**The thick end of the wedge: Good faith in corporate law and the rule of law**

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In certain instances, English case law has recently begun to expressly recognise an obligation to perform a contract in good faith.[[1]](#footnote-1) This adds weight to existing literature that good faith is/or should be the organising principle of contract law, even if it is not expressly acknowledged in orthodox authorities.[[2]](#footnote-2) One instance of such an obligation arising is in the performance of the corporate constitution. The potential for longevity and informality in corporate constitutions make contractual incompleteness an acute problem in the corporate context. The corporate constitution is a “statutory” contract because it derives its binding force from statute, not common law.[[3]](#footnote-3) The enforcement of rights under the constitution is not unrestricted but is limited in two ways: (1) “majority rule” the company;[[4]](#footnote-4) and (2) only membership rights are enforceable.[[5]](#footnote-5) As the company progresses in its life-cycle, circumstances may change and the majority may insist on running the company in a manner contrary to what was agreed. However, any personal right a minority might have under the constitution may be unenforceable because the majority may be capable of lawfully or legally changing the agreement.[[6]](#footnote-6) If the majority was successful in changing the agreement, there was no adequate remedy for the minority who may find themselves trapped in the company.[[7]](#footnote-7) Parties have, therefore, sought to mitigate this problem by obligating that performance of the corporate contract is done in good faith. This paper argues that an expanding obligation to perform the corporate contract in good faith is not compatible with the rule of law. To begin, we make a descriptive argument before making a normative one.

The descriptive argument consists of two points. First, the rule of law requires like cases to be treated alike. In law certain causative events may give rise to rights: consent, wrongs, and unjust enrichment. Whether the event gives rise to rights is determined by the formal rules of the legal category the event falls into: contract, tort, or unjust enrichment.[[8]](#footnote-8) To observe the rule of law by treating like cases alike, the rules must be applied equally to disputes in individual contexts of law that bring together all the law on a particular subject, i.e. corporate law, unless a rational distinction can be made. To not do would be to irrationally distinguish cases based on the language spoken. For example, imagine your football team has a goal disallowed for offside. In their next match a goal is scored from an offside position but, in this instance, it is allowed to count because the referee decides the situation is governed by a different rule of ‘unfair advantage’. You would be incensed at the lack of consistency, and rightly so. There has not been equal treatment of like cases. They have been irrationally distinguished based on the language spoken: offside or unfair advantage. Therefore, we cannot have different rules applying to the corporate context simply because we use the language ‘corporate law’.[[9]](#footnote-9)

Since the corporate constitution is a contract, the law of contract applies to determine rights arising from that contract. Determining what a good faith term obligates parties to do cannot be determined from a textual approach to give ordinary meaning to the term and construing it within the contract as a whole. That is because, while good faith is often associated as deriving from bona fides, the noun ‘fides’ encompasses 13 different behaviours, not just faithfulness.[[10]](#footnote-10) As such, if we imagine a good faith term as a wedge, encompassing more behaviours the broader it gets, only good faith at the thin end of the wedge, encompassing the behaviour of ‘dishonesty’, can such a term be compatible with the law of contract’s rules of interpretation and the rule of law.[[11]](#footnote-11) As the wedge gets thicker, additional, broader behaviours are brought within the meaning of such an obligation, such as co-operation, communication, loyalty, fidelity, and integrity, and at the end of the wedge a broad appeal to “acceptable behaviour according to reasonable and honest people”.[[12]](#footnote-12)

As the wedge gets thicker the traditional bottom-up approach to contractual construction, whereby one starts with the words used and seeks to construe their meaning within the context of the contract in question, is flipped to a top-down approach, whereby the court starts with a behaviour and moulds the term to fit it.[[13]](#footnote-13) This is because we cannot be certain what these additional behaviours obligated the parties to do, so the court starts with a behaviour, such as loyal or faithful to the contract’s purpose and interprets the good faith term to make it fit. Therefore, the thicker the wedge becomes in encompassing more behaviours the less certain the term is, restricting the possibility it can be characterised as an obligation consented to by the parties, whether expressly agreed or implied in fact, even if the judges say this is what is going on.[[14]](#footnote-14) That means the obligation imposed by the court is a rule of law, whether that is in regard to the interpretation of an express term or implied in law.

The second descriptive argument is that to impose a good faith obligation on the parties is ultra vires of the court. Parliamentary supremacy denies judicial interference in matters it has already legislated for. To overcome the limitations of enforcement of the corporate contract, Parliament legislated for the oppression remedy, later relaxed to the unfair prejudice petition,[[15]](#footnote-15) whereby shareholders were given a statutory cause of action whereby if the company’s affairs were conducted in a manner unfairly prejudicial to their interests as a member, the member would be entitled to remedy, often a personal remedy for the purchase of their shares at a fair value. The high watermark of when unfair prejudice may arise was stated in the House of Lords.[[16]](#footnote-16) Lord Hoffmann delivering the only judgment stated that unfair prejudice may arise where there has been some breach of the terms agreed or equitable considerations make it unfair for those conducting the affairs of the company to rely on their strict legal powers. For the latter, this was tempered by a need for legal certainty. Lord Hoffmann continued that it would be in those circumstances where the shareholder cannot reasonably have said to have agreed. Therefore, the high watermark is still agreement. The court cannot “decide whether to grant or refuse relief from unfair prejudice on the basis of palm-tree justice”.[[17]](#footnote-17) By supplementing the corporate constitution with a term of good faith the court is, therefore, going further than what has been legislated for by providing a remedy in circumstances beyond what was agreed.

Having made the descriptive argument, attention can turn to the normative position as to whether a rational distinction should be made in the context of corporate law to treat the corporate constitution differently from other contracts.

There are certainly concerns in corporate contracts that may make the problem of incompleteness more pronounced. Frydlinger and Hart[[18]](#footnote-18) summarised these issues arising from incompleteness as: (1) ex post adaption problems;[[19]](#footnote-19) (2) ex ante investment distortions;[[20]](#footnote-20) (3) corner cutting;[[21]](#footnote-21) and (4) shading costs[[22]](#footnote-22) that may increase the transaction costs of the corporate contract. Putting it more broadly, Collins summarises the problem of incompleteness as risking opportunism.[[23]](#footnote-23) However, these costs, we argue do not warrant a rational distinction being made.

In the authorities, the reason given for treating contracts such as the corporate constitution different is that it is a “relational” contract.[[24]](#footnote-24) However, to make a rational distinction in a legal context to the formal rules of a legal category that would otherwise apply, the substantive reasons for doing so must be rationally defensible. By that it means the reasons for doing so must confine the exception to the rule to the context it arises in. If it can be applied to other contexts then there would be no reason not to count the exception as the general rule. If the general concern in “relational” contracts is opportunism, it is not apparently clear why this concern is not warranting special treatment in other contexts of more discrete contracting such as a one-off sale. For example, it would be unclear why a buyer or seller who opportunistically avoids performing the contract because of a change in market conditions would not be subject to a good faith obligation in performance while parties would be in a relational contract would be.

If the substantive reasons are not rationally defensible, then the reason for distinction being made in the corporate context remains the language spoken. This then offers valid reason for denying a special rule in the corporate context, even if there are transactional costs consequences from not applying it.

The reasons why we should deny treating them specially is because treating contracts differently because they are “relational” is to use a descriptive, rather than substantive reason for distinction. Descriptive terms such as “relational” are labile terms, manoeuvrable at a court’s discretion. There is certainly no more consensus on what a “relational” contract is than there is on what is good faith. Therefore, we would be deciding cases according to a discretion, not law. Exercising a discretion to decide what is fair and just in individual cases erodes the benefits of the rule of law and may inadvertently increase transaction costs.

If there are two rules functioning to resolve the same dispute distinguished only by the language spoken there is a duplication. When the descriptive terms of the event that gives rise to those rights is uncertain that duplication is a problem because parties cannot be sure which language the court will speak. This means it becomes harder for parties to plan their affairs with certainty. For example, while the conduct of the Post Office is now an infamous example of a miscarriage of justice,[[25]](#footnote-25) in the decision in Bates the Post Office did have a legitimate concern that in categorising their contract as “relational” and subjecting them to a broad term of good faith would make it difficult to manage and control their network and constitute the court rewriting their bargain.[[26]](#footnote-26) This uncertainty then risks the increase of contractual drafting and litigation costs. If parties must perform the contract in accordance with broad, speculative behaviours that the court may subject them to if they deem it to be a “relational” contract, the drafting will need to address that risk and who is responsible for that risk may be litigated.

In conclusion, contract law functions at the thin end of the wedge, holding parties to what they consented to, objectively ascertained. To go further and recognise rights in the law of contract from a good faith term encompassing behaviours at the thick end of the wedge is to impose obligations on parties we cannot be sure they consented to and goes beyond what Parliament has legislated for. This approach should be maintained because while incompleteness can create transactional costs in performance of the corporate contract, a good faith obligation would be contrary to the rule of law and may well increase those costs, rather than reduce them.

1. See, for example, *Faulkner v Vollin Holdings Ltd* [2022] EWCA Civ 1371**;** *UTB LLC v Sheffield United Ltd* [2019] EWHC 2322 (Ch); *Bates v Post Office Ltd (No 3)* [2019] EWHC 606 (QB); *Yam Seng Pte Ltd v International Trade Corp Ltd* [2013] 1 All ER (Comm) 1321; *Sheikh Al Nehayan v Kent* [2018] EWHC 333 (Comm); *Bristol Groundschool Ltd v Intelligent Data Capture Ltd* [2014] EWHC 2145 (Ch); *D&G Cars Ltd v Essex Police Authority* [2015] EWHC 226 (QB); *Globe Motors v TRW Lucas Varity Electric Steering* [2016] EWCA Civ 396 [↑](#footnote-ref-1)
2. See, for example, G Gilmore, *The Death of Contract* (Ohio State University Press 2nd ed, 1995); D Percy, ‘The emergence of good faith as a principle of contract performance’ in S Degeling et al, *Contract in Commercial Law* (Thompson Reuters, 2009); A Mason, ‘Contract, good faith and equitable standards in fair dealing’ (2000) LQR 66; E Peden, ‘Incorporating terms of good faith in contract law in Australia’ (2001) 23 *Sydney Law Review* 222 [↑](#footnote-ref-2)
3. UK Companies Act 2006, s 33 [↑](#footnote-ref-3)
4. *Foss v Harbottle* (1843) 67 ER 189 [↑](#footnote-ref-4)
5. *Hickman v Kent or Romney Marsh Sheepbreeders’ Association* [1915] 1 Ch 881 [↑](#footnote-ref-5)
6. *Mozeley v Alston* (1847) 1 Ph 790 [↑](#footnote-ref-6)
7. Pre-existing remedies all had limitations. See class rights; shareholder agreements; special majorities; entrenchment; good faith voting; derivative claims; winding up orders; and director’s duty to exercise powers within authority given [↑](#footnote-ref-7)
8. See, for example, P Birks, “Equity in the Modern Law: An Exercise in Taxonomy” [1996] UW Austl L Rev 1 [↑](#footnote-ref-8)
9. The argument in this paragraph is taken from, D Gibbs-Kneller, ‘“A rule adumbrated”: Bailment on terms and the rule of law’ (2023) LQR(oct) [↑](#footnote-ref-9)
10. See, P Birks, ‘The content of fiduciary obligation’ (2000) 34 Isr L Rev 3 [↑](#footnote-ref-10)
11. See, M Bridge, ‘The exercise of contractual discretion’ (2019) LQR 227 [↑](#footnote-ref-11)
12. *Yam Seng Pte Ltd v International Trade Corp Ltd* [2013] 1 All ER (Comm) 1321 [↑](#footnote-ref-12)
13. *Investors Compensation Scheme Ltd v West Bromwich Building Society* [1998] 1 WLR 896 HL; Lord Grabiner, ‘The iterative process of contractual interpretation’ (2012) LQR 41 [↑](#footnote-ref-13)
14. *Bates v Post Office Ltd (No 3)* [2019] EWHC 606 (QB); *Yam Seng Pte Ltd v International Trade Corp Ltd* [2013] 1 All ER (Comm) 1321; *Carewatch Care Services v Focus Caring Services* [2014] EWHC 2313 (Ch) [↑](#footnote-ref-14)
15. Companies Act 1948, s 210 (oppression remedy); Companies Act 2006, ss 994-996 (unfair prejudice petition) [↑](#footnote-ref-15)
16. *O’Neill v Phillips* [1999] 1 WLR 1092, HL [↑](#footnote-ref-16)
17. *Re Tobian Properties Ltd* [2012] EWCA Civ 998 [↑](#footnote-ref-17)
18. D Frydlinger and O Hart, ‘Overcoming contractual incompleteness: the role of guiding principles’ (2023) 00 JLEO 1 [↑](#footnote-ref-18)
19. Ex post adaption problems are the difficulty of modifying the agreement to changing circumstances [↑](#footnote-ref-19)
20. Ex ante investment distortions are those investments that cannot be specified in contract, either due to complexity or verification issues [↑](#footnote-ref-20)
21. Corner cutting on quality is looking for ways to cut corners on the contract without breaching it [↑](#footnote-ref-21)
22. Shading costs are where the parties have fallen out and shade on performance [↑](#footnote-ref-22)
23. H Collins, ‘Is a relational contract a legal concept?’ in S Degeling et al, *Contract in Commercial Law* (Thompson Reuters, 2009) [↑](#footnote-ref-23)
24. For an overview see, *Bates v Post Office Ltd (No 3)* [2019] EWHC 606 (QB) [↑](#footnote-ref-24)
25. BBC, ‘Post Office Scandal: What the Horizon sage is all about’ <<https://www.bbc.co.uk/news/business-56718036>> last accessed 19th Sep 2023 [↑](#footnote-ref-25)
26. *Bates v Post Office Ltd (No 3)* [2019] EWHC 606 (QB) [↑](#footnote-ref-26)