Termination Clauses and Good Faith – when is the exercise of a termination clause restricted by an implied duty of good faith?

Saaman Pourghadiri and Patrick Tomison, *Outer Temple Chambers*

> ***"Good faith contractual performance is a general organizing principle of the common law of contract…"***[1]

These words, radical to an English commercial lawyer, formed part of the judgment of Justice Cromwell in a landmark case in 2014 which was heard in the Supreme Court of Canada. The English common law has not adopted the same approach, retaining its preference for incrementalism over grand overarching theories. Over the past few decades, there has, however, been a slow and steady recognition of the relevance of good faith to commercial contractual dealings.

Whether in the field of so-called 'relational contracts' and implied duties to act in good faith[2], in the enforcement of express terms to negotiate in good faith[3], or the increasing proliferation in case law concerning contractual discretions, the English common law has shown increasing willingness to grapple with, and apply, notions of good faith in commercial contracts between business people. In a 2018 lecture, Lord Leggatt urged the Courts to show flexibility and resourcefulness in recognising and

giving practical meaning to obligations to negotiate in good faith.[4]

In the last few years, the English courts have considered several cases concerning whether an implied term of good faith should qualify the operation of express termination clauses. Thus far, the Courts have declined this invitation (with one notable exception). In this article, we will first consider the case law and arguments which suggest that an implied term to act in good faith cannot qualify an express termination clause. We will then critically scrutinise the case law.

[1] Cromwell J in **Bhasin v Hrynew** 2014 SCC 71, [2014] 3 SCR 494 at [33].
[2] See Leggatt J (as he then was) in **Yam Seng Pte v International Trade Corp** [2013] 1 All ER (Comm) 132.
[3] See **Petromec Inc v Petroleo Brasileiro SA Petrobas (No 3)** [2005] EWCA Civ 891; [2006] 1 Lloyd's Rep 121 and **Emirates Trading Agency LLC v Prime Mineral Exports Private Ltd** [2014] EWHC 2104 (Comm); [2014] 2 Lloyd's Rep 457.
[4] Lord Leggatt, "Negotiation in Good Faith: Adapting to Changing Circumstances in Contracts and English Contract Law" (Jill Poole Memorial Lecture) 19 October 2018.

Good faith not implied into termination clauses

There is a consistent body of case law that termination clauses are not subject to an implied duty to act in good faith. It appears there are two principal obstacles to subjecting express termination clauses to such an implied term.

The first obstacle lies in the high bar for the implication of terms into commercial contracts ("**the implication argument**"). The Supreme Court has said that a term will not be implied unless it is "*so obvious as to go without saying or to be necessary for business efficacy*"[5]. Where there is an express termination clause, typically it will be argued that "good faith" is neither necessary nor obvious.

The second obstacle is that termination clauses concern the ending of the contract rather than the ongoing performance of the contract. This difference in kind means that the parties should be free to consider their own commercial interests, rather than be qualified by notions of good faith ("**the termination argument**").

The third obstacle is that termination clauses are simple binary decisions and so it is not apt to import the good faith restrictions which ordinarily apply to contractual discretions ("**the discretions argument**"). Most attempts to introduce good faith into termination clauses have been premised on an argument that they ought to be treated as contractual discretions.

A helpful summary of these arguments can be found in **Monde Petroleum SA v Westernzagros Limited**.[6] The case arose out of the scramble by Western companies, in the period following the fall of Saddam Hussain, to access the natural resources of the Kurdistan region of Iraq. The Defendant, a Canadian oil and gas company, wished to explore for oil and develop oil production, and it was attempting to negotiate with the Kurdistan Regional Government to reach an exploration and production sharing agreement ("EPSA"). To facilitate the conclusion of the EPSA, the Defendant entered a consultancy agreement with the Claimant. The Claimant company was run by the son of a formerly prominent Iraqi politician. The consultancy agreement provided for monthly fees, success fees payable on the achievement of certain milestones, and an option to acquire a 3% interest in the EPSA on the achievement of the final milestone. The consultancy agreement also included a termination clause.

Following the conclusion of the EPSA, the Defendant served a Termination Notice on the Claimant. Among other things, the Claimant brought a claim for breach of contract. The Claimant's argument was that: (1) the consultancy agreement contained an implied obligation to act in good faith; (2) that implied obligation meant that the termination clause could not be exercised other than in good faith; (3) the Defendant had exercised the termination clause in bad faith because in doing so it intended to deprive Monde of the monthly fees and the 3% option which would have vested if the final milestone was achieved; and (4) as a result, the Claimant had lost its right to those fees and that option.

The Deputy Judge rejected the Claimant's argument that the termination clause was subject to an implied obligation to act in good faith for two reasons. First, applying the general law on the implication of terms into contracts, the contact did not lack commercial or practical coherence without it: [248]-[259]. Second, the Deputy Judge held that *"a contractual right to terminate is a right which may be exercised irrespective of the exercising party's reasons for doing so"*: [261].

The judge identified two features of termination clauses which made it unsuitable to subject them to an implied duty of good faith. First, a contractual right to terminate is not the exercise of a contractual discretion in which there are a range of options; rather it involves a binary choice: [266]. As such, the ordinary restrictions which are placed on a party exercising a contractual discretion do not apply.

Second, termination powers differ from the sort of rights which may arise in the course of a contract's performance. The purpose of the right to terminate is to give a right to end the parties' shared endeavour, not to regulate the performance of that endeavour. The Deputy Judge emphasised the particular importance of certainty in relation to such clauses which would be

[5] Lord Neuberger (with whom Lord Sumption and Lord Hodge agreed) in **Marks and Spencer plc v BNP Paribas Securities Services Trust Co (Jersey) Limited** [2015] UKSC 72; [2016] AC 742 at [23].
[6] [2016] EWHC 1472 (Comm); [2016] 2 Lloyd's Rep 229.

undermined if parties thought that their motives for terminating an agreement would be examined. He relied on the analogy with the right to terminate a contract in response to a repudiatory breach and the judgment of Longmore LJ in **Lomas v IFB Firth Rixson**[7] at [46] that: "*[t]he right to terminate is no more an exercise of discretion, which is not to be exercised in an arbitrary or capricious (or perhaps unreasonable) manner, than the right to accept repudiatory conduct as a repudiation of a contract*".

A similar conclusion was reached by HHJ Pelling QC (sitting as a Judge of the High Court) in **TAQA Bratani Ltd v Rockrose UKCS8 LLC**.[8] The parties were involved in the exploitation of North Sea oil, and had concluded several Joint Operating Agreements between them. The Claimants served termination notices on the Defendant. The Claimants sought declarations that termination notices served by them on the Defendant were valid.

The Defendant argued that the relevant termination clauses were subject to implied terms that qualified the circumstances in which the Claimants could exercise the right to terminate. Importantly the Defendant argued this in two ways. First, they ran the classic argument that the clause was a contractual discretion subject to an implied term qualifying the manner in which it may be exercised by concepts of good faith, and genuineness and the absence of arbitrariness, capriciousness, perversity and irrationality[9]. Second, they ran an argument that the contract was relational and so was, as a whole, subject to an implied duty of good faith. Such a term would qualify the manner in which the termination clause (like all clauses in the contract) could be exercised. This argument relied on the line of authorities starting with **Yam Seng Pte v International Trade Corp**.[10]

The judge rejected the Defendant's arguments. His conclusion relied primarily on the implication argument: that there was no space in the express terms of the contract to allow for such a term to be implied. Looking at the JOAs, he concluded that the relevant clauses conferred an unqualified right to terminate: [34]. As a result, he concluded that the express termination clause could not be constrained by an implied term like **Braganza**: [44]. After reviewing the authorities, HHJ Pelling QC at [49] stated that:

In my judgment these authorities speak with a single voice – where the parties choose to include within their agreement a provision that entitles one or more of the parties to terminate the agreement between them, that clause takes effect in accordance with its terms.

The judge reached a similar conclusion on the question of whether an implied term of good faith could qualify the termination clause at. He held that whilst the contract as a whole might be subject to an implied duty of good faith, that duty did not extend to the termination clause because [56]:

> *(a) on its true construction that power is an absolute and unqualified power for the reasons explained earlier; in consequence;*
>
> *(b) it is impermissible to imply a term that qualifies what the parties have agreed between them; and*
>
> *(c) it follows that the parties have legislated in the sense referred to by Leggatt J and it is not necessary, indeed it would be wrong, to imply such a term to qualify the power on which the claimants rely because it is not necessary in order to make the contract the parties have chosen work as it is to be presumed they intended it to work, or, to the extent there is any difference, to give effect to their presumed common intention.*

There have also been several cases in the employment law context which have dealt with the question of whether damages are recoverable at common for the manner of dismissal through a breach of the implied term of mutual trust and confidence[11]. The House of Lords in **Johnson v Unisys Ltd**[12] held that such damages were irrecoverable at common law, and that the proper

[8] [2020] EWHC 58 (Comm); [2020] 2 Lloyd's Rep 64.
[9] **Braganza v BP Shipping Limited** [2015] UKSC 17; [2015] 1 WLR 1661.
[10] [2013] 1 All ER (Comm) 132.
[11] See e.g., **Johnson v Unisys Ltd** [2003] 1 AC 518 and **Reda v Flag Limited** [2002] UKPC 38.
[12] [2003] 1 AC 518.

remedy was for unfair dismissal in the Employment Tribunals. However, in our view, the reasons for this decision were focussed on the fact that Parliament had chosen to create a legislative framework to deal with unfair dismissal, and that this statutory remedy, not the common law, should govern the termination of employment contracts (see e.g. Lord Hoffman at [55]-[59]).

A dissenting voice?

An outlier in the authorities is the decision of Fraser J in **Bates v Post Office (No 3: Common Issues)**[13]. The Post Office Group Litigation concerned claims brought against the Post Office by around 550 Sub-Postmasters who had been detrimentally affected by the introduction of a new IT and accounting system – Horizon – in around 2000. In **Bates** Fraser J was required to consider many issues, one of which was whether the contracts between the Post Office and Sub-postmasters were 'relational contracts', and whether the contractual right to terminate was tempered by the implied obligation to act in good faith.

Having concluded that the contacts between the Post Office and the Sub-Postmasters was a relational one which included an implied obligation of good faith, Fraser J considered the Claimants' argument that terms should be implied that their contracts could not be terminated arbitrarily, irrationally or capriciously, and that any contractual, or other power had to be exercised honestly and in good faith: [756]. Fraser J held that the Post Office was required to undertake consideration of whether to terminate on notice *"in compliance with its duty of good faith… and take into account all relevant factors, and not take account of irrelevant ones"*: [895].

Fraser J dismissed the Post Office's argument that it was entitled to exercise its right to terminate without complying with the obligation to act in good faith as *"a surprising position"* and *"obviously incorrect*": [911]. Fraser J drew no distinction between termination clauses and other clauses citing Lord Sumption JSC in **British Telecommunications plc v Telefonica O2 UK Ltd**[14] at [37] that "*[absent] very clear words to the contrary, a contractual discretion has to be exercised consistently with its contractual purpose, and in good faith and not arbitrarily or capriciously*."

A new approach?

In our view, **Bates** is likely to be treated with caution. First, the reasoning of Fraser J is thin, there is little analysis of the differences between termination clauses and other contractual powers. Whilst Fraser J cited **Monde**, there was no analysis as to why that case should be distinguished. Second, the subsequent case of **TAQA Bratani** was decided without reference to **Bates** and followed the approach in **Monde**.

Nevertheless, in the right circumstances an English Court could well find that a termination clause is subject to a duty of good faith and that the arguments in **Monde** rejecting such an approach are not comprehensive.

As can be seen in **TAQA**, the problem can be approached both by reference to the case law on contractual discretions and good faith in relational contracts. We think the latter approach is likely to be more fruitful, though the former should still be argued.

It seems to us that "the implication argument", should not serve as a principled bar to a termination clause being subject to a duty of good faith. Such a term of good faith can be implied into contracts in accordance with the test in **M&S v BNP Paribas.** It also now appears to be the position that a term of good faith can be implied into "relational contracts" as a class by operation of law[15]. Such relational contracts are typically long-term contracts in which the parties are committed to collaborating with one another[16]. Examples would include joint venture agreements, long-term franchising arrangements, long term agency agreements or similar.

Once the term is implied into the contract, one needs to identify specific reasons why it ought not to be implied into the termination clause. Whilst such reasons were identified in the contract in **TAQA** one can

[13] [2019] EWHC 606 (QB).
[14] [2014] UKSC 42.
[15] See **Sheikh Tahnoon v Kent** [2018] 2 CLC **216** at [174], **Bates** at [711] and **Cathay Pacific v Lufthansa Technik** [2020] EWHC 1789 (Ch) at [218(a)].
[16] The characteristics of such a contract were summarised by Fraser J in **Bates** at [725].

readily envisage circumstances where a termination clause ought not to be excluded from such a restriction. By the same token, once can envisage circumstances where it would be necessary to constrain the exercise of a termination right in a similar manner to other contractual discretions.

As to the termination argument, the purported analogy with the choice to affirm or terminate a contract in response to a repudiatory breach in common law is not as helpful as it may seem. Such a right is not unrestrained in the way suggested in **Monde**. Rather, a party cannot affirm the contract where he has no legitimate interest in doing so[17].

In **MSC Mediterranean Shipping Co SA v Cottonex Ansalt**,[18] Leggatt J (as he then was) held that this "legitimate interest" principle was akin to good faith. After citing the case of **Bhasin v Hrynew**, Leggatt J questioned the distinction between contractual discretion and the choice to accept repudiatory conduct at [97]:

In each case one party to the contract has a decision to make on a matter which affects the interests of the other party to the contract whose interests are not the same. The same reason exists in each case to imply some constraint on the decision-maker's freedom to act purely in its own self-interest. The essential concern, as Rix LJ observed in the Socimer *case at para 66, is that the decision-maker's power should not be abused.*

The Court of Appeal rejected the analogy with good faith or that it supplied a 'general organising principle'[19]. However, it is plain that common law termination rights are not as unfettered as some have suggested. If the common law right to terminate is subject to a fetter, one might suggest that a contractual right to terminate might also be subject to fetters.

Finally, as for the discretion argument, the distinction between contractual powers which involve discretions and binary termination clauses is not as conceptually neat as it may seem.

First, we agree with Asplin J (in **PAG v RBS**[20] at [277]) that the distinction between "binary" and "non-binary" decisions is not particularly helpful in identifying when a power is subject to a **Braganza** review. For example, the choice in **Braganza** was whether the cause of Mr Braganza's death was accidental or not. On its face, this was a binary decision.

Second, the decision to terminate a contract is not a simple binary decision. In addition to the decision as to whether to terminate, typically a party must decide when to terminate.

In our view, in the right circumstances it could be open to the court to constrain a termination clause with an implied duty of good faith. Such a case would be particularly strong where the contract is relational and where the conduct of one party is sufficiently egregious that a judge will want to find a remedy for the other party.

Conclusion

The evolution of the common law is one of incremental adaption to commercial norms. Although recent authority suggests that termination clauses are not subject to an implied duty of good faith, we anticipate that a court presented with the right facts could decide the other way. Such a decision would be apt for consideration by the Supreme Court and given the elevation of the principal protagonists in the development of good faith in English contract law, Lord Leggatt may yet have the last word.

SAAMAN POURGHADIRI

saaman.pourghadiri@outertemple.com

PATRICK TOMISON

patrick.tomison@outertemple.com

18 October 2020

[17] **White and Carter (Councils) Ltd v McGregor** [1962] AC 413.
[18] [2015] EWHC 283 (Comm).
[19] [2016] EWCA Civ 789; [2016] 2 CLC 272 at [45].
[20] [2016] EWHC 3342 (Ch).