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Relational contracts, an implied duty of good faith and commercially unacceptable conduct

Bates v The Post Office [2019] EWHC 606 (QB) (Judgment No.3, "Common Issues")

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Introduction

English law's scepticism towards an implied duty of good faith in contract has been replaced by a "growing recognition" that a duty of good faith might readily be implied in a relational contract following the approach of Leggatt J (as he was) in *Yam Seng Pte Ltd v International Trade Corp* [2013] EWHC 111 (QB) where he said that English law was swimming against the tide in refusing to recognise an implied duty of good faith and in which he identified a category of contracts involving longer terms relationships, rather than a simple exchange, requiring a high degree of communication, co-operation and predictable performance based on mutual trust and confidence and expectations of loyalty, at [142]. In *Bates* the first instance judge, Fraser J, reviewed the obligations of transparency and co-operation in the context of the bitterly fought Post Office Group litigation and supplemented previous decisions by providing a checklist of the typical characteristics of a relational contract.

The facts

The claimants were approximately 500 sub-postmasters running branch post offices. The focus of the claims was the introduction in 2000 by the defendant of a new computerised system for accounting called Horizon, which used dial-up modems. The claimants argued that the software for the Horizon system contained coding errors, bugs and defects that resulted in shortfalls and discrepancies in the accounting of different branches; the common theme in the litigation was that the defendant considered the claimants responsible for any shortfalls and demanded payment on the basis that it was impossible for the Horizon system to make errors. The judge noted that, while technical evidence would be critical, the defendant sought to argue that as a matter of contract it was entitled to rely on an inference that the shortfalls shown by the Horizon system were correct.

One of the "common issues" for determination was whether the contractual relationship between the defendant and the sub-postmasters was a relational contract so that the defendant was subject to duties of good faith, fair dealing, transparency, co-operation, and trust and confidence. That issue was reached at [702] of the judgment, an indication of the complexity of the contract terms and the raft of additional implied terms that the claimants argued should be read into the contract as a relational contract.

The law

A number of post-*Yam Seng* decisions have embedded relational contracts as a recognised specie. In *Astor Management AG v Atalaya Mining Plc* [2017] 2 B.C.L.C. 119 (Bus. L.B. 151(Dec), 1–4), where the defendant's obligation to purchase the claimant's interest in a copper mine was conditional on obtaining finance for the purchase, Leggatt J said that a duty to act in good faith was a modest requirement that did no more than reflect the expectation that a contracting party would act honestly toward the other party and not act in a way calculated to frustrate the purpose of the contract or that would be seen as commercially unacceptable by reasonable and honest people, at [98]. He held that any implied duty of good faith was subsumed by a positive obligation to use all reasonable endeavours and did not describe the contract as a relational one.

In *Amey Birmingham Highways Ltd v Birmingham City Council* [2018] EWCA Civ 264, at [92]–[93] Jackson LJ said that a private finance initiative contract intended to run for 25 years was a relational contract; he added that any relational contract of that character was likely to be of massive length, containing many infelicities and oddities; both parties should adopt a reasonable approach in accordance to what is obviously the long-term purpose of the contract and not latching onto the infelicities and oddities in order to disrupt the project and maximise their own gain. The fact that the contract was detailed and lengthy did not mean that it could not be relational.

In *Sheikh Al Nehayan v Kent* [2018] EWHC 333 (Comm), Leggatt J rejected an argument by one of the parties to a joint venture to establish a brand of luxury hotels that the other party owed him fiduciary duties. He then added at [167] that in *Yam Seng* he had referred to a category of contract in which parties were committed to collaborating, typically on a long-term basis in ways that respected the spirit and objectives of their venture, but that they had not tried to specify exhaustively in a written contract. Such relational contracts involved trust and confidence, the trust being that the other party would act with integrity and in a spirit of co-operation. The legitimate expectations that the law should protect in relationships of that kind were embodied in the normative standard of good faith. At [167] he said that the nature of the parties' relationship was one in which they naturally and legitimately expected of each other greater candour and co-operation and greater regard for each other's interests than ordinary commercial parties dealing with each other at arm's length.

Franchise agreements and long-term distribution agreements are examples of relational contracts. The parties in *New Balance Athletics Ltd v The Liverpool Football Club Ltd* [2019] EWHC 2837 (Comm) had made a 10 year distribution agreement and at [43]–[44] Teare J noted that while good faith was not mentioned in the contract it was common ground that there was an implied obligation of good faith, presumably on the basis that it was a relational contract. A duty of good faith (or fair dealing) could be breached not only by dishonesty but also by conduct that lacked fidelity to the parties' bargain. In judging whether a party had not been faithful to the parties' bargain it was necessary to bear in mind the nature of the bargain, the terms of the contract and the context in which the matter arose. Ultimately, the question for the court was whether reasonable and honest people would regard the challenged conduct as commercially unacceptable.

First instance

Fraser J referred to a number of authorities, including *Amey Birmingham Highways Ltd* and *Sheikh Al Nehayan*, which he said made it clear that "relational contracts" was an established concept in English law, at [705]. He did note, however, that whether even a long-term contract was a relational contract depended on the terms of the particular contract. Two examples of long-term contracts that did not qualify were a long-term franchising contract, where the parties' obligations had been comprehensively set out in the written agreement (*Carewatch Care Services Ltd v Focus Catering Services Ltd* [2014] EWHC 2313 (Ch)) and a contract between distributors of financial products and independent financial advisers that neither side saw as an exclusive relationship and where the sort of obligations and commitments expected in a relational contract to maintain the relationship were absent (*Acer Investment Management Ltd v The Mansion Group Sheikh* [2014] EWHC 3011 (QB). The judge noted at [705] that the implication of a duty of good faith was only possible where the language of the contract, viewed against its context, permitted it.

At [721] he concluded that there was no general duty of good faith in all commercial contracts but that a duty of good faith could be implied into some contracts where it was in accordance with the presumed intention of the parties. Whether a contract was relational was heavily dependent on context as well as the terms and on the circumstances of the relationship defined by the terms of the agreement set in its commercial context. He then provided a non-exhaustive list of nine specific characteristics of a relational contract, although he emphasised that only the first was determinative and that in different factual situations different characteristics might be relevant. Those characteristics were: (1) no specific express term preventing a duty of good faith being implied; (2) a long-term contract with the mutual intention of a long-term relationship; (3) an intention of performance with integrity and fidelity to the bargain; (4) a commitment to collaborating in the performance; (5) the spirits and objectives of the venture may not be capable of being expressed exhaustively in a written contract; (6) an expectation of trust and confidence (but different to a fiduciary relationship); (7) a high degree of communication, co-operation and predictable performance based on mutual trust and confidence and expectations of loyalty; (8) a degree of significant investment/substantial financial commitment by one party (or both); and (9) exclusivity of relationship, at [725].

He added that all of the specified characteristics were present in the agreements between the sub-postmasters and the defendant, saying that very specific characteristics were necessary for a commercial contract to be categorised as relational. The sub-postmasters had made major and significant financial commitments and both parties reposed trust in each other. Further, the fact that the sub-postmasters performed transactions on the behalf of the publicly funded defendant was significant, as was the fact that the defendant audited potential crime so the sub-postmasters trusted the defendant to do so fairly.

The consequence of the implied obligation of good faith was that both parties had to refrain from conduct that would be regarded as commercially unacceptable by reasonable and honest people and that transparency, co-operation, trust and confidence were implicit within the implied obligation of good faith, at [738]. In a relational contract the raft of additional implied terms pled by the claimants, for example to co-operate to identify the cause of any shortfalls, were not individual implied terms in themselves but consequences or examples of the good faith obligation.

Conclusion

Although *Bates* provides a useful checklist to identify a relational contract, the very broad nature of the characteristics means that the exercise will remain fact-specific with only limited assistance from first instance decisions. In addition, it will be necessary to identify the commercially unacceptable behaviour which constitutes a breach of a good faith obligation. However, that obligation will prove useful where one party seeks to rely on entirely technical but commercially unacceptable performance and where the express terms are silent.