

Gotta Have [good] Faith

August 29, 2023

This advisory discusses the recent case law developments on the express duty of “good faith” in English law and what they may mean within the context of commercial real estate.

Background

It is commonplace for certain legal agreements, such as overage deeds and option agreements, to impose an obligation on the contracting parties to act in good faith towards each other. However, whilst it may seem obvious to the parties what good faith may look like, particularly when it is not being applied, there is still no industry-accepted definition of the expression under English law. A number of recent cases have added some guidance on what the Courts may look at when considering whether good faith has been shown.

Brooke Homes (Bicester) Ltd v. Portfolio Property Partners Ltd

In a case decided by the High Court in 2021, two parties entered into heads of terms for the sale of c. 100 acres of land, where the parties agreed to use good faith to enter into a binding contract. When matters still had not been concluded three years later, it was alleged that the non-performing party had breached their duty of good faith.

In giving its judgment, the Court held that whilst there was no binding sale contract that could be enforced, the non-performing party had breached its positive obligations to use all reasonable endeavours to enter into a binding sale contract and act in good faith. The duty of good faith was summarised as:

- requiring a party to act honestly (judged by reference to reasonable and honest people);
 - to observe reasonable commercial standards of fair dealing;
 - to demonstrate fidelity or faithfulness to the common purpose (or contractual purpose); and generally
 - to act consistently with the justified expectations of the parties.

Importantly, the Court also decided it was clear that the failure to perform was due to a change of heart based on commercial reasons.

Unfortunately, these principles cannot necessarily be used as a binding precedent for future references, as the principle has been moved on by more recent Court decisions.

Re Compound Photonics Group Ltd; Faulkner v. Vollin Holdings Ltd

In the recent Court of Appeal ruling in a claim brought by a group of minority shareholders in Compound Photonics Group Ltd (Compound), the Court provided important clarification around the scope and construction of contractual provisions obliging parties to act in good faith.

The Compound case involved a dispute based on a shareholders’ agreement which created an express obligation on each shareholder to act in good faith towards each other. The dispute resulted in the removal of certain directors, who were also shareholders in the company, from the board.

At the first instance, the High Court held that the express contractual duty of good faith in the shareholders' agreement required the parties to observe the following set of "minimum standards":

- they must act honestly;
- they must be faithful to the parties' agreed common purpose as derived from their agreement;
- they must not use their powers for an ulterior purpose;
- they must deal fairly and openly; and
- each party can consider and take into account its own interests, but must have regard for the other party's interests.

The High Court held that in removing one party from the board, there had been a breach of the good faith clause as the shareholders had exerted their power to "override" the constitutional balance.

The Court of Appeal

Perhaps unhelpfully, the above list of clear principles has been thrown into doubt since the decision of the High Court was overruled. The Court of Appeal stated that the High Court's reasoning was flawed in that it did not take into account defined principles set out in previous case law that stated "the express duty of good faith must be capable of being derived as a matter of interpretation or implication from the other terms of the contract in issue in the particular case".

The Court of Appeal ultimately overturned the High Court's decision, ruling that there was no breach of the good faith clause in the shareholders' agreement. Therefore, the old principle that each case must be decided on its own merits has never rung more true.

Conclusion

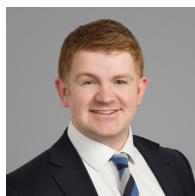
In what is a potentially complicated issue, the message is simple: if parties wish to include a duty of good faith, the contract should spell out *exactly* what that duty entails. The principles set out above in recent case law are a good place to start.

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