

HIGH COURT IMPLIES A DUTY OF GOOD FAITH INTO ENGLISH LAW DISTRIBUTION AGREEMENT

Earlier this year, the High Court ruled that a duty of good faith may be implicit in long-term relational contracts, such as joint venture agreements, franchise agreements and long-term distribution agreements. The ruling creates risks as well as opportunities for parties to such contracts. Parties contemplating entering into such contracts should consider appropriate provisions to manage the risks. For example, the laws of certain other jurisdictions are very different to English law in this regard, as illustrated by a recent decision of the Delaware Supreme Court. So, the choice of law could be very important.

YAM SENG v INTERNATIONAL TRADE CORPORATION

Yam Seng Pte Limited v International Trade Corporation Limited [2013] EWHC 111 (QB) concerned an agreement for the international distribution of Manchester United-branded toiletries. The contract term was 2¹/₂ years. During the first year of the relationship, the supplier, ITC:

- failed to ship orders promptly;
- failed to make products available when promised or, in the case of certain products, at all;
- provided false information which Yam Seng relied on to market the products; and
- allowed Yam Seng's pre-agreed duty-free prices to be undercut in domestic outlets.

Yam Seng terminated the contract after one year and brought an action for damages. As part of that action, Yam Seng alleged that there was an implied term of the agreement that the parties would deal with each other in good faith.

Leggatt J discussed the traditional English law hostility towards a doctrine of good faith – a stance which he noted is out of time with a number of other jurisdictions – and concluded that English law has not yet reached the stage where it is ready to recognise a requirement of good faith as a duty implied by law in all contracts. However, following the established methodology of English law for implying terms in fact, he saw no difficulty in implying such a duty based on the presumed intention of the parties.

Leggatt J ruled that the distribution agreement implicitly required a high degree of communication, cooperation and predictable performance based on mutual trust, confidence and expectations of loyalty and that an obligation of good faith was, therefore, implicit. He ruled that ITC had breached that obligation when it knowingly allowed Yam Seng to labour under a false impression which ITC had created but not subsequently corrected. The breach was sufficient to allow Yam Seng to terminate the contract.

The decision in *Yam Seng* has been referred to by the Court of Appeal, without disapproval, although the reasoning has not yet been affirmed in any subsequent cases. At this stage, it is therefore unclear to what extent the *Yam Seng* decision will form the basis for the recognition of a general duty of good faith applicable to long-term relational contracts governed by English law.

WHAT TERMS MIGHT BE IMPLIED?

In *Yam Seng*, the judge emphasised that implied terms are necessarily dependent on the background against which the relevant contract is concluded. The conduct required to discharge implied obligations will be equally fact-specific. However, the judge highlighted three obligations which he believed were commonly implicit in longer-term relational contracts:

- Honesty
- Fidelity to the spirit of the agreement
- Observance of standards of commercial fair dealing

Because implied terms are so sensitive to the factual background and the relationship between the parties, commercial parties cannot be certain whether, when and to what extent the courts might imply good faith obligations into a contract in the event of a dispute. Equally, there will be uncertainty in the performance of the contract around whether a party's conduct would breach any good faith obligations were they to be implied.

For example, in one recent High Court case (*Hamsard 3147 Ltd and another v Boots UK Ltd [2013] EWHC 3251*), Norris J referred to the decision in *Yam Seng* but distinguished it on the facts, stating that *Yam Seng* is not authority for the proposition that a general obligation of good faith should be implied into *all* commercial contracts. The agreement in question was an implied transitional contract which came into existence on the termination of a long-term joint venture when one of the JV parties went into administration. The judge stated that a good faith obligation should not be implied into the transitional agreement notwithstanding an express term to that effect in the JV agreement.

The judge also commented that, while there *will* generally be an implied term in commercial contracts not to do anything to frustrate the purpose of the agreement, this does not mean that a contracting party should subordinate its own commercial interests to those of the other party and, also, that, if a good faith term *were* to be implied in the *Hamsard* case, it would only have imposed on the parties a duty to deal with each other on an open and collaborative basis.

CONSEQUENCES FOR COMMERCIAL PARTIES

These uncertainties create risks and opportunities for commercial parties. The risks include a lack of certainty as to what parties' obligations are and the risk that, by restricting the parties from rigorously pursuing their respective commercial interests, a contract may potentially be more onerous than the parties intended or understood it to be.

The opportunities afforded by this development include the possibility of deploying the specter of implied good faith obligations as leverage to terminate a contract and/or sue or countersue the other party.

CAN THE IMPLIED TERMS BE EXCLUDED OR MODIFIED?

To the extent any terms of good faith *are* implied into a contract by the court, this will only be done to give effect to the presumed intention of the parties. Therefore, the parties are free to modify or exclude any such implied terms expressly in the agreement.

For example, in one recent case (*TSG Building Services plc v South Anglia Housing Ltd* [2013] EWHC 1151 (TCC)), the High Court ruled that there was no implied term of good faith because the contract stated expressly that the parties would act reasonably and work together in a “spirit of trust, fairness and mutual co-operation”. The judge held that the contract expressly and exhaustively defined the scope of the parties’ reciprocal obligations to co-operate and, therefore, no further obligations could be implied.

OPTIONS FOR COMMERCIAL PARTIES

One option for commercial parties looking to regulate the uncertainty of implied good faith obligations and manage the risks discussed above might, therefore, be to introduce express terms to define precisely the extent of the parties’ obligations to one another (e.g., the extent – or absence – of any ongoing disclosure obligations). Obviously, any such language would cut both ways.

PRE-CONTRACTUAL DUTIES OF GOOD FAITH

The *Yam Seng* decision did not consider the application of pre-contractual duties of good faith and it remains the case that there is no duty in English law to negotiate in good faith.

An express obligation to negotiate in good faith will usually¹ be unenforceable as a matter of English law. However, such an obligation may be enforceable in certain other jurisdictions. For example, the Delaware Supreme Court has recently decided² that, as a matter of Delaware law:

- agreements to negotiate in good faith, even in preliminary agreements (such as term sheets, letters of intent, memoranda of understanding and heads of agreement) are enforceable;
- proposing deal terms that deviate materially from terms set out in a term sheet may be deemed to evidence bad faith in negotiations; and

¹ Note: an express obligation to negotiate in good faith matters which are capable of objective assessment by a third party *may* be enforceable if contained in a legally binding agreement.

² *SIGA Technologies, Inc. vs. PharmAthene, Inc.* No. 314, 2012, 67 A.3d 330 (Del. 2013).

- if an obligation to negotiate in good faith is breached and the aggrieved party is able to establish that a final, binding agreement would have been reached absent the other party's bad faith negotiations, the aggrieved party is entitled to "expectation" damages (e.g., loss of profits) rather than simply "reliance" damages (e.g., costs and expenses of the failed negotiation).

This recent decision reinforces the importance of choosing the appropriate law to govern an agreement. For example, a party that wants to ensure that the other side cannot easily deviate from the term sheet could include an express obligation to negotiate in good faith and choose Delaware law to govern the term sheet. On the other hand, parties who want to reduce the risk that their freedom to negotiate will be inhibited by the term sheet may prefer English law.

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