and wording of that contract and the context of the relationship.
- It cannot be ignored as a meaningless provision and typically will require parties to act in accordance with the spirit as well as the letter of the relevant obligations, and be faithful to the agreed common purpose.

#### *Implied terms*

- Under English law, a duty of good faith is already a feature of certain relationships, for instance employment, partnership, consumer and fiduciary.
- Outside of these special relationships, there is no general principle of good faith in English contracts, and therefore arguments are often raised as to whether a duty of good faith can be implied.
- English courts do not readily imply terms into contract – the UK Supreme Court has provided detailed guidance on this. (For further detail see [here](#) and [here](#))
- There has, however, been growing judicial consideration as to whether there should be an implied obligation of good faith in 'relational' contracts, i.e. a long-term relationship between the parties to which they make a substantial commitment.

### Key considerations

- **Be specific in contracts:** In many long-term relationships, good faith obligations are critical for the venture. If businesses want good faith obligations to apply (either to the contract as a whole or to specific obligations) – or if good faith is to play no role – make it clear in the contract to avoid the court taking a different approach than you intended.
- **Think through and document decisions:** When exercising a discretion, make sure it is done rationally and that you document the basis.
- **Prepare for creativity in any dispute:** Both in formulating your own arguments and in addressing those of others – the unsettled state of English law leaves the door wide open.



## What is a relational contract?

There is no precise definition – but a helpful starting point is that relational contracts 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”.*

A recent court decision on relational contracts has recognised that English law is unsettled on the precise consequences of a contract being a relational contract, albeit that an obligation of good faith is far more likely to be implied into such a contract. Ultimately, each contract will turn on its own terms and context.

### Key characteristics of relational contracts

1. A long-term relationship.
2. Performance with integrity and fidelity to the bargain.
3. Collaboration in performance.
4. Spirit and objective of venture not capable of being expressed exhaustively in a written contract.
5. Trust and confidence between parties but of a different kind to that involved in fiduciary relationships.
6. A high degree of communication, co-operation and predictable performance based on mutual trust and confidence, and expectations of loyalty.
7. Significant investment by one party (or both) in the venture, e.g. a substantial financial commitment.
8. Exclusivity of the relationship.
9. No specific express terms that exclude the possibility of a relational contract.

### Examples of relational contracts cited in judgments

- Joint venture agreements
- Franchise agreements
- Long-term distributorship agreements
- Long term investment agreements
- A PFI contract intended to run for 25 years

### Examples of contracts held not to be relational in judgments

- A loan agreement with a term of three years
- A contract for aircraft engine maintenance services
- Contracts where the express terms dictate they are not relational

## What about contractual discretion?

It is now well established that a duty of rationality can exist as an implied obligation to ensure a contractual discretion is not exercised irrationally, arbitrarily, or capriciously. The precise obligation depends on the terms and context of the contract in question. For example, a party may not be prevented from exercising its discretion in the pursuit of its legitimate commercial aims as long as it does not do so to vex the other party maliciously.

Notably, it is the discretion that is subject to the duty of rationality (e.g. a discretion to change interest rates) and not the exercise of contractual rights (e.g. termination or right to call in a loan). However, even where the contract gives a party a “sole” or “absolute” discretion it is important to demonstrate that the party has exercised its discretion (and the basis) by, for example, having documents that demonstrate the decision making process and the calculations undertaken.

## What else is impacting the direction of travel in this area?

There are a number of different relational contracting models gaining traction in some jurisdictions across the globe – particularly where the concept of good faith is already a key feature of contractual arrangements. English lawyers are, however, going to be cautious. COVID-19 has led to many businesses reassessing how they approach contractual performance and dispute processes. The British Institute of International and Comparative Law recently launched its third concept note in the “Breathing Space” series, outlining some suggested behaviours to support contractual relationships. We are therefore very much at the initial stages of development in this area, which provides real opportunity for businesses to think through how best to structure contractual relationships, particularly where the arrangement is much more relational in nature.

## What does this mean for businesses?

The debate continues as to when a duty of good faith can be implied into a contract and whether or not a party needs to behave rationally when exercising its contractual discretion. What is becoming clear is that the English courts are grappling with these issues. If businesses do not give due consideration to these issues at the outset, a court determination will undoubtedly leave one party disappointed with the outcome.

Faced with the challenge of formulating a claim (or defence) outside of the strict parameters of the text of any contract, parties are likely to run more creative arguments around implied terms, duties of rationality and a general obligation of good faith, given the developing law in this area. These arguments can become substantive issues in a dispute and businesses should take them into account as part of their risk mitigation strategy.

## Authors



**Kushal Gandhi**  
Partner, Finance Disputes  
**T** +44 20 7367 2664  
**E** kushal.gandhi@cms-cmno.com



**Tim Sales**  
Partner, Dispute Resolution  
**T** +44 20 7524 6162  
**E** tim.sales@cms-cmno.com