

# An Implied Duty of Good Faith in English Law Franchise Agreements - is the Genie Out of the Bottle?

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## Introduction

The English law of contract is well known for not having a general duty of good faith and the approach to dealing with good faith situations in case law has been piecemeal, in line with the general development of common law. One of the main reasons advanced for this is the uncertainty which would arise if a general duty of good faith was imported into contracts generally.

However, recent case law has reignited the debate over whether or not English law recognises a general duty of good faith in commercial contracts.

In a recent High Court case between Yam Seng Pte Limited ("Yam Seng") and International Trade Corporation ("ITC"), the judge, Mr Justice Leggatt, held that a distribution agreement governed by English law contained an enforceable, implied obligation on the parties to act in "good faith".

Subsequent to the Yam Seng case, the Court of Appeal heard a case between Mid Essex Hospital Services NHS Trust ("NHS Trust") and Compass Group UK and Ireland Limited ("Compass"). The Yam Seng case was cited in the Court of Appeal's judgement, in which, the Court of Appeal rejected the first instance ruling that there was an implied term which required the NHS Trust not to exercise a contractual discretion arbitrarily, capriciously or irrationally.

An even more recent High Court judgment (TSG Building Services plc v South Anglia Housing Ltd - 8 May 2013) also cited the Yam Seng case but followed the rationale of the Compass case, where the judge ruled that an express good faith clause did not extend to acting reasonably when terminating the contract, and that there was not an implied duty of good faith which would restrict the parties' contractual right to terminate at any time.

If the Yam Seng judgment was an attempt to let the genie of good faith out of the bottle, the Compass ruling can be interpreted as the Court Appeal acting swiftly to try and push it back in.

Nevertheless, all three cases highlight a growing tendency to attempt to imply obligations of good faith into commercial contracts. If the Yam Seng case is more than an aberration in English case law, is it indicative of a slow but steady creep towards recognising a general duty of good faith in English law with regard to certain types of commercial contracts?

Franchisors and distributors should take heed of these developments and exercise caution before exercising contractual discretion and bear in mind that their longer term relational contracts may be held to a high standard of performance, including a duty to disclose.

## Background to Yam Seng

In 2009, ITC entered into an exclusive distribution agreement with Yam Seng to sell Manchester United branded toiletries across duty free outlets in the South East Asian region.

The relationship quickly broke down amid accusations that ITC had misled Yam Seng on a number of issues, including its ability to supply the products, the nature of its licence with Manchester United and its dealings with another authorised distributor for the products in the region who was servicing the non duty-free market and whose pricing strategy was undermining Yam Seng's business model. As the relationship degenerated, ITC threatened to withdraw Yam Seng's exclusivity. Despite being ostensibly a dispute between two companies involving a global brand, in reality it boiled down to a relationship between two individual entrepreneurs, leading two small companies, who did not take legal advice prior to entering the agreement and who had diametrically opposed interpretations of the truth and legal culpability.

Yam Seng argued that its business suffered financial loss as a result of ITC's erratic and, at times, dishonest behaviour. Yam Seng argued successfully that the agreement contained an implied obligation to act in "good faith" and that ITC's breaches were "repudiatory". Yam Seng purported to terminate for breach and claimed damages, and also had an alternative and successful claim for misrepresentation.

The decision is surprising in that it seems to have been unnecessary to resort to any implied obligation of good faith. However, the written contract itself was skeletal and Mr Justice Leggatt repeatedly emphasised the absence of consistent standards of open and honest behaviour on the part of the individual representing ITC, so it is perhaps not surprising that he analysed this issue in some depth.

## Background to Compass

Compass' performance in a NHS Trust catering contract was measured by the calculation of service failure points. The NHS Trust was entitled to award those points to Compass and levy deductions from payments due by the NHS Trust. Compass claimed that the NHS Trust had exercised its discretion in this regard in a way which was contrary either to the implied term not to act arbitrarily, capriciously or irrationally, or in breach of an express duty of good faith and which therefore entitled Compass to terminate the contract. The judge at first instance, agreed, on the basis that the NHS Trust was exercising a discretion which attracted the implied term.

The Court of Appeal disagreed, partly on the basis that such an implied term was unnecessary because any wrong calculation or deduction was itself a breach and regulated by other terms of the contract, but also on the basis that it was the wrong sort of discretion to attract this implied term. The law only implies a limitation on the exercise of contractual discretion where a party exercising it had to make an assessment or choose from a range of options open to it, taking into account the interests of both parties. Here, the contractual discretion related to an absolute contractual right to award the service failure points or not.

The more recent TSG Building Services case will not be analysed in this article, other than to note that in its first opportunity to revisit the issue of good faith since the Yam Seng case, the High Court's ruling in this case is closer in spirit to the Compass ruling.

## Analysis

In the Yam Seng judgment, Mr Justice Legatt recognises the "traditional English hostility" towards the doctrine of good faith but states that, to the extent English law does not recognise this general duty, "this jurisdiction would appear to be swimming against the tide", as evidenced by its introduction in the implementation of various specific pieces of European legislation and an increasing recognition of a general duty of good faith in other common law jurisdictions, such as the US, Canada and Australia and much closer to home in Scotland.

He argues that implying such a duty is no more uncertain than contractual interpretation - an implied term of good

faith is to be determined objectively, based on the presumed intention of the parties to behave in good faith as a reasonable onlooker would assess it and given the relevant background context of the contract. It may extend to a duty to disclose information. This is consistent, he argues, with the case by case approach of common law jurisdictions and he makes the point that an implied term can be modified by express terms in the contract.

Mr Justice Leggatt concludes by noting that contracts involving a longer term relationship and substantial commitment require a high degree of communication, cooperation and predictable performance based on mutual trust and confidence. These expectations are rarely legislated for in the express terms of contracts, but are implicit in the parties' understanding, and are necessary to give business efficacy to such arrangements. Examples of "relational contracts" included franchise agreements, joint venture agreements and long term distribution agreements.

The Compass case demonstrates the Court of Appeal's willingness to defer to the express terms of a contract when assessing culpability for breach. One wonders whether the brief reference to the Yam Seng case in the Court of Appeal's judgment is itself a thinly veiled and deliberate attempt to downplay the significance of Mr Justice Leggatt's comments and reaffirm the cherished certainty of express contractual terms.

## What does this all mean for Franchisors?

In light of the Court of Appeal's judgment, it is far too early to say that English law now has a general implied duty of good faith which applies to franchise agreements.

However, it is dangerous to disregard the views of a distinguished High Court judge as merely those of a "lone rider". The concept of good faith underpins many of the franchise specific regulations which apply in jurisdictions across the world and it may be that English law is "swimming against the tide", albeit valiantly, as it sticks to its common law traditions of developing principles in relation to these matters on a case by case basis.

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One response to this ruling could be to look at franchise agreement boilerplates and consider excluding all implied terms and conditions: but conceivably this may lead to a franchisee asking if a franchisor is therefore intending to engage in commercially unacceptable behaviour! What is clear is that it is prudent for franchisors to take extra care, both when exercising in-term contractual discretions and when they consider the manner in which they provide pre-contractual disclosure (which is a requirement of membership for the British Franchise Association) and ongoing information to franchisees during the course of the relationship.

Businesses which operate corporate and franchise networks should ensure that there is a good two-way line of communication with their franchised network, and carefully consider whether their supply chains are seen to operate transparently and fairly.

If you would like more information on this topic, please contact [Gordon Drakes](#)



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