

## Implied Terms: the Foundation in Good Faith and Fair Dealing

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Confusion as much as controversy permeates the subject of implied terms in contracts. Controversy always surrounds their purpose and legitimacy, for implied terms lie on the point of friction between the basic disposition of the common law to respect freedom of contract and the regulatory impulse to prevent the worst instances of market exploitation and opportunism. Implied terms permit judicial intervention whilst maintaining the appearance of conformity to the idea of respecting the parties' self-determination. Confusion now reigns as well, however, for there is no consensus on the legal tests for the introduction of implied terms into contracts, even to the extent of losing them altogether within the nebula of the interpretation of contracts. Historical guidance is scant: the influential scholars of contract law in the nineteenth century such as Anson, Pollock, and Leake, did not acknowledge the existence of implied terms as they are understood in modern contract law.<sup>1</sup> It was not till the middle of the twentieth century that the topic of implied terms was addressed explicitly at any length in the books.<sup>2</sup> Today, the treatises recite numerous tests for the implication of terms such as the presumed intention of the parties, business efficacy, the officious bystander, business necessity, reasonableness, custom, and the construction of the contract as a whole, but seem unable to choose between these approaches in so far as they may differ, or indeed to present an internally consistent view of how many tests are available. Despite this lack of coherent guidance from the learned authors, even in the most deferential texts, judges are sometimes chastised for getting the law or the results of cases wrong. In the hope of dispelling confusion, though at the risk of provoking controversy, an interpretation of the law will be presented that explains how implied terms represent the principal technique by which English courts ensure performance of contracts in good faith.

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<sup>1</sup> Initial and subsequent impossibility of performance (today often regarded as mistake and frustration respectively) were regarded as 'implied conditions' of the existence/enforceability of the contract, as in *Taylor v Caldwell* (1863) 3 B & S 826, e.g. M Leake, *Principles of the Law of Contracts* (R R A Walker (ed) 8<sup>th</sup> edn, Stevens 1931). These and other conditions, particularly in the law of sales, (breach of which entitled the injured party to escape liability) were increasingly ascribed to the intentions of the parties rather than the application of rules of law: D J Ibbetson, *A Historical Introduction to the Law of Obligations* (OUP 1999) 225.

<sup>2</sup> The first seminal and thoughtful modern discussion of implied terms in English law (which distinguishes two kinds of implied terms) was probably Sir John Salmond and P H Winfield, *Principles of the Law of Contracts* (Sweet & Maxwell 1927) 45-55. R Sutton and N P Shannon, *On Contracts* (Butterworths 1933) included under the heading 'discharge of contracts' a reference to implied terms based on the 'intention of the parties'. After 1945, textbooks included modern accounts of implied terms as contrasted with express terms: G C Cheshire and C H S Fifoot, *The Law of Contracts* (Butterworths 1945) 102-3; followed by A Guest (ed), *Anson's Law of Contract* (21<sup>st</sup> edn OUP 1959) p.117; G H Treitel, *The Law of Contract* (Stevens 1962) 120.

## 1. The Bull in the China Shop

An authoritative restatement of the law of contract in the Western legal tradition, entitled *The Principles of European Contract Law* (commonly called PECL), advances the following synthesis of the law of implied terms.

*In addition to the express terms a contract may contain implied terms which stem from*

- (a) the intention of the parties,*
- (b) the nature and purpose of the contract, and*
- (c) good faith and fair dealing.*<sup>3</sup>

Another recent restatement of European contract law, the Draft Common Frame of Reference, essentially repeats the second and third headings, but substitutes the idea of ‘tacit agreement’ for the intention of the parties.<sup>4</sup>

Although the idea of an implied term originates from the common law, for English lawyers these formulations of when terms may be implied into a contract use some unfamiliar and somewhat uncomfortable concepts. The unguarded reference to the intention of the parties appears dangerously subjective in orientation, looking at what the parties actually wanted or would probably have agreed, rather than using the objective approach to the interpretation of contracts normally favoured in English law.<sup>5</sup> The second ground for implication of terms based on the ‘nature and purpose of the contract’ is reminiscent in its reference to the ‘nature’ of the contract of the now discredited late scholastic Aristotelian philosophy;<sup>6</sup> and the reference to the purpose of the contract is surely influenced by the German professors’ metaphysical use of the purpose or ‘Zweck’ of the contract to guide its interpretation and application.<sup>7</sup> Finally, the reference to good faith and fair dealing, we have been told by eminent legal authorities, is contrary to the ethos of the common law of contracts,<sup>8</sup> unworkably vague, and destructive of

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<sup>3</sup> O Lando and H Beale (eds), *Principles of European Contract Law* Part I and II (Kluwer Law International 2000) 302-5, Article 6:102 Implied Terms. It should be noted as well that PRCL proposes a mandatory duty of good faith and fair dealing (art. 1:201), a default duty to ‘co-operate in order to give full effect to the contract,’ (Art 1:202) and the binding quality of ‘reasonable generally applicable usages’ (Art 1:105).

<sup>4</sup> C Von Bar and E Clive (eds), *Principles, Definitions and Model Rules of European Private Law: Draft Common Frame of Reference (DCFR)* (OUP 2010) Article II-9:101, Vol. 1 575.

<sup>5</sup> *Smith v Hughes* (1871) LR 6 QB 597; *Investors Compensation Scheme Ltd v West Bromwich Building Society* [1998] 1 WLR 896 (HL). PECL explains, however, that the formulation should not be taken literally: ‘The first indicator refers to the presumed intention of the parties; the court should consider what parties, acting in accordance with good faith and fair dealing, would reasonably have agreed if they had discussed the question.’ O Lando and H Beale (eds), *Principles of European Contract Law* Part I and II (Kluwer Law International 2000) 303.

<sup>6</sup> J Gordley, *The Philosophical Origins of Modern Contract Doctrine* (Clarendon Press OUP 1991) 208-213. PECL probably derives the phrase from the French Civil Code art 1135: ‘the obligations under a contract extend not only to what is expressly stipulated, but also to everything which by law, equity or custom must follow from the nature of the particular contract.’

<sup>7</sup> In a typical example in German law of ‘constructive interpretation’ it is said that the duty of a judge is to ‘discover and take into account what, in the light of the whole purpose of the contract, they [the parties] would have said if they had regulated the point in question, acting pursuant to the requirements of good faith and sound business practice.’ See BGH 18 December 1954, BGHZ 16, 71, 76. See DCFR above n 4 Vol 1 581.

<sup>8</sup> Eg Lord Ackner in *Walford v Miles*, ‘the duty to carry on negotiations in good faith is inherently

commercial certainty.<sup>9</sup> To quote Professor Michael Bridge: ‘The introduction of a general principle of good faith and fair dealing would be like letting a bull loose in a china shop.’<sup>10</sup>

Even so, this list of sources of implied terms in PECL at least rings a bell for an English lawyer. As Professor Andrew Burrows acknowledges in a comment on this provision in PECL in his casebook:

‘The first two of these correspond to the implication of terms by the English courts although the tests in English law mean that terms are not readily implied. In English law, there is no *overt* reference to good faith and dealing (sic) as a source of implied terms.’<sup>11</sup>

Presumably he has in mind the classification used in most (though not all)<sup>12</sup> textbooks today of the two categories of terms ‘implied in fact’ and terms ‘implied by law’; these categories display some similarities with the first and second sources of implied terms listed in PECL. His final remark regarding the lack of overt reference to good faith and fair dealing may need revision in the light of the recent decision of the High Court in *Yam Seng v International Trade Corporation*.<sup>13</sup> In that case, Leggatt J asserted that ‘there is nothing novel or foreign to English law in recognising an implied duty of good faith in the performance of contracts.’<sup>14</sup> In order to emphasise the objectivity of this particular standard of good faith, he added that the term could advantageously be described as a duty of good faith and fair dealing in the performance of contracts.<sup>15</sup> In particular, Leggatt J suggested that some enhanced duties of disclosure and co-operation might apply in ‘relational’ contracts.<sup>16</sup> In making those adventurous remarks, has Leggatt J. brought English law into broad conformity with the restatement of the law of implied terms in PECL, thereby unleashing the bull in the china shop?

The thesis advanced here is that the judicial practice of implying terms into contracts in English law has never been properly understood and is poorly represented by the tripartite division of sources of implied terms in PECL. The true ground for implying terms into contracts is always good faith and fair dealing, though the distinction between terms implied in fact and terms implied in law signifies different meanings of the kaleidoscopic idea of good faith. In short, implied terms have always been the bull in the china shop, but the predicted destruction has not happened, thanks indubitably to the skills of the matadors, the common law judges. My thesis advances in a number of propositions, which it may be convenient to list in advance.

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repugnant to the adversarial position of the parties when involved in negotiations”. [1992] 2 AC 128, 138.

<sup>9</sup> M Bridge, ‘Doubting Good Faith’ (2005) 11 *New Zealand Business Quarterly* 430, 450: ‘There is no general duty of good faith and fair dealing in English contract law and there is no reason why there should be.’

<sup>10</sup> M Bridge, ‘Doubting Good Faith’ (2005) 11 *New Zealand Business Quarterly* 430, 448. The metaphor of the china shop may be introduced by Powell: ‘When I read of a lawyer trying to tread daintily in the china-shops of ethics, I wish that someone would lead him back to the streets where walk all manner of men.’ R Powell, ‘Good Faith in Contracts’ (1956) 9 *CLP* 16, 38.

<sup>11</sup> A Burrows, *A Casebook on Contract* (4th edn, Hart Publishing 2013) 227 emphasis in the original.

<sup>12</sup> Eg H Beale (General Ed), *Chitty on Contracts* (31<sup>st</sup> edn, Sweet & Maxwell 2012) Vol I 13-003 (p.986).

<sup>13</sup> *Yam Seng Pte Ltd v International Trade Corporation Ltd* [2013] EWHC 111.

<sup>14</sup> *Ibid*, [145].

<sup>15</sup> *Ibid* [150].

<sup>16</sup> *Ibid* [142].

1. There are two types of implied terms, not three as in PECL, and certainly not only one.
2. There are political and structural reasons that provoke confusion surrounding the categorisation of implied terms.
3. Neither sort of implied term has much in common with interpretation of contracts.
4. Ideas of good faith and fair dealing should be acknowledged as central to the implication of terms, though different notions of good faith apply to terms implied in fact and terms implied by law.
5. Although the category of ‘relational contracts’ is both imprecise and unsuitable for the task, it is possible to identify a group of contracts (to be called networks) that shares crucial relevant features in common - an intensified economic logic of both competition and co-operation that arises from their structure as a quasi-integrated production regime – and that requires intensified duties of loyalty and co-operation implied by law.

## 2. Two Sources of Implied Terms

There are two sources of implied terms in English law, not three and not one. This claim depends both upon an interpretation of the authorities and a logical claim. When asked to imply a term into a contract, a court is always being asked to do one of two things.

The first request is to devise a default rule that applies to a standard kind of transaction whenever it is used. Although this request is made in respect of a particular contractual dispute, the court will appreciate that its ruling will generate a precedent for all subsequent cases involving the same type of transaction where the proposed rule will be applied in the absence of some express term that contradicts the default rule. The rule might be that goods sold should be warranted to be of merchantable quality,<sup>17</sup> or that a service should be performed with reasonable care.<sup>18</sup> In responding to that request, a court is providing in an incremental way, with some trial and error arising from subsequent litigation, the default rules or standard ‘incidents impliedly annexed to particular forms of contracts.’<sup>19</sup> In codified systems of law, these standard incidents are specified in articles of the civil code, but under the common law, even in legislation, they are attributed artificially to the agreement of the parties as an implied term rather than a rule of law.<sup>20</sup> These are the terms usually described as terms ‘implied by law’.<sup>21</sup>

<sup>17</sup> *Gardiner v Gray* (1815) 4 Campbell 144, 171 E.R. 46; *Jones v Just* (1868) LR 3 QB 197.

<sup>18</sup> *Coggs v Bernard* (1703) 2 Ld Raym 909, 92 ER 107.

<sup>19</sup> *Equitable Life Equitable Life Assurance Society v Hyman* [2000] UKHL 39, [2002] 1 AC 408, Lord Steyn 458-9 (HL).

<sup>20</sup> Lord Denning MR may have been a lone voice objecting explicitly to this artificial terminology: *Shell UK Ltd v Lostock Garage Ltd* [1976] 1 WLR 1187, at p. 1196G: ‘the obligation is a legal incident of the relationship which is attached by the law itself and not by reason of any implied term.’; but Lord Wright was also a ‘Realist’ in this respect: *Luxor (Eastbourne) Ltd Cooper* [1941] AC 108, at p. 137, ‘The expression “implied term” is used in different senses. Sometimes it denotes some term which does not depend on the actual intention of the parties but on a rule of law, such as the terms, warranties or conditions which, if not expressly excluded, the law imports, as for instance under the Sale of Goods Act and the Marine Insurance Act’.

<sup>21</sup> *Lister v Romford Ice and Cold Storage Co Ltd* [1957] AC 555, 579: ‘the implied term is imposed by law, not in respect of a particular contract but as a legal incident of this kind of contract’, Viscount Simmonds 579; ‘Some contractual terms may be implied by general rules of law. These general rules, some of which

The second request is to devise a rule for a particular contract that alters its allocation of risks on the ground that one party is seeking to take advantage of an omission in the express allocation of risks to obtain an advantage that has not been bargained for. Such a request tries to tempt a court, with the benefit of hindsight, to rewrite a contract by providing for an allocation of risk that had not been mentioned in the express terms, for the purpose of ensuring (what it is hoped to persuade the court would be) a fairer result. The principal rhetorical strategy when making such a request is to present the proposed implied term as having always been, at least from an objective point of view, an unexpressed ingredient of the intentions of the parties. These are terms usually described as terms ‘implied in fact’.

These two types of implied terms are logically distinct, though not always easy to separate in practice. The difference between them lies in the regulatory aim of the judicial intervention. For terms implied by law, the aim is to provide a default rule for a particular kind of contract that will serve to regulate this market transaction for the future. For terms implied in fact, the objective is a precise surgical operation to revise the allocation of risk in the context of a particular transaction. It is possible that a succession of cases concerning a particular kind of contract involving disputes over a similar issue will gradually create a body of precedents that may be adopted as a general default rule. But the transition from a term implied in fact to a term implied by law requires a significant reorientation in legal reasoning. Until there is judicial recognition that the term has become a standard incident for that type of contract, the precedents provide an unreliable source of a general default rule.

Custom is often held up as a third category of implied term.<sup>22</sup> But on closer inspection, all such cases fall into different categories. Most often custom is used as a point of reference for understanding the meaning of the contract; it is part of the context that a reasonable person uses to interpret the meaning of a promise. That is why a customary rule has to be both reasonable and notorious to be incorporated into a contract.<sup>23</sup> In the county of Suffolk, in 1832, local custom proved that a promise to sell 1000 rabbits really meant one hundred dozen or 1200 rabbits.<sup>24</sup> In other cases, custom is used to explain the incorporation of documents into a contract without the need for an explicit agreement between the parties.<sup>25</sup> The remaining cases that have regard to customary practices would now be classified as terms implied by law as a standard incident of this type of contract. In the nineteenth century, customs were sometimes

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are now statutory, for example, Sale of Goods Act, Bills of Exchange Act, etc., derive in the main from the common law by which they have become attached in the course of time to certain classes of contractual relationships, for example, landlord and tenant, innkeeper and guest, contracts of guarantee and contracts of personal service.’ Lord Tucker, 594.

<sup>22</sup> E.g. Neil Andrews, *Contract Law* (Cambridge U P 2011) 373; M Chen-Wishart, *Contract Law* (4<sup>th</sup> edn, OUP 2012) 378; E Peel, *Treitel: The Law of Contract* (13<sup>th</sup> edn Sweet & Maxwell 2011) 222; E McKendrick, *Contract Law: Text, Cases and Materials* (5<sup>th</sup> edn OUP 2012) 343.

<sup>23</sup> *Cunliffe-Owen v Teather & Greenwood* [1967] 1 WLR 1421, 1438-9.

<sup>24</sup> *Smith v Wilson* (1832) 8 B & Ad 728, 110 ER 266. Pollock suggest that this custom was based on ‘long hundreds’ of six score used in the ‘Anglicus Numerous’ of Anglo Norman surveys: F Pollock, *Principles of Contract* (10<sup>th</sup> edn, Stevens 1936) 248, though possibly the customs of Suffolk are idiosyncratic.

<sup>25</sup> *British Crane Hire Corporation Ltd v Ipswich Plant Hire Ltd* [1975] QB 303 (CA); *Henry v London General Transport Services Ltd* [2002] EWCA Civ 488, [2002] ICR 910.

described as implied terms to avoid the parole evidence rule,<sup>26</sup> but this device is unnecessary under the modern English approach to the interpretation of contracts.<sup>27</sup>

The alternative view - that there is only one type of implied term – probably originates from a turning point in the development of the law in the late nineteenth century. English law confronted the difficulty of trying to reconcile the settled practice of the judges imposing standard incidents or default rules on contracts with the ideals of freedom of contract and the fashionable view at that time that the source of all contractual obligations had to be discovered in the agreement or will of the parties.<sup>28</sup> This problem of coherence in legal doctrine came to a head in 1889 in the famous case, *The Moorcock*.<sup>29</sup> The issue in the case was whether the owner of a jetty, who had permitted the plaintiff to moor his steamship there temporarily for the purpose of unloading in due course at the owner's nearby wharf, was under any liability for damage to the vessel. There was a cock up with the mooring of the *Moorcock*, because the ship's hull was damaged by an unexpected bar of rock or gravel in the Thames' muddy river bed as it settled at low tide. In modern terminology, the issue was whether the owner of the wharf would be liable in negligence in the provision of a service by failing either to inspect the bottom of the river or to warn the owner of the vessel of the potential danger. The informal contract was silent on the matter, so the claimant suggested liability should arise under an implied term. Previous cases had held that, as a standardised term, the owner of a mooring owed a duty of care to those it invited to use the mooring. This case was slightly different, because the berth was the river bed, not owned by the defendant and some distance from the wharf, reached by a jetty. Bowen LJ concluded his judgment by holding that this case, with a suitably modified implied term to take account of the point that the defendants had no power to make the berth safe, fell within the previous line of authorities. But an earlier passage of his judgment is one for which the case is always remembered. Bowen LJ said,

‘In business transactions such as this, what the law desires to effect by the implication is to give such business efficacy to the transaction as must have been intended at all events by both parties who are business men; not to impose on one side all the perils of the transaction, or to emancipate one side from all the chances of failure, but to make each party promise in law as much, at all events, as it must have been in the contemplation of both parties that he should be responsible for in respect of those perils or chances.’<sup>30</sup>

Why were these *obiter* and perhaps *ex tempore* remarks significant? Initially, nothing happened. More than forty years on, in 1930, the editors of Chitty on contracts for the first time acknowledged almost in passing that there were such things as implied

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<sup>26</sup> *Hutton v Warren* (1836) 1 M & W 466, 150 ER 517. Parke B, 150 ER 521: ‘It has long been settled that, in commercial transactions, extrinsic evidence of custom and usage is admissible to annex incidents to written contracts, in matters with respect to which they are silent.’

<sup>27</sup> Law Commission, *Law of Contract: The Parol Evidence Rule*, (Law Com No 154, 1986) Cmnd. 9700 .

<sup>28</sup> P S Atiyah, *The Rise and Fall of Freedom of Contract* (Clarendon Press OUP 1979); D Kennedy, *The Rise and Fall of Classical Legal Thought* (Beard Books 2006) Chapter 4 (though neither of these works examine the particular instance of implied terms).

<sup>29</sup> *The Moorcock* (1889) 14 PD 64, CA.

<sup>30</sup> *Ibid* 68.

terms and that the test in *The Moorcock* was frequently invoked in the courts.<sup>31</sup> The formula for inserting implied terms on the grounds of business efficacy proved attractive to authors of contract law textbooks for two reasons. First, the test sought to reconcile the practice of imposing default rules with the fashionable ‘will theory’ of contract. Bowen LJ’s argument was that the parties must be presumed to have intended this term, not because they had actually thought about it, but because it must have been in their contemplation as a necessary ingredient of the contract in view of their commercial aims. This point provided a formula based upon a presumption of intention or will that purported to reconcile the practice of imposing standardised terms with the need to attribute those terms to the will of the parties. Second, even better from a libertarian perspective, Bowen LJ insisted that such terms should not be inserted into contracts to make them fairer or more reasonable, but only when the term was strictly necessary to give business efficacy to the transaction. This formula limited any potential infringement with the parties’ freedom of contract to instances where apparently they must have implicitly agreed to the condition. In short, this conception of an implied term was invented to reconcile the practice of judicial imposition of standardised obligations on market participants with liberal theories of the sources of contractual obligations.

In the *Moorcock* case itself, however, it was far from clear that the business efficacy test was satisfied. On the contrary, all members of the Court of Appeal seem to have been heavily influenced by the point that the owner of the wharf was in a better position to inspect the hidden reef, or, to put the point in modern language, the defendant was in the best position to avoid the accident at the least cost. In short, these implied provisions on liability were efficient and therefore applied as standard incidents of the contract. The leading case on terms implied in fact, *The Moorcock*, was in actuality merely a routine instance of the imposition of terms implied by law by reference to precedents, but out of deference to the prevailing will theory of contract, was presented in addition as justified by reference to the presumed intentions of the parties. It created the impression, therefore, that there was only one type of implied term, a term that was attributed to the presumed intentions of the parties.

The error that there is only one type of implied term, a term implied in fact, constantly resurfaces in cases during the following century.<sup>32</sup> On at least two occasions, in *Lister v Romford Ice and Cold Storage Co Ltd*<sup>33</sup> and *Liverpool City Council v Irwin*,<sup>34</sup> Lord Denning found himself in a minority in the Court of Appeal when applying a standard incident to a contract, with the majority sticking rigidly to the formula of business efficacy derived *The Moorcock*, though on both occasions the House of Lords eventually approved the use of terms implied by law. Indeed, in the latter case, after much hand-wringing, Lord Wilberforce relied upon a decision by no other than Bowen LJ, in which the latter had in effect created a standardised term for multi-occupancy dwellings under which the tenant enjoyed an implied easement over the common parts

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<sup>31</sup> W.A. MacFarlane and G.W. Wrangham (eds), *Chitty’s Treatise on the Law of Contracts* (18<sup>th</sup> edn Sweet & Maxwell 1930) 121.

<sup>32</sup> This view may be strongly influenced by *Chitty on Contracts* (above n. 12), which presents implied terms as a single category, all of which are implied by law (which is of course literally true), though acknowledging with respect to standardised terms (at para. 13-003, p. 986) ‘it is somewhat artificial to attribute such terms to the unexpressed intention of the parties.’

<sup>33</sup> [1957] AC 555.

<sup>34</sup> *Liverpool City Council v Irwin* [1977] AC 239 (HL).

affording access to his home and the landlord was placed under a duty to maintain the staircase to keep it reasonably safe.<sup>35</sup> As we will note below, it seems that we may be entering a new period of collective amnesia, when the possibility of terms implied in law is forgotten in the haste to amalgamate terms implied in fact with construction of the contract. Each generation of judges has to rediscover that there are two types of implied terms, which logically consider separate questions.

### 3. The Political and Structural Origins of Confusion.

English judges are understandably wary about invitations to create either sort of implied term. For the task of rule-making, not only is the court being invited to legislate, but also to do so perhaps without all the necessary information regarding this particular type of transaction, how it functions economically, and how the law regulates the contract in other ways that may not be immediately apparent in the course of a particular instance of litigation. For the retrospective adjustment of the obligations of the parties, the courts are concerned that any hint of a power to rewrite contracts in order to ensure fair outcomes would precipitate an avalanche of claims from litigants who have discovered they are at the losing end of a bargain. As Lord Bingham MR once pithily remarked:

‘So the court comes to the task of implication with the benefit of hindsight, and it is tempting for the court then to fashion a term which will reflect the merits of the situation as they then appear. Tempting, but wrong.’<sup>36</sup>

To avoid the appearance of acting either as legislator or shining white knight, the courts spend a great deal of time either denying that they have such powers or insisting, in the alternative, if such powers do exist, that they are strictly confined by legal tests such as necessity or business efficacy that rule out any general power to rewrite contracts on the ground of fairness.

These political and policy motivated denials of the powers involved in creating implied terms sow the seeds of confusion, but there are deeper roots for systematic misrepresentation. To avoid the perils of appearing to ask a court to act either as legislator or saviour of the incautious, advocates can frame their submissions for implied terms in ways that misrepresent their character. Four possible scenarios can be deconstructed, though in some instances similar arguments can be used to achieve rather different ends.

*A. If a court is invited to create a standard incident for a type of contract, but is not inclined to do so, it can adopt the following lines of argument to reject the implied term.*

1. Deny or conveniently forget the possibility of a term implied by law as a standardised incident and insist that all terms must conform to the presumed intentions of the parties, as terms implied in fact, and that in this particular case those tacit intentions probably do not coincide.<sup>37</sup>

2. Define the category of contract for which the standard incident is proposed broadly, so that the standard incident may not seem appropriate for every type of case

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<sup>35</sup> *Miller v Hancock* [1893] 2 QB 177, (CA) 180-181.

<sup>36</sup> *Phillips Electronique Grand Public SA v British Sky Broadcasting* [1995] EMLR 472 (CA) 481.

<sup>37</sup> *Eg* majority opinion in *Liverpool City Council v Irwin* [1976] QB 319 (CA).

that might arise within that broad classification of the standard contract, so that the term can be rejected.<sup>38</sup>

3. Deny that this is a recognisable standard type of contract, but is rather idiosyncratic and infrequent, so that the implication of any term in law would be inappropriate.<sup>39</sup>

*B. If a court is invited to create a standard incident for a particular type of contract and is willing to do so, it can adopt the following lines of argument.*

1. Claim that the matter has already been decided by precedent.

2. Describe the nature of the contract in narrow terms, so that the legislative character of the decision to create a standardised term is masked and its potential unforeseen ramifications are to some extent avoided.

3. Describe the implied term as a term implied in fact for that particular contract, whilst of course creating the precedent that might be followed in the future. This is what happened in *Yam Seng*.<sup>40</sup> Use of this strategy in the higher courts of appeal is particularly unfortunate, since it relieves the court of having to engage with the complexity of its legislative task, even though its decision is likely to be adopted as a precedent in future cases.

*C. If a court is invited to create an adjustment of the terms of a particular contract and is unwilling to do so, it can adopt the following lines of argument.*

1. Claim that it is being invited to create a term implied in law for a broad class of contracts, for which it would be inappropriate to legislate.<sup>41</sup>

2. Insist that terms can only be implied if they satisfy a strict test of necessity. Once the contract has been construed according to the objective approach to interpretation and the perspective of the reasonable person, it is unlikely that this test of necessity could ever justify a further implication.

*D. If a court is invited to create an adjustment of the terms of a particular contract and is willing to do so, but does not want to appear as a shining white knight, it can adopt the following lines of argument.*

1. Claim that it is applying a term implied in law, often appealing to precedents to bolster the case, thereby avoiding the charge of acting as a saviour.<sup>42</sup> To achieve that goal without disturbing the normal legal framework, the implied term may have to be applied to a tiny and rare class of contracts.<sup>43</sup>

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<sup>38</sup> Peden points out that this was the strategy of the CA in *Reid v. Rush & Tompkins Group Plc* [1990] 1 WLR 212 (CA): E Peden, 'Policy Concerns Behind Implications in Law' (2001) LQR 459, 461-462; if the class of employment contracts to which the duty had been applied had been confined to those involving foreign postings, the duty would have appeared much less burdensome and more appropriate.

<sup>39</sup> *Eg* Lord Denning MR, *Shell UK Ltd v Lostock Garage Ltd* [1976] 1 WLR 1187 (CA), 1197D.

<sup>40</sup> Above n 13 [131].

<sup>41</sup> *Eg* the majority opinion in *Lister v Romford Ice and Cold Storage Co Ltd* [1957] AC 555 (HL).

<sup>42</sup> *Eg* the minority opinion in *Lister v Romford Ice and Cold Storage Co Ltd* [1957] AC 555 (HL).

<sup>43</sup> *Eg* *Scally v Southern Health and Social Services Board* [1992] 1 AC 294 (HL), where the judicial committee reached the conclusion that there is a sub-category of contracts of employment where the express terms confer a valuable right contingent on action being taken by the employee and the employee

2. Claim that it is merely interpreting the contract and not really inventing a term or making an adjustment at all.

The point of setting out these various strategies of argument is to emphasise how much it may benefit the persuasiveness of an argument in favour or against an implied term by misclassifying the case between the two categories of implied term. To persuade a judge to act as a shining white knight, for instance, it is usually advisable to disguise the measure by hiding behind precedents and to claim merely to be applying a well-established implied term for this class of contracts. After all, that is what Bowen LJ, the doyen of the subject, did in *The Moorcock*.

#### 4. The Distinction between Interpretation and Implied Terms.

Most recently, this confusion about the grounds for the implication of terms has been compounded by unguarded judicial claims that implied terms are merely an aspect of interpretation of the contract. In *Attorney-General of Belize v Belize Telecom Ltd*,<sup>44</sup> Lord Hoffmann gave the advice that:

‘It follows that in every case in which it is said that some provision ought to be implied in an instrument, the question for the court is whether such a provision would spell out in express words what the instrument, read against the relevant background, would reasonably be understood to mean.’<sup>45</sup>

From a more theoretical and linguistic point of view, Adam Kramer has argued that terms implied in fact are simply a special instance of interpretation of contracts.<sup>46</sup> Can the implication of terms be reduced to the task of interpretation?

The general point of the ‘interpretivists’, who occupy this position, is that where the words used in the contract are ambiguous, unclear, vague or incomplete, a court necessarily engages in an analysis of what the reasonable person would understand those words to mean, taking into account the context and the normal inferences to be drawn from the use of the language. At one end of a spectrum of interpretation, the proper inference to be drawn from the express words used in contract in the context of the transaction will be obvious and uncontroversial; at the other end of the spectrum, it will be much less clear what inferences can and should be drawn because of the absence of directly pertinent language in the contract and the unforeseen character of the problem

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cannot reasonably be aware of the existence of the right unless the employer draws it to his or her attention. This narrowing of the class of contracts to which the implied term applied avoided a more general duty of disclosure of information in contracts of employment.

<sup>44</sup> [2009] UKPC 10, [2009] 2 All ER 1127 (PC).

<sup>45</sup> See also: ‘As in the case of any implied term, the process is one of construction of the agreement as a whole in its commercial setting’, *South Australia Asset Management Corporation v. York Montague Ltd.* [1997] A.C. 191, Lord Hoffmann, 212. ‘The implication of terms is also part of the process of interpretation of written contracts’, Lord Steyn, ‘Legal Texts and their Landscape’, in B. Markesinis (ed.) *The Coming Together of the Common Law and the Civil Law: The Clifford Chance Millenium Lectures* (Oxford 2000) 84, and, more recently, J. Steyn, ‘The Intractable Problem of The Interpretation of Legal Texts’ (2003) 25 Sydney L Rev 5, 11.

<sup>46</sup> Adam Kramer, ‘Implication in Fact as an Instance of Contractual Interpretation’ (2004) CLJ 384.

that has arisen. Kramer's suggestion is that, as the task of interpretation moves across this spectrum of difficulty, increasingly the courts use the terminology of implied terms. But, it is argued, there is no qualitative difference in the task being addressed. The issue always is: what is the correct interpretation of the contract, taking into account its commercial purpose and the context in which it was made?

It does little harm to acknowledge that implied terms can be used as a device for making the terms of a contract more specific or precise, though this tool hardly seems necessary today in view of the modern practice of construction according to the perspective of the reasonable person and frequent invocations of the mantra of 'business common sense'<sup>47</sup> to provide elaborate interpretations of written documents. The question is, however, whether the language of implied terms is used typically or characteristically for this interpretive purpose. My view is that either in the rule-making of terms implied in law or the adjustment of risks through terms implied in fact, a court is typically venturing beyond the terms expressed by the parties, even taking into account the possibility of expansive readings of the contract informed by context and commercial common sense.

Sometimes the claim that the implied terms are used to venture beyond interpretation of ambiguity is explained by reference to the notion of a gap in the contract.<sup>48</sup> Implied terms are presented, like mastic, as gap-fillers. The problem with that view is that contracts function to allocate risks between the parties, so that any gap left by the contract implicitly allocates the risk onto the party who suffers the loss. Hence the owner of *The Moorcock* had apparently accepted the risk of loss caused by an unsafe mooring by not insisting on an express warranty of a safe berth. When successfully invoked, implied terms serve to reallocate risk away from the party who would otherwise bear the loss. The reference to a gap in the contract avoids the appearance of rewriting the contractual allocation of risk. It is true, admittedly, that sometimes it will be the case the parties have genuinely not foreseen the unlikely event that has occurred and have therefore made no express provision, so that there was a gap in the planning document. More often, though, it seems likely that standard risks, such as damage to the boat, have been discounted as improbable in the circumstances (the muddy riverbed of the Thames) and therefore not worth the cost of explicit consideration and express regulation in the terms of the contract. The combination of transaction costs, misperceptions of risk, and attention bias in favour of the main aspects of the deal account for the omission of an express term to address the matter. The problem with the metaphor of gap-filling is therefore that a more accurate description of the situation is often that the parties consciously made no provision in the contract, leaving the loss to lie where it fell. It is not so much a gap as a conscious omission to address (what are perceived to be) improbable or remote risks.

A sharper distinction between interpretation and implied terms therefore contrasts a lack of specificity or precision in the contract with an omission to protect against a

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<sup>47</sup> *Antaios Cia Naviera SA v Salen Rederierna AB, The Antios* [1985] AC 191, 201: 'business common sense' Lord Diplock; *Lord Napier and Ettrick v R F Kershaw Ltd* [1999] 1 WLR 756, 763: 'commercially sensible construction' Lord Steyn; *Rainy Sky SA v Kookmin Bank* [2011] UKSC 50, [2011] 1 WLR 2900, 'business common sense', Lord Clarke [30].

<sup>48</sup> Implied terms are described as supplementing defective actual intention by filling lacunae in Salmond Winfield, above n2, 51, giving as examples *The Moorcock* and *Krell v Henry* [1903] 2 KB 740 (CA).

particular risk. Where a contract is vague on a particular point, it can usually be completed through an interpretation of the words that were used. Where one party has omitted to protect itself against a particular risk that has arisen, the issue moves beyond interpretation to a consideration whether, notwithstanding the omission, it would be appropriate for the court to create a term that affords protection against the risk. This contrast between interpretation and implied terms becomes especially evident in cases where one party is exercising unfettered rights or discretionary powers conferred explicitly by the contract in a self-interested way. There is no gap in the contract, but there is an omission to protect against misuse of the right or the exercise of discretion for an improper purpose.<sup>49</sup> A court may decide to remedy this omission by inserting an implied term that effectively fetters an unqualified right or discretionary power conferred explicitly by the contract. Only in a very loose sense can this adjustment of risks be described as an interpretation of the contract. The implied term remedies an omission by one party to protect itself against a risk that otherwise it would have to carry. The famous officious bystander test, first formulated by Scrutton LJ,<sup>50</sup> then developed by Mackinnon LJ, initially at a lecture at the London School of Economics and subsequently in the Court of Appeal,<sup>51</sup> focuses correctly on this idea of addressing omissions in the express allocations of risk. Unfortunately, the officious bystander is never there when you need her.

If this sharp distinction between interpretation and reallocation of risk can be drawn, why does Lord Hoffman insist upon assimilation? His advice in *Attorney-General of Belize v Belize Telecom Ltd* should be placed in context. His quarrel in this case was with the way in which an earlier decision by Lord Simon of Glaisdale, giving the advice of the majority of the Privy Council in *BP Refinery (Westenport) Pty Ltd v Shire of Hastings*,<sup>52</sup> had been taken up in Australian law. There the law developed the dubious proposition that implied terms have to satisfy the business efficacy test and the officious bystander test, as well as a reasonableness test, plus some others.<sup>53</sup> Lord Hoffmann protests that all these tests are designed to spell out the meaning of the contract, as understood by a reasonable man, and should not be regarded as independent tests. He is surely correct that the tests were intended to function as alternatives, not cumulative requirements, and that in so far as the request to imply a term is based upon

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<sup>49</sup> Eg *Equitable Life Assurance Co. Ltd v Hyman* [2002] 1 AC 408 (HL); *Abu Dhabi National Tanker Co v Product Star Shipping Ltd (The "Product Star")* (No 2) [1993] 1 Lloyd's LR 397 (CA); *Horkulak v Cantor Fitzgerald International* [2004] EWCA Civ 1287, [2005] ICR 402 (CA); *Socimer International Bank Ltd v Standard Bank London Ltd* [2008] EWCA Civ 116, [2008] 1 Lloyd's LR 558. Cp: *Patterson v Meyerhofer* 97 N.E.2d 472 (N.Y. 1912); *Fortune v National Cash Register Co.*, 364 N.E. 2d 1251 (Mass. 1977). Cf H Collins, 'Discretionary Powers in Contracts' in D Campbell, H Collins and J Wightman (eds), *Implicit Dimensions of Contract: Discrete, Relational, and Network Contracts* (Hart Publishing 2003) 219.

<sup>50</sup> *Reigate v. Union Manufacturing Co. (Ramsbottom)* 1918] 1 K.B. 592 at 605 "A term can only be implied if it is necessary in the business sense to give efficacy to the contract; that is, if it is such a term that it can confidently be said that if at the time the contract was being negotiated some one had said to the parties, 'What will happen in such a case,' they would both have replied, 'Of course, so and so will happen; we did not trouble to say that; it is too clear.'"

<sup>51</sup> *Shirlaw v Southern Foundries (1926) Ltd* [1939] 2 KB 206 (CA) 227; A. Phang, 'Implied terms, business efficacy and the officious bystander – a modern history' (1998) *JBL* 1.

<sup>52</sup> (1977) 180 CLR 266, 282-283.

<sup>53</sup> J Paterson, A Robertson, A Duke, *Principles of Contract Law* (4<sup>th</sup> edn Lawbook Co. 2012) 330-337.

the presumed intentions of the parties with respect to vague or imprecise terms, the principal question remains the proper interpretation of the contract, the answer to which may to some extent be aided by the various tests. Whilst concurring with that general point of criticism of the multi-test approach, my argument is that implied terms serve also what Lord Bingham described as ‘a different and altogether more ambitious undertaking’<sup>54</sup> concerning (in my view) the reallocation of risk. This more ambitious undertaking requires a more circumspect approach than a simple reference what a reasonable man would think the parties had agreed. Recognising this distinction between interpretation and implied terms, though not in the framework advanced here, the Court of Appeal has stressed recently that the touchstone for the implication remains necessity rather than reasonableness.<sup>55</sup> Whilst I shall maintain that necessity is the incorrect test and that a single test for the two types of implied terms is plainly wrong, the Court of Appeal is surely right to reject the imperialism of the interpretivists.

## **5. Good Faith and Fair Dealing as the Source of Implied Terms.**

Having clarified these various points, it is convenient to address my central claim that the notion of good faith and fair dealing plays a crucial role in the implication of terms. But the notion of good faith differs between terms implied in fact and terms implied in law, so these categories have to be considered separately. The contrasting notions of good faith need to be set out before looking in detail at their application to the implication of terms.

### ***The Spectrum of Good Faith***

The standard of good faith and fair dealing should be understood as comprising a spectrum of norms. At its narrowest end, good faith merely requires honesty in fact. This minimum requirement probably applies to all contracts, even in the most antagonistic trading.<sup>56</sup> At the other end of the spectrum of good faith, it edges close to fiduciary duties by requiring performance of the contract that takes the interests of the other party into account.

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<sup>54</sup> *Philips Electronique Grand Publique SA v British Sky Broadcasting Ltd* [1995] EMLR 472, (CA) 481.

<sup>55</sup> *Mediterranean Salvage & Towage Limited v Seamar Trading & Commerce Inc, The Reborn* [2009] EWCA Civ 531, [2009] 2 Lloyd’s Rep. 639; *Lomas & Ors v JFB Firth Rixson Inc & Ors* [2012] EWCA Civ 419; see also: Baroness Hale JSC in *Geys v Société Générale, London Branch* [2012] UKSC 63, [2013] ICR 117, [55].

<sup>56</sup> *HIH Casualty v Chase Manhattan Bank* [2003] 2 Lloyd’s Rep 61 (HL): ‘Parties entering into a commercial contract ... will assume the honesty and good faith of the other; absent such an assumption they would not deal’ Lord Bingham [15]. Lord Kenyon, *Mellish v. Motteux* (1792) Peake 156 at 157 (170 E.R. 113 at pp. 113-114), ‘In contracts of all kinds, it is of the highest importance that courts of law should compel the observance of honesty and good faith’. It is arguable that this is what Lord Mansfield meant when he suggested that good faith was a governing principle applicable to all contracts in *Carter v. Boehm* (1766) 3 Burr. 1905, 1909 (97 E.R. 1162, 1164). In the US, this end of the spectrum is described as the ‘intentional torts’ such as fraud: T D Rakoff, ‘Good Faith in Contract Performance: Market Street Associates Ltd Partnership v Frey’ (2007) 120 *Harv Law Rev.* 1187, 1190.

Paul Finn has helpfully distinguished a point along this spectrum of good faith (near the minimum honesty requirement) that imposes a standard of unconscionability.<sup>57</sup> Although this sense of unconscionability does not require proof of dishonesty in the subjective sense of knowingly misleading the other party to the contract, it may be satisfied by opportunistic actions that take unfair advantage of the other party's weaknesses (as in the law of undue influence) or of omissions in the express allocations of risk in the contract (as in terms implied in fact). Unconscionability in this sense consists in taking advantage of an omission to protect against risk in circumstances where this advantage had not been bargained for as part of the consideration.

This narrow meaning of good faith, labelled here as unconscionability, should be contrasted with a broader sense towards the centre of the spectrum of good faith that is concerned with establishing efficient and balanced obligations under contracts. It is here that the standard famously proposed by Lord Steyn of the 'reasonable expectations of honest men' can be invoked to shape a contract.<sup>58</sup> The reasonable expectation standard requires the court to interpret the contract so that it makes commercial sense for both parties, to place duties of care on the parties during the course of negotiations to provide reliable information, and to supplement contracts with standard incidents that are conducive to the efficiency of the contract and serve to maintain a fair balance of interests between the parties. Reasonable expectations are grounded both in the express terms of the contract and the business context in which it is made.<sup>59</sup> Good faith and fair dealing requires both parties to a contract to respect those reasonable expectations of the other (provided, of course, they are not excluded by express terms of the contract). A party may still look primarily to his or her own interests, but in the performance of the contract and in the exercise of rights and powers conferred by the contract, that party must not defeat or undermine the reasonable expectations of the other. It implies a duty on each party to do what, within his reasonable powers, is necessary to permit the other party to enjoy the benefit of the contract.<sup>60</sup>

### ***Terms Implied in Fact***

The tests commonly invoked for terms implied in fact, such as 'business efficacy' or 'business necessity', are unsatisfactory. Both of these tests necessarily assume an understanding of the purpose of the contract, for it is only against this purpose that business efficacy or necessity can be judged. The problem with the idea of the purpose of the contract is that it is a metaphysical construct that seeks to create a unity of purpose in a situation where the parties may well have to a considerable extent conflicting

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<sup>57</sup> P Finn, 'The Fiduciary Principle' in T.G. Youdan (ed), *Equity, Fiduciaries and Trusts* (Carswell 1989) 3. See also, J. Stapleton, 'Good Faith in Private Law' [1999] *CLP* 1, 7.

<sup>58</sup> *First Energy (U.K.) Ltd v. Hungarian International Bank Ltd* [1993] 2 Lloyd's Rep 194 (CA) 196, Steyn LJ: 'A theme that runs through our law of contract is that the reasonable expectations of honest men must be protected. It is not a rule or principle of law. It is the objective which has been and still is the principal moulding force of our law of contract ... if the prima facie solution to a problem runs counter to the reasonable expectations of honest men, this criterion sometimes requires a rigorous examination of the problem to ascertain whether the law does indeed compel demonstrable unfairness.'

<sup>59</sup> Catherine Mitchell, 'Leading a Life of its Own? The Roles of Reasonable Expectation in Contract Law' (2003) 23 *OJLS* 639.

<sup>60</sup> A F Mason, 'Contract, Good Faith and Equitable Standards in Fair Dealing' (2000) 116 *LQR* 66, 74.

purposes. Furthermore, given the broader approach to interpretation used in the courts today, it seems unlikely that such tests could ever justify the addition of a term: once the terms of the contract have been elucidated according to the standard of commercial common sense, what else could be truly necessary? Nor do these tests properly acknowledge the incompleteness of the contract in the sense that one party has failed to protect itself a foreseeable risk. The ‘officious bystander’ test has the virtue that it acknowledges the presence of an omission in the allocation of risk, but its appeal to the tacit agreement of the parties fails to address adequately the crucial question whether it would be unjust to leave the loss to lie where it falls or whether the omission should be rectified. .

In general, without a doubt, the courts should not engage in such a reallocation of risk, but let the loss lie where it falls. But there are a few instances where it is appropriate for a court to intervene. In these cases, one party is seeking to take an advantage that has not been paid for as part of the consideration of the contract. The contract may omit to regulate this particular advantage or it may apparently permit this advantage to be taken by one party owing to the broad terms in which the contract is written. A court should then ask whether permitting this advantage to be taken in accordance with the express terms of the contract would be a breach of standards of good faith and fair dealing in the narrow sense of ‘unconscionability’. If so, an implied term to fill the omission or qualify the power will be appropriate. Let me illustrate this analysis by reference to *Equitable Life Assurance Co. Ltd v Hyman*.<sup>61</sup>

In *Equitable Life Assurance Co. Ltd v Hyman*, the House of Lords was invited to imply a term in fact into a with-profits pension assurance scheme. Under such schemes, the assured invests in a fund through regular savings, which, when the appropriate profits of the investment fund are added as a discretionary final bonus, creates a capital sum that can then be used to purchase an annuity for life at the then prevailing rates of interest. In this case, however, Equitable Life had guaranteed 90,000 of its investors a minimum percentage rate of interest for the annuity without additional charge. When other annuity interest rates fell below this guaranteed amount, the company began to find itself in financial difficulty. To solve the problem, it relied upon its discretionary power to determine the final bonus in order to reduce the amount of the guaranteed investors’ capital fund, thereby reducing the effective annuity to the standard market rate of interest. In other words, under the contractual scheme the company had two levers by which to prevent excessive pay-outs: it could lower interest rates or set the final bonus at a lower level. Having foregone the opportunity to lower interest rates, it used the other lever to reduce its liability. The question before the House of Lords was whether an implied term in the contract would prevent the company from discriminating against the group of customers with the guaranteed minimum rate of interest by awarding them a lower final bonus. The company insisted that the express terms of the contract with the investors awarded it complete discretion with respect to the declaration of a final bonus and that its conduct in effect gave all savers the same rate of return and would save the company from financial difficulty. The House of Lords upheld the existence of the implied term.

Although Professor Neil Andrews describes the implied term as disastrous in view of the subsequent collapse of Equitable Life,<sup>62</sup> this is precisely the sort of case

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<sup>61</sup> [2002] 1 AC 408 (HL).

<sup>62</sup> Neil Andrews, *Contract Law* (Cambridge U P 2011) 367.

where an implied term should be considered. The House of Lords held that the term was necessary for business efficacy, which seems unconvincing: the contract could function perfectly well as a tax efficient investment vehicle and pensions device without the implied term. The problem was rather that, without the implied term, the promised guaranteed minimum rate of return for the annuity was illusory. It was a case of financial misselling and the court could use the implied term to punish Equitable Life for misleading 90,000 investors. Is that a good enough reason to introduce the implied term into the contract? It certainly could be described as an instance of a breach of an implied obligation of good faith and fair dealing (though the House of Lords made no mention of that standard). But in my view, breach of that standard is insufficient in itself. It is also necessary to reach the conclusion, under the standard of unconscionability described above, that the company was taking an advantage under the contract for which it had not bargained. The question is whether, by tempting investors with the promise of a guaranteed minimum rate of return, the company had implicitly accepted a limitation on how it would exercise its normally unfettered discretion in the declaration of final bonuses. Was the company trying to recapture a foregone opportunity?<sup>63</sup> This is the hard issue in the case. On the one hand, the promise of a guaranteed rate of interest suggests that the company had agreed implicitly to exercise its discretion over the final bonus in the normal way, but on the other hand it was also true that the express terms of the contract reserved the normal discretion over the declaration of the bonus and the customers had not paid an additional fee for this advantage in comparison with other investors. On my analysis, the absence of an additional payment probably tips the balance against finding an implied term in favour of the investors, though the House of Lords preferred the competing view that the company was trying to take an advantage under the contract that it had by implication already sacrificed.

In a second ground for the decision in favour of the investors, the House of Lords approved unanimously the application of an implied term that the company's discretion in awarding the final bonus should not be exercised capriciously, arbitrarily, or irrationally. In applying this implied term, Lord Cooke argued that the discretion over the declaration of a final bonus had been used for an improper purpose: to equalise the share of all investors in the capital fund rather than to uphold the guaranteed benefit to some. This implied term, though probably better classified as a term implied in law to govern discretionary powers conferred by contracts,<sup>64</sup> seems to be a good faith standard under a different name. The purpose for which the discretion was exercised is surely only improper if it seeks to recapture an advantage that had been explicitly or implicitly foregone in the original agreement. In contrast, if the company exercised its discretion or rights under the contract to benefit its own financial position within the terms permitted by the contract, or, as a mutual fund to advance its mandate to protect all investors,<sup>65</sup> it would be odd to label this behaviour as irrational.

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<sup>63</sup> For a similar formula, Stephen J Burton, 'Breach of Contract and the Common Law Duty to Perform in Good Faith (1980) 94 *Harv Law Review* 369.

<sup>64</sup> Terms implied by law are usually linked to particular types of contract, but here the practice has emerged of applying this term to any type of contract that confers a discretionary power to increase or reduce the financial payment or costs to the other party: *Mallone v BPB Industries plc* [2002] EWCA Civ 126, [2002] IRLR 452 and references in n 49 above.

<sup>65</sup> I am most grateful to Sir George Leggatt for pointing out this mutuality dimension of the case.

It helps to clarify this meaning of good faith and fair dealing as unconscionability to contrast the litigation in *Equitable Life* with that in *Concord Trust v Law Debenture Trust Corp.*<sup>66</sup> The issuer of bonds was concerned that the Trustee for the bondholders was about to give notice of an ‘event of default’, when in the view of the issuer no such event had occurred. The consequence of the Trustee giving notice would have been to accelerate all the payment obligations, force further defaults, and probably to cause considerable economic loss to the issuer. Although the trust deed required the Trustee to give the notice of default if instructed to do so by the bondholders, the Trustee was reluctant to do so without an indemnity from the bondholders against the potential liability for substantial consequential loss to the issuer. The question before the House of Lords was: if the Trustee issued a notice of default that turned out to be invalid in the circumstances, would it be liable to the issuer for damages? The Judicial Committee rejected any grounds of liability including a suggested implied term that the Trustee would not give an invalid notice of default. The implied term was dismissed peremptorily on the ground that it did not satisfy the *Moorcock* test of business efficacy. The implied term was treated as one of fact, though it was appreciated that its existence would be of considerable significance for all Eurobonds and syndicated loan agreements. Accordingly, the issuer would have to take its chances that the Trustee would not make mistakes. The result was surely correct, but the answer should have been more circumspect and nuanced. The question that would be posed under my proposed good faith standard of unconscionability would be whether the contract should limit the power of the Trustee to give notice of default on the ground that the trustee might take an unbargained-for advantage in giving notice. It seems unlikely that any trustee would act in such a way, but it seems to me that it would be appropriate to add a safeguard against any trustee acting dishonestly, for an improper purpose, or arbitrarily, capriciously, carelessly, or in a way that no reasonable trustee would act. Such an implied term would not have helped the borrower in this case as the trustee had acted with utmost circumspection, but it would have established potential grounds for liability towards issuers in the future instead of the crude rejection of any risk of liability for the Trustee.

Terms implied in fact are likely to be rare. They are designed to address a particular type of incompleteness in contracts, where one party has omitted to protect itself against a risk. The implied term should not be inserted on the ground that it is said to be necessary, because a contract, when properly interpreted, should normally function adequately without it. The implied term is needed rather to address a different problem: one party is relying on the express terms and the other’s omission to qualify them with respect to a particular risk to take an advantage that has not been bargained for or paid for, thereby taking unfair advantage of the other’s error. In general, English law will not rescue parties to contracts from mistaken omissions, but where the standard of unconscionability has been breached, this deliberate opportunism can be parried by the sword of an implied term.

### ***Terms Implied by Law***

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<sup>66</sup> [2005] UKHL 27, [2005] 1 WLR 1591.

For the standard incidents of contracts that apply as default rules, the terms implied by law, a court is prescribing the ground rules for typical transactions. In doing so, a court should normally conform to previous decisions in analogous contracts. In the absence of such governing precedents, many judges have recognised that this legislative activity requires consideration of a broad range of factors. For example, Dyson LJ said with respect to standardised terms:

‘It seems to me that, rather than focus on the elusive concept of necessity, it is better to recognise that, to some extent at least, the existence and scope of standardised implied terms raise questions of reasonableness, fairness and the balancing of competing policy considerations.’<sup>67</sup>

Elizabeth Peden has helpfully trawled through the cases to identify the kinds of policy considerations that have been mentioned by the courts.<sup>68</sup> In my view, however, an open-ended examination of policy considerations is neither appropriate nor necessary for the formulation of terms implied in law. In my view, the task can be narrowed satisfactorily to a two-stage enquiry.

A court should first of all try to discover a default rule that achieves an efficient allocation of risks as between the parties. One reason for emphasising efficiency is that such a default rule is likely to prove to be the rule that the parties would have agreed if they had negotiated the issue.

‘If the condition is such that every reasonable man on the one part would desire for his own protection to stipulate for the condition, and that no reasonable man on the other part would refuse to accede to it, then it is not unnatural that the condition should be taken for granted in all contracts of the class without the necessity of giving it formal expression.’<sup>69</sup>

As a consequence, the rule should reduce transaction costs. But even if it seems improbable that the parties would have actually agreed the term, the efficient rule should be selected as the default rule so that parties who wish to insist upon inefficient and unreasonable arrangements should be forced to do so explicitly. The House of Lords in *Liverpool City Council v Irwin*<sup>70</sup> rightly chose the efficient rule that imposed a duty on the Council to maintain the common parts of the tower block, notwithstanding the strong suspicion that the Council had deliberately intended to avoid any responsibility for the appalling conditions of the common parts of the tower block. But efficiency should not be the only criterion.

Despite its commercial good sense in general, an efficiency criterion may be indeterminate and it may unbalance the obligations in the transaction or create risks of opportunism. An efficient rule may have to be balanced or modified by a further implied term that restricts its application or controls the discretion that it confers for the purpose of creating a fair balance of obligations. The second stage of the enquiry should return to

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<sup>67</sup> *Crossley v Faithful & Gould Holdings Ltd* [2004] EWCA Civ 293, [2004] 4 All ER 447 (CA) [36]; quoted with approval by Baroness Hale JSC in *Geys v Société Générale, London Branch* [2012] UKSC 63, [2013] ICR 117 [56].

<sup>68</sup> E Peden, ‘Policy Concerns Behind Implications in Law’ (2001) LQR 459; cf C Riley, ‘Designing Default Rules in Contract Law: Consent, Conventionalism and Efficiency’ (2000) 20 OJLS 367.

<sup>69</sup> A Scottish test derived from *William Morton & Co v Muir Brothers & Co*, 1907 SC 1211, 1224 Lord McLaren, but applied in the context of the Sale of Goods Act 1979, in *J & H Ritchie v Lloyd* [2007] UKHL 9, [2007] 1 WLR 670 (HL).

<sup>70</sup> [1977] AC 239 (HL).

another version of the standard of good faith and fair dealing. The rule should conform to the reasonable expectations of the parties in entering the contract by avoiding the potential risk of granting one or the other an unexpected advantage. These reasonable expectations are likely to be informed by normal commercial practices, customs, usages, and an understanding of an appropriate commercial balance of obligations.

Consider, for instance, the implied term of mutual trust and confidence that was declared by the House of Lords to be a term implied in law in contracts of employment.<sup>71</sup> The courts had already held that the contract of employment contains implied terms requiring employees to comply with lawful instructions of employers and to serve the employer faithfully within the requirements of the contract.<sup>72</sup> These implied terms serve to uphold the efficient operation of contracts of employment, which are necessarily incomplete in their design of the performance obligations.<sup>73</sup> To prevent misuse of these contractual powers to manage the workforce, the courts developed the implied term that an employer should not ‘without reasonable and proper cause, conduct itself in a manner calculated and likely to destroy or seriously damage the relationship of confidence and trust between employer and employee.’ Lord Nicholls has described the implied term in the language of good faith: ‘In his conduct of his business, and in his treatment of employees, an employer must act responsibly and in good faith’.<sup>74</sup> It is possible to justify this implied term on the ground of efficiency: conduct of the kind prohibited by the implied term is likely to diminish the motivation, commitment, and performance of employees and lead them to quit the job, causing the employer considerable costs arising from labour turnover.<sup>75</sup> Modern human resources management rejects the autocratic regimes practiced under ‘scientific management’;<sup>76</sup> it seeks instead through fair management to build ‘organisational citizenship behaviour’, performance ‘beyond contract’, and commitment to the goals of the business, in order to maximise productivity through co-operation or ‘partnership’.<sup>77</sup> In addition, however, as Lord Steyn pointed out, the implied term could be justified as matching the expectations of the parties under modern employer-employee relationships, in which employers are expected to assume obligations to care for the physical, financial and psychological welfare of employees.<sup>78</sup> Lord Steyn further presented the implied term as a tool for striking the balance between an ‘employer’s interest in managing his business as he sees fit and the employee’s interest in not being unfairly and improperly exploited’.<sup>79</sup> The implied term of mutual trust and confidence was therefore justified both by reference to an efficiency criterion

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<sup>71</sup> *Malik v Bank of Credit and Commerce International S.A.* [1997] UKHL 23, [1997] ICR 606, [1998] AC 20 (HL).

<sup>72</sup> *Secretary of State for Employment v ASLEF (No 2)* [1972] ICR 19 (CA).

<sup>73</sup> Incompleteness by design is explained in Hugh Collins, *Regulating Contracts* (OUP 1999) 167-172.

<sup>74</sup> *Eastwood v Magnox Electric plc* [2004] UKHL 35, [2004] ICR 1064 (HL).

<sup>75</sup> H Collins, K D Ewing, A McColgan, *Labour Law* (CUP 2011) 123.

<sup>76</sup> F W Taylor, *Scientific Management* (Harper and Row 1947).

<sup>77</sup> D Guest and R Peccei, ‘Partnership at Work: Mutuality and the Balance of Advantage’ (2001) 39 *British Journal of Industrial Relations* 207; D Katz, ‘The Motivational Basis of Organisational Behaviour’ (1964) 9 *Behavioural Science* 131; C A Smith, D W Organ and J P Near, ‘Organisational Citizenship Behaviour: Its Nature and Antecedents’ (1983) 68 *Journal of Applied Psychology* 653.

<sup>78</sup> [1997] ICR 606, 621F, citing Lord Slynn, *Spring v Guardian Assurance Plc* [1994] ICR 596, (HL) 628E.

<sup>79</sup> [1997] ICR 606, at p. 622A.; cf D Brodie, ‘Mutual Trust and the Values of the Employment Contract’ (2001) 30 *ILJ* 84; D Brodie, ‘Beyond Exchange: The New Contract of Employment’ (1998) 27 *ILJ* 79.

and a fair balance of obligations that conform to the reasonable expectations of the parties.

The importance of standard incidents in setting a fair balance of obligations emerges even more clearly in the application of judicial controls over unfair terms in contracts. In most civil law systems, where an exclusion clause removes or detracts from a standard incident that is applied by the civil code to a particular contract type, a court will treat the term as presumptively unfair and unenforceable. Further examination of the contract may reveal some compensating benefit in return for the exclusion, in which case the term will be enforceable.<sup>80</sup> Although English law has not explicitly embraced this conception of unfair terms in contracts, it is implicit, for instance, in the reluctance to permit exclusion of negligence liability that normally arises from a default rule,<sup>81</sup> and it is a helpful tool in tackling the meaning of the ideas of 'good faith' and 'substantial imbalance' in the Unfair Terms in Consumer Contracts Regulations 1999.<sup>82</sup>

English lawyers may be alarmed by this invocation of the notion of fairness in the criteria for adopting implied terms in law. This fear is misplaced. Courts are not being authorised to act as shining white knights to relieve parties from bad bargains. For terms implied in law, they are being asked to create standard incidents for particular types of contracts that should normally ensure a fair balance of burdens and advantages between the parties. Moreover, the parties are always free to vary the incidents of their particular contract. In the case of the common law's implied term of merchantable quality for sales of goods, for instance, the argument employed originally in favour of this default rule was to achieve a fair balance of advantages, for if someone paid the market price for a commodity he would have a reasonable expectation of receiving goods in a sound condition. If he did not receive such goods, without any excepting conditions, the contract was 'simply an unfair exchange'.<sup>83</sup> The test for terms implied by law is not appropriately described as one of necessity, for the task of fashioning default rules is not confined to radical omissions that remove business efficacy from the contract. The standard incidents should be fashioned rather to secure a fair balance of obligations, which may be achieved by asking both what would be an efficient allocation of risk for this type of contract and what would conform to the reasonable expectations of honest men and women.

## 6. Relational Contracts and Networks

Despite the frequent references to good faith, the above interpretation of the English law of implied terms in contracts provides scant support for the striking suggestion of Leggatt J, in *Yam Seng v International Trade Corporation*, that there is an independent and general implied term of good faith and fair dealing in the performance of contracts. But

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<sup>80</sup> Eg Case C-237/02 *Freiburger Kommunalbauten GmbH Baugesellschaft & Co KG v Hofstetter* [2004] ECR I-3403.

<sup>81</sup> *HIH Casualty and General Insurance Ltd v Chase Manhattan Bank* [2003] 2 Lloyd's Rep 61, (HL); *Canadian Steamship Lines Ltd v R* [1952] AC 192 (PC).

<sup>82</sup> Unfair Terms in Consumer Contracts Regulations 1999, Reg. 5(1).

<sup>83</sup> P S Atiyah, *above n 28*, discussing *Jones v Bright* (1829) 5 Bing 533, 130 E.R. 1167.

what light does this interpretation throw on his more guarded proposal to find enhanced obligations of good faith in 'relational contracts'?<sup>84</sup>

I agree with Leggatt J's general observation that the English common law approaches duties of good faith, loyalty, and co-operation arising in contractual arrangements according to an unsatisfactory binary divide. On the one side there are fiduciary duties or their equivalent that require utmost good faith, the avoidance of even the appearance of a conflict of interest, and the placing of the other party's interests ahead of one's own. On the other side of the divide, short of fraud or other illegitimate practices, every party to a contract is entitled to look solely to their own interests subject to the constraint of actual subjective dishonesty and general obligations arising under the law of tort. Given the complexity of commercial relationships, however, this binary divide is inevitably too crude to capture full range of the reasonable expectations of honest participants in contractual arrangements. The problem for the common law is to construct a richer apparatus of classification, so that limited duties of good faith, loyalty, and co-operation can be applied in one or more intermediate categories. Earlier I suggested that we are looking at a spectrum of good faith obligations, not a single intermediate category, but the question remains how to identify a class of contracts that require more intense obligations of co-operation and loyalty, which nevertheless fall short of fiduciary obligations. What is the crucial variable that alters as contracts move across the spectrum from norms of self-interested antagonistic interests to obligations of good faith, disclosure, and co-operation?

Following an original suggestion by Ian Macneil,<sup>85</sup> law and economics scholarship appropriated the idea of relational contracts to explore problems arising in long-term contracts.<sup>86</sup> Certainly, many long-term contracts seem to require supplementary duties for their business efficacy. Given the impossibility of knowing

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<sup>84</sup> 'In some contractual contexts the relevant background expectations may extend further to an expectation that the parties will share information relevant to the performance of the contract such that a deliberate omission to disclose such information may amount to bad faith. English law has traditionally drawn a sharp distinction between certain relationships - such as partnership, trusteeship and other fiduciary relationships - on the one hand, in which the parties owe onerous obligations of disclosure to each other, and other contractual relationships in which no duty of disclosure is supposed to operate. Arguably at least, that dichotomy is too simplistic. While it seems unlikely that any duty to disclose information in performance of the contract would be implied where the contract involves a simple exchange, many contracts do not fit this model and involve a longer term relationship between the parties which they make a substantial commitment. Such "relational" contracts, as they are sometimes called, may require a high degree of communication, cooperation 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.' *Yam Seng Pte Ltd v International Trade Corporation Ltd* [2013] EWHC 111. [142].

<sup>85</sup> I Macneil, 'Contracts: Adjustments of Long-term Economic Relations under Classical, Neoclassical and Relational Contract Law' (1978) 72 NW ULR 854. D Campbell, 'Ian Macneil and the Relational Theory of Contract' in D Campbell (ed), *The Relational Theory of Contract: Selected Works of Ian Macneil* (Sweet & Maxwell, 2001) 3. Ian Macneil really proposed the idea of relational contract to argue in favour of a more contextual approach to contract law that is opposed to the formalism of classical or nineteenth century contract law.

<sup>86</sup> V Goldberg, 'Relational Exchange: economics and complex contracts' (1980) 23 *American Behavioural Scientist* 337; C J Goetz and R E Scott, 'Principles of Relational Contracts' (1981) 69 *Virginia Law Review* 1089.

what the future holds, such long-term contracts are likely to be incomplete in their allocation of risks. Although parties to long-term contracts foresee that they may well need to adapt their arrangements to respond to future contingencies, their forward planning achieved by the use of vague terms or agreed governance procedures for making such adjustments may prove inadequate to prevent opportunism. Flexible terms that permit adjustments such as price variations may prove too coarse to respond appropriately to unexpected events, giving one party an unbargained-for advantage. Similarly, granting one party a discretionary power to vary the terms of the contract unilaterally will perhaps keep it afloat even in choppy seas, but at the price of the serious risk of opportunism and exploitation. These risks of opportunism may be intensified in long-term contracts owing to the heavy investment of one or both parties in the commercial project.<sup>87</sup> Given these features of long-term contracts, it seems inevitable that they will occasionally require judicial surgery through construction and the implication of terms in fact.

Whilst those points are surely correct, they do not lend support to the further claim that there should be enhanced duties of good faith, loyalty and co-operation in *all* long-term contracts as a standard incident implied by law. The context of the transaction may reveal that the long-term contract was intended to be rigid and binding, no matter what the change of circumstances, as a hedge against risk, so that in the absence of express allocations of risk, a fair interpretation of the contract would be to let the risks lie where they fall. In syndicated loan agreements, for instance, though they may be expected to last for many years, no-one involved is expecting to adjust their terms or to help the other party out of financial difficulty; rigidity of obligations is their commercial attraction. Enhanced duties of loyalty and co-operation may be required more frequently in long-term contracts than spot contracts, but the expected duration of the contract is not a reliable or helpful guide to a need for the law, adopting a contextual approach, to specify such enhanced obligations.<sup>88</sup>

In my view, it is not the duration of contracts that provides the key variable in the spectrum of good faith obligations, but rather the incentive structure of the contract, which itself is determined by how the contract fits into relations of production. In economic theory, a crude but insightful distinction is drawn between markets and organisations (or firms).<sup>89</sup> In markets, contracts for goods and services are made between parties with antagonistic interests in the transaction. There is predominantly a zero sum game in which the purchaser and seller seek to maximise their advantage at the cost of the other party to the transaction. Within organisations, however, though there is a network of contracts that bind the parties together, such as contracts of employment, share ownership, and directorships, the zero-sum game is replaced by a mechanism that requires co-operation from everyone to maximise the profits of the organisation itself, the profits then being distributed according to the formula set by the contracts. The law reflects the economic logic of the organisation by imposing duties of loyalty on all the

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<sup>87</sup> D Campbell and D Harris, 'Flexibility in Long-term Contractual Relationships' (1993) 20 *Journal of Law and Society* 166.

<sup>88</sup> H Collins, 'Competing Norms of Contractual Behaviour' in D Campbell and P Vincent-Jones (eds), *Contract and Economic Organisation* (Dartmouth 1996) 67.

<sup>89</sup> R H Coase, 'The Nature of the Firm' (1937) 4 *Economica N.S.* 386; O E Williamson, *The Economic Institutions of Capitalism: Firms, Markets and Relational Contracting* (Free Press, 1985).

members of the organisation: the directors of a company owe fiduciary duties, employees and managers duties of loyalty and good faith. The crucial variable that determines the incidence of obligations of loyalty and co-operation is the point at which the contract falls on the spectrum between market and organisation. International commodity sales are right at the market end of the spectrum; partnerships lie at the other organisational end.

Contracts that lie well towards the organisational end of the spectrum may be described as contracts that constitute an arrangement for quasi-integration of production, hybrids, or, more snappily, networks.<sup>90</sup> By quasi-integration is meant the idea that though no single legal entity binds the parties together but rather the arrangement is formed by two or more separate organisations that retain their antagonistic interests, the agreement seeks to achieve many features of organisations for the purpose of establishing efficient relations of production. In business format franchise agreements, for instance, the franchisor and franchisee remain separate business entities, but they co-operate for the purpose of marketing a product or service. Both parties have an interest in maximising retail sales, for which purpose they will need to co-operate intensively, yet both parties have an interest in maximising their own returns on their investment by securing a greater share of the profits in the franchise agreement. As an illustration, consider the problem that arose in *Shell UK Ltd v Lostock Garage Ltd*.<sup>91</sup> Shell, the franchisor of tied petrol stations, discriminated between neighbouring franchisees in the level of rebates, with the effect that the claimant had to run the business at a loss for a period of months. Although the contract was silent on the topic of rebates, thereby apparently leaving Shell complete discretion, its conduct was calculated to destroy the claimant's franchise contract and undermine the whole business operation by favouring some franchisees. Shell also granted substantial rebates to its own in-house petrol stations, thereby competing with its own small franchisees in a manner calculated to drive them out of business. The underlying economic logic in these quasi-integration arrangements is driven both by the market and the organisation: parties must both compete and co-operate.<sup>92</sup> Shell in this instance acted solely within a market frame of reference: it only granted the concessionary rebates to franchisees with sufficient bargaining power to demand them. Though in a minority in the Court of Appeal, Bridge LJ was surely correct to find an implied term that placed constraints on the franchisor's power to discriminate between franchisees,<sup>93</sup> which in effect imposed a duty of loyalty towards the franchise network.<sup>94</sup>

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<sup>90</sup> W W Powell, 'Neither Market nor Hierarchy: Network Forms of Organisation' (1990) 12 *Research in Organisational Behaviour* 295; G Thompson, J Frances, R Levacic, J Mitchell, *Markets, Hierarchies & Networks: The Coordination of Social Life* (Sage 1991); A Grandori and G Soda, 'Inter-firm Networks: Antecedents, Mechanisms and Forms' (1995) 16(2) *Organization Studies* 183; R M Buxbaum, 'Is "Network" a Legal Concept?' (1993) 149 *Journal of Institutional and Theoretical Economics* 698.

<sup>91</sup> [1976] 1 WLR 1187 (CA).

<sup>92</sup> H Collins, 'Introduction', G Teubner, *Networks as Connected Contracts* (H Collins ed, Hart Publishing, 2011) 21-25; G Teubner, 'Coincidentia Oppositorum: Hybrid Networks Beyond Contract and Organisation' in M Amstutz and G Teubner (eds), *Networks: Legal Issues of Multilateral Co-operation* (Hart Publishing 2009) 3; E Schanze, 'Symbiotic Contracts: Exploring Long-Term Agency Structures Between Contract and Corporation', in C Joerges (ed), *Franchising and the Law: Theoretical and Comparative Approaches in Europe and the United States* (Nomos 1991) 67.

<sup>93</sup> [1976] 1 WLR 1187 (CA) 1206.

<sup>94</sup> On the obligation of loyalty in networks, see: *Seven Eleven Corporation of SA (PTY)Ltd v Cancun Trading No 150 CC*, Case No 108/2004, 24 March 2005, *Dymocks Franchise Systems (NSW)*

In *Yam Seng v International Trade Corporation*, Leggatt J correctly identified franchises, joint ventures, and distributorships as examples of contracts where greater duties of co-operation and good faith arise. Commercial agents should be added to the list.<sup>95</sup> The reason why these contracts require as normal incidents greater duties of loyalty and co-operation is not because they are long-term and not because the parties may have invested substantially in the project, though both of these features are likely to be present, but because the contract establishes a quasi-integrated system of relations of production with intensified contradictory pressures simultaneously both to co-operate and to compete. The economic logic of networks is that both parties will be better off if they co-operate to maximise the size of the pie, such as sales in a franchise or distribution network, but simultaneously they need to compete to obtain a greater slice of the profits arising from their labours. Each party needs to be co-operative and loyal to the general aim of the networked business enterprise, whilst ensuring that it obtains the maximum share of the rewards. These obligations of loyalty and co-operation within networks must fall short of those applicable to organisations, however, for both parties remain residual profit-takers with antagonistic interests. Loyalty is owed, not to each other, but rather to the network as an independent business operation.<sup>96</sup>

These implicit obligations may be divided into three aspects. First, there is the duty to assist the other in its performance of the contract for the sake of maximising the benefits to both parties that will accrue from a successful business network. Under this heading, the sharing of information is often crucial, but disclosure is confined to information which is necessary for the profitability of the network, but does not extend to information that might damage a party's interest in a greater residual share of the profit. Second, there is a duty to avoid harming the interests of the other party unless there is a compensating interest in profit or benefit to oneself. The third element of the intensified duties of loyalty is to defend the quasi-integrated system of production and the joint interests of the parties against adverse interference by third parties.

In the *Yam Seng* case, the defendant had committed a breach of all three aspects of the duties of loyalty and co-operation. The contract was for the distribution of the defendant's bottles of fragrances and other toiletries through duty free shops and elsewhere in the Far East. The brand of the fragrances was Manchester United and the packaging used the insignia of the soccer team. Given the worldwide popularity of the brand name, presumably it was expected that consumers would purchase the products as a way of identifying with their heroes. The contract was brief and relatively informal. As well as complaining about misrepresentations made prior to entry into the contract, the claimant argued that there had been a breach of contract by the defendant when it permitted sales of the product in high streets in the Far East at prices below those specified for sales in the duty free airport outlets where the claimant was marketing the products. The court found that although the defendant had not deliberately permitted this

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*Pty Ltd v Todd* [2002] UKPC 50 (7 October 2002), discussed in Collins, above n 92, 45-51; Cf R Bohner, 'Asset-sharing in Franchise Networks: The Obligation to Pass On Network Benefits' in MAMstutz and G Teubner (eds), *Networks: Legal Issues of Multilateral Co-operation* (Oxford, Hart Publishing, 2009) 153.

<sup>95</sup> Legislation provides the core implied term in this case, though framed as a remedy on termination: European Directive 86/653 of 18 December 1986 on the coordination of the laws of the Member States relating to self-employed commercial agents.; Commercial Agents (Council Directive) Regulations 1993; Cf *Wood v Lucy, Lady Duff-Gordon*, 118 N.E. 214 (N.Y. 1917).

<sup>96</sup> G Teubner, *Networks as Connected Contracts*, (H. Collins ed, Hart Publishing 2011), Chapter 4, III.

under-cutting of prices in the duty free shops, it had failed to cooperate either by stopping the undercutting or by alerting the claimant to his inability to prevent it. Leggatt J decided in favour of the claimant on this point on the narrow ground of actual dishonesty rather than a broader duty of co-operation,<sup>97</sup> therefore not relying at all on his ambitious claims about good faith and relational contracts. This was regrettable: on my analysis, the conduct involved a failure to disclose information that was vital to the success of the business operation, harming the interests of the claimant without any compensating advantage to the defendant since he did not benefit from the higher retail sales price in the high street, and defendant's conduct failed to defend this distributorship against its competitors. In short, there had been a clear breach of a term that should have been implied by law requiring loyalty and co-operation within this quasi-integrated system of production.

This analysis confirms the main proposition in the *Yam Seng* case that there is a class of contracts where intensified duties of loyalty and co-operation arise. These contracts demand obligations of good faith in performance, expressed through default rules, which lie closer to the end of the spectrum of good faith near fiduciary duties. Unlike fiduciary duties, they do not require sacrifices to the interests of the other party to the contract, but they do require loyalty to the aims of the joint project. The rationale for imposing such intensified duties of loyalty in such cases is that the contractual arrangements constitute an organisational framework for production that should function in a similar (though not identical) way to a single firm by binding each member to duties of performance in good faith.

## 7. Good Faith in Performance of Contracts

American and Australian readers of this investigation of implied terms in English contract law will be struck by the similarity between my interpretation of the use of implied terms in England and the meaning placed in those other common law jurisdictions on the notion of the duty to perform the contract in good faith. What is done under the rubric of good faith in performance in the United States,<sup>98</sup> or an implied term of good faith in performance in Australia,<sup>99</sup> can be matched in England by the device of implied terms without explicitly mentioning the concept of good faith itself.

My analysis of implied terms suggests that English law has, to its advantage, developed a nuanced conception of good faith in performance by using its chosen

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<sup>97</sup> [171].

<sup>98</sup> Restatement (Second) of Contracts s. 205; Uniform Commercial Code section 1-203; R. S. Summers, '“Good Faith” in General Contract Law and the Sales Provisions of the Uniform Commercial Code' (1968) 54 *Virginia L. Rev.* 195; Stephen J Burton, 'Breach of Contract and the Common Law Duty to Perform in Good Faith' (1980) 94 *Harvard Law Review* 369; in the US, it is said that the duty to perform in good faith cannot be waived, but it is often described as an implied covenant and is rarely used to override detailed express terms: E.A. Farnsworth, 'Good Faith in Contract Performance', in J. Beatson and D. Friedmann, *Good Faith in Contract Law* (Oxford: Clarendon Press, 1995) 153, 166-169.

<sup>99</sup> J. Paterson, A. Robertson, A. Duke, *Principles of Contract Law* 4<sup>th</sup> edn (Sydney: Lawbook Co., 2012) 341-351. In most Australian cases good faith is described as an implied term, though often one implied in law e.g. *Hughes Aircraft Systems International v. Airservices Australia*, (1997) 146 A.L.R. 1; *Burger King Corporation v Hungry Jack's Pty Ltd* [2001] NSWCA 187, (2001) 69 NSWLR 558, 569.

mechanism of implied terms. Some of the heavy lifting can be done by interpretation of the contract in context, bearing in mind ‘commercial common sense’. In addition, with great reluctance, English law is prepared to intervene to rewrite allocations of risk, but only where an omission to transfer a risk has been taken advantage of in an unconscionable manner. Otherwise, a claimant will have to persuade a court that the omission to transfer a risk is covered by a standard incident for that type of contract, which corresponds to the reasonable expectations of honest participants in the market. Although these two types of arguments for implied terms are logically distinct and employ different conceptions of good faith and fair dealing, we have noted how the techniques are often elided or used inappropriately for instrumental reasons.

If all implied terms, except those that merely contribute to the interpretation of the original contract, are founded on a principle of good faith and fair dealing, there is no reason for English law to follow Leggatt J, PECL, and Australia in creating a separate and independent implied term of good faith and fair dealing. Nevertheless, it would be useful to recognise a class of contracts where there exists a type of ‘good faith regime’.<sup>100</sup> Within the spectrum of transactions ranging from market to organisation, implied duties of loyalty and co-operation should intensify as a contractual arrangement approaches the organisational end of the spectrum in a quasi-integrated system of production or network.

In my view, therefore, the polarised positions developed in the English scholarly literature for and against a duty to perform a contract in good faith are beside the point. As so often was the case, Lord Bingham hit the nail on the head when he observed that ‘In many civil law systems...the law of obligations recognises an overriding principle that in making and carrying out contracts parties should act in good faith ...English law has, characteristically, committed itself to no such overriding principle but has developed piecemeal solutions in response to demonstrated problems of unfairness.’<sup>101</sup> In short, the bull has been loose in the china shop for more than a century under the disguise of the ‘piecemeal solution’ of implied terms.

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<sup>100</sup> R. Brownsword, ‘“Good Faith in Contracts” Revisited’ (1996) 49 *Current Legal Problems* 111.

<sup>101</sup> *Interfoto Picture Library Ltd v Stiletto Visual Programmes Ltd* [1989] QB 433, 439 (CA).