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To what extent does *Good Faith* have a role to play in English Commercial Law and with Sale of Goods transactions in particular?

by

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Of all the principles in English law that are difficult to define none is more so than the principle of good faith. The characteristics of good faith were described by Bingham LJ in *Interfoto v Stiletto*[1] where he stated that good faith's "*effect is perhaps most aptly conveyed by such metaphorical colloquialisms as "playing fair," "coming clean" or "putting one's cards face upwards on the table.""*.[2] Part of the reason why the principle is so difficult to define is because it revolves around what people consider fair in the circumstances; this will inevitably differ from person to person and according to the events. This essay will seek to examine the current state of good faith in English commercial law and sale of goods transaction together with an explanation on how the law has reached this position.

Good faith was introduced into English law by Lord Mansfield in the case of *Carter v. Boehm*.[3] His Lordship developed the doctrine by stating "*[g]ood faith forbids either party by concealing what he privately knows, to draw the other into a bargain, from his ignorance of that fact, and his believing the contrary*".[4] The principle of good faith was predominately developed by the Court of Chancery and as such has its roots in equity rather than common law. This point is highlighted by Harrison[5]: "*the main source of fair-dealing terms in contracts was the old Courts of Equity. One would expect the Chancery Bar, and in particular the Chancery judges, would be enthusiastic proponents of the presumption of fair dealing*".[6] The fact that good faith is an equitable principle rather than a product of the common law is important because of the modern reluctance to employ equitable doctrines in commercial law.

Since the introduction by Lord Mansfield, good faith has ceased to be as widely recognised in English commercial law. There are a number of possible reasons why this is so. Firstly, the industrial revolution had a profound impact on contracting and the commercial world in general. In particular, there was a significant increase in large industrial firms that operated on classic *laissez faire* principles. This meant that there was little room for contracts to be negotiated on grounds of "fairness". Secondly, and linked to the increasing *laissez faire* attitudes, is the growth of *"caveat emptor"*. Fitzgibbon LJ explained the legal impact of *caveat emptor*: "*Caveat Emptor does not mean in law or latin that the buyer must "take a chance", it means that he must "take care"…it is a term of the contract, express or implied,*

1 [1989] Q.B. 433
2 *Ibid* , p.439
3 (1766) 3 Burr 1905
4 *Ibid*, p. 1910
5 Harrison. R., Good Faith in Sales, (London: Sweet & Maxwell, 1997)
6 *Ibid*, p.5

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that the buyer shall not rely on the skill, or judgment of the seller".[7] If the buyer is to be 'aware' or 'cautious' in sale of goods transactions it leaves little room for notions of good faith.

Another important factor, highlighted by Harrison, which led to the decline in good faith principles were the Judicature Acts of 1873 and 1874. Harrison states the "*merging of Equity and Common Law jurisdictions in England provided a background…because of the shifting for position which ensued quite naturally as a result*".[8] It is fair to assume that "the shifting of position" referred to is the common law, rather than equity, dominating commercial law. This is an important point because in modern commercial law, sale of goods transactions are predominately governed by the common law, as a result of this there has been a significant decline in the use of good faith in English commercial law.

Despite the events which contributed to a decline in the importance of good faith in commercial law there is evidence to suggest that the principle is still in use certain areas and that, possibly, there should be wider recognition. Section 61(3) of the Sale of Goods Act 1979 (the **"SGA"**) introduced for the first time a statutory definition of good faith. The section defines good faith as "*honestly, whether it is done negligently or not*". This clearly shows that good faith is within commercial law, and particularly sale of goods transactions, as it requires statutory definition.

Despite the recognition there have been calls from Goode for wider use of good faith in commercial law: "*surely it is high time that English law adopted a general principle of good faith and cast off its historical shackles*"[9]. The statement by Goode is extremely controversial in many respects and has attracted large amounts of criticism. Firstly, it is important to note that one of the most fundamental principles of commercial law is the need for certainty. The need for certainty has been highlighted by judges on numerous occasions: Lord Browne-Wilkinson stated in *Wesdeutsche*[10] that "*wise judges have often warned against the wholesale importation into commercial law equitable principles inconsistent with the certainty and speed which are essential requirements for the orderly conduct of business affairs*"[11]. This view is shared by Sir Peter Millett (now Lord Millett) "*[b]usinessmen need speed and certainty; these do not permit a detailed and leisurely examination of the parties'*

7 *Wallis v Russell* (1902) 2 IR 585, at p.615
8 Harrison, Good Faith in Sales, para 1.09
9 Goode R. M., "The Codification of Commercial Law" (1988) 14 Mon LR 135 cited in Sealy. L. S. & Hooley. R. J., Commercial Law: Text, Cases and Materials, (Oxford: Oxford University Press, 2005), p. 45
10 *Westdeutsche Landesbank Girozentrale v Islington London Borough Council* [1996] 1 AC 669.
11 *Ibid*. p.704

conduct. Commerce needs the kind of bright lines which the common law provides and which equity abhors".[12] These passages show that two of England's most prominent commercial judges believe that the main priority of commercial law is certainty and speed. Equitable principles, like good faith, are concerned with the manner in which parties have behaved and therefore require a more complex and lengthy process with an uncertain outcome because it will depend on individual factors and a judge's interpretation of that factor.

The importance of certainty has been highlighted by Bradgate[13] who believes that for business transactions to work effectively there is a need for certainty because "*[i]f the law is certain, the outcome of a dispute may be predicted and the parties may resolve it without resort to litigation*".[14] The statement made by Bradgate is of the upmost importance to business in the 'real world' as opposed to legal theory: businesses are reluctant to pursue an issue to court because of the costs and time involved. The doctrine of good faith is a serious flaw in the ability to provide certainty in commercial transactions because of the unpredictable nature of its outcome.

Secondly, if good faith were recognised in English commercial law it would provide judges with large levels of discretion, which is contrary to business demands for speed and certainty. Brownsword expressed doubts about the impact of good faith in English law: "*such a vague principle invites judges to act on their own idiosyncratic views of fair dealing*".[15] It is possible that if good faith were to have wide scale implementation in English law it would lead to a flood of litigation. If judges can decide commercial disputes based on notions of 'fairness' there would always be the possibility that one judge's reasoning would differ from another which could increase litigation levels and unpredictability.

It is important to note that Goode has altered his stance on good faith, perhaps because of the fierce criticism he received. In a later article[16] Goode, for instance, expressed doubts as to its workability.

Some commentators have argued that if good faith did have a general application in commercial law it would not produce needless uncertainty. Lord Steyn expressed the

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[12] Millett. P. J., "Equity's Place in the Law of Commerce" (1998) 114 Law Quarterly Review 214, p.214

[13] Bradgate. R,. Commercial Law, (Oxford: Oxford University Press, 2005)

[14] *Ibid*, p.5

[15] Brownsword. R., "Good Faith in Contract and Property Law" (2000) 63 Modern Law Review 940, p.940

[16] Goode. R. M., "Commercial Law in the Next Millennium: The Hamlyn Lectures" (London: Sweet & Maxwell, 1998)

opinion that good faith would not lead to uncertainty and that the term is not as ambiguous as many would have us believe. Writing extra-judicially, he stated:

> "*I am quite confident that businessmen and indeed people on the Underground have no problem with the concept of good faith, or fair dealing. They understand very well what bad faith means*".[17]

It has been argued that the uncertainty associated with good faith is linked to the fact that it appears to be a subjective test and therefore leads to unpredictable results, as it is impossible to ascertain what people are thinking. In his article[18] Lord Steyn argues that the test is both subjective and objective which therefore reduces the uncertainty "*good faith additionally sets an objective standard, viz, the observance of reasonable commercial standards of fair dealing in the conclusion and performance of the transaction concerned*".[19] It is true that an objective standard would go some way to eliminating uncertainty and could, in theory, allow for the general application of good faith because a professional body, such as the CBI could deliver an opinion. However, it is possible to argue that the uncertainty would be just as apparent under an objective system. This is because what the reasonable man believes often differs according to circumstances. The reasonable man is by no means predictable in his opinion. If this were the case it would do nothing to eliminate the concerns expressed by Brownsword regarding the large levels of discretion given to judges.

Lord Steyn is, by no means, the only prominent judge who has expressed confidence in good faith with the former Chief Justice of Australia, Mason, also expressly an opinion which favours the adoption of good faith[20] and has criticised the law for its failure to implement: "*[i]t seems to be going a very long way indeed to assert that a contract to negotiate in good faith is unnecessarily unworkable and too uncertain to be enforced*".[21] Mason does not however confine his criticism to uncertainty: he attacks the law for an apparent lack of justice and even goes so far as to suggest that good faith would in fact bring coherence to the law:

> *"good faith and fair dealing duties, based on the reasonable expectations of the parties, might advance the interests of justice. Moreover, recognition of good faith and*

17 Steyn J. Z., "Contract Law: Fulfilling the Reasonable Expectations of Honest Men" (1997) 113 Law Quarterly Review 433, p.438
18 *Ibid*, p.433
19 *Ibid*. p.438
20 Mason. A., "Contract, Good Faith and Equitable Standards in Fair Dealing" (2000) 116 Law Quarterly Review 66
21 *Ibid*, p.81

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> *fair dealing concepts would bring greater coherence and unity to the varied array of principles which are presently available in the area of contract performance".*[22]

It is true that principles of good faith would increase the chances of justice in specific cases; equity does strive for justice. However Mason's comments that it would bring coherence are misleading. Yes, it is true that if the law were to adopt a single policy of good faith in place of doctrines such as estoppel, waiver or agreements for transactions like hire purchase[23] there would be a greater coherence, however it would be to replace effective mechanisms of protection with an ambiguous and uncertain policy.

Despite this flourishing academic debate on whether or not good faith should be recognised as a general doctrine in English commercial law, and especially in the sale of goods, it is recognised in some key areas. One of the most controversial areas where good faith plays a fundamental role is the principle of *nemo dat quod non habet*, as outlined in section 21 of the SGA and the exceptions to the rule covered in ss.22-25.

The principle of *nemo dat* is that no person can pass better title than he possesses. Section 21(1) of the SGA states:

> *"Where goods are sold by a person who is not their owner, and who does not sell them under the authority or with the consent of the owner, the buyer acquires no better title to the goods than the seller had".*

The classic example is where a rouge acquires property by deceit and sells to a third party. Following *nemo dat*, the innocent third party will not obtain good title because the rogue never had good title to pass. This is one of the most controversial issues in the sale of goods because it involves two "innocent" parties and the apportionment of loss. Denning LJ eloquently summed up the situation "*two principles have striven for mastery. The first is for the protection of property: no one can give better title than he himself possesses. The second is the protection of commercial transactions: the person who takes in good faith and for value without notice should get a good title*".[24] As a result of the perceived unfairness there are well established exceptions to the *nemo dat* rule. The first of these is a sale under a voidable title which has not yet been avoided, and the buyer purchases in good faith without notice[25]. The second exception is a disposition by a seller remaining in

[22] *Ibid*, p.94
[23] These criteria were recognised by Bingham LJ in *Interfoto v. Stiletto* [1989] Q.B 433
[24] *Bishopsgate Motor Finance Corp. Ltd. v Transport Brakes Ltd.* [1949] 1 KB 322, pp. 336-337
[25] Sale of Goods Act 1979, Section 23

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possession.[26] The third exception[27] is a disposition by a buyer obtaining possession. This relates to a situation where a buyer is in possession of the goods and sells them to a purchaser but for some reason the buyer did not have title to the goods (e.g. the original sale was voidable and had been avoided). Although each of the statutory exceptions cover a different scenario the common feature to all of them is that the innocent third party must have acted in good faith and not have notice of the seller's defect in title.

Good faith has received statutory definition in Section 61(3) of the SGA as "*honestly, whether it is done negligently or not*". Although it is a positive step that Parliament has taken in defining the term it can be seen as a weak definition because what is meant by 'honestly'? Goode attempted to clarify this problem by saying honesty equates to "*a person who genuinely believes his conduct is morally justified is not dishonest unless he is also aware that it would be so regarded by reasonable and honest people*".[28] Although this definition commands the utmost respect because of the contribution given to commercial law by Goode, it is possible to perceive the clarification as poor. Firstly, it is unwise to use the word in need of definition within the definition: this only adds to the perpetuating circle of confusion. Secondly, lessons can be learnt from the criminal law about the use of the word dishonesty and the problems it creates. In *R v. Gosh*[29] the Court of Appeal laid down the criminal test for dishonesty as "*according to the ordinary standards of reasonable and honest people…then the jury must consider whether the defendant himself must have realised that what he was doing was by those standards dishonest*".[30] Although concerned with the criminal definition of dishonesty, it is a useful tool in highlighting the problems which may be created by defining good faith as acting honestly. Honestly is subjective therefore there is no definitive method of telling whether a person is acting dishonestly. If an objective element is added it assumes that all people have the same perception of what amounts to honesty which is far from true.

Even though good faith is a requirement to the exceptions of *nemo dat*, the reception it has received by the court has been poor. An example of how English judges will not compromise the certainty of commercial contracts is *Shogun Finance Limited v. Hudson*.[31] The Law Lords held (by a 3:2 majority) that Shogun Finance could reclaim the goods let under a hire purchase agreement to Mr Patel who the rogue impersonated when making the application

[26] Factors Act 1889, Section 8 and Sale of Goods Act 1979, Section 24
[27] Factors Act 1889, Section 9 and Sale of Goods Act 1979, Section 25
[28] Goode R. M., Commercial Law, (London: Penguin Books, 2004), p.96
[29] [1982] 2 All ER 689
[30] *Ibid*, p.696
[31] [2004] 1 All E.R. 215

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for finance. Lord Hobhouse, giving the leading opinion of the majority, relied upon the principle in *Hector v. Lyons*[32] that no evidence should be admitted to rebut the allegation that a person intended to contract with someone other than the person named in the contract (the application for finance was made through a motor deal and faxed to the finance company; as a side issue the House of Lords followed its earlier decision in *Branwhite v Worcester Works Finance Limited*[33] and agreed that the dealer did not act as Shogun Finance's agent). In contrast to this, a good faith defence found favour with two of their Lordship; Hudson had purchased in good faith and without notice.

It could be argued that English law has attempted to recognise good faith in an implied, rather than, express manner. In the second half of the twentieth century there was increasing pressure on the courts and Parliament to prevent businesses terminating contracts to escape bad bargains. In *Arcos v. Ronaasen*[34] the House of Lords famously held that where goods were contracted to be ½ inch thick and the specification was not met, despite the goods still being fit for purpose, they could be rejected as a breach of condition. The motive behind this is purely economic: the buyer was keen to avoid the contract because the price of the goods has fallen so he wished to purchase at the fallen rate. Many would say that the buyer was, in fact, acting with a lack of good faith because the product is still fit for the intended purpose and the seller is unfairly disadvantaged. The opposing view is that good faith should not prevent a buyer rejecting for a breach of condition: a condition is a condition and failure to comply with such requirement is to the cost of the seller.

In response to *Arcos v. Ronaasen* a number of measures were created to prevent a buyer from terminating when the breach was minimal. The Court of Appeal introduced the use of the famously difficult and often misunderstood 'innominate terms'[35] and an amended to the SGA, leading to the introduction to Section 15A. Bradgate[36] recognises that the responses introduced can be seen as good faith working in English sale of goods law: "*all can be seen as being concerned with the protection of 'good faith'. So too can the reluctance of the courts to allow a buyer…to terminate a contract on the grounds of a minor breach or in order to escape from a bad bargain*".[37]

32 [1988] 58 P & CR 156
33 [1969] 1 AC 552
34 [1933] AC 470
35 *Hong Kong Fir Shipping Co Ltd v. Kawasaki Kisen Kaisha Ltd* [1962] 2QB 26
36 Bradgate, Commercial Law
37 *Ibid*, p. 27

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Section 15A and the use of innominate terms have had a significant impact on the buyers' ability to reject goods in commercial transactions. Section 15A applies to breaches of the statutory implied terms in Sections 13 to 15 of the SGA where the commercial seller's breach would be so minor that it would be unreasonable for the buyer to reject. The importance of innominate terms is that the court will look to the effect of the breach and decide whether the term is a warranty or condition. If it is a condition then the breach is deemed serious enough entitle the buyer to reject. It is clear that both of these provisions attempt to bring a degree of good faith into sale of goods transactions by looking to the impact of the breach rather than the strict wording of the contract. However it is important to note that these provisions can be eliminated. Firstly, parties may contract out of Section 15A subject to the reasonableness test in Section 11 of the Unfair Contract Terms Act 1977 (**"UCTA"**). Secondly, the impact of innominate terms can be reduced by parties expressly and clearly stating that a term is a condition: this eliminates the court's ability to treat the term as a warranty entitling the buyer to damages and not rejection. Whilst this is possible, few contracts are bespoke due to the likely costs and time implications meaning that innominate terms continue to have a large impact. This shows that part of the law already recognises good faith, albeit inadvertently, but its scope can be significantly reduced which highlights the disregard for good faith that parties often have in commercial law.

It is submitted that good faith has a role to play within the law of agency. Agents are of vital importance to commercial law and particularly sale of goods transaction because often sales take place through the use of agents, especially international sales. It is important to note that an agent has the ability to affect his principal's legal position and, therefore, the law will often impose a fiduciary duty on the agent. The importance of the fiduciary relationship is that equity will impose a duty to act in good faith. Millett LJ explained it as "*the distinguishing obligation of a fiduciary is the obligation of loyalty… A fiduciary must act in good faith*".[38] The importance of this statement cannot be over estimated due to the nature of agency within commercial law. Without the use of agents, trade would grind to a halt with sellers having difficulty in reaching their intended market. The scope of good faith has been further extended by the Commercial Agents (Council Directive) Regulations 1993 (the **"Commercial Agents Directive"**). This introduces, for the first time, a duty for principals to act in good

38 *Bristol and West Building Society v. Mothew* [1998] Ch 1, p.18

faith towards their agents[39]. Bradgate says this "*represent[s] another example of the infiltration of civil law concepts of 'good faith' into English commercial law*".[40]

Another area of commercial law that recognises the importance of good faith in transactions, especially sales transactions, is consumer contracts. The importance of good faith in this area of the law is centred on the imbalance between the parties involved. It is a legitimate aim of society to protect consumers against big businesses abusing their powers. A means of protecting consumers is by requiring parties to contract in good faith. Although English law has never expressly recognised good faith, Section 11 of the UCTA has a requirement that parties act "reasonably" when contracting. This was supplemented, particularly in consumer contracts, by the introduction of "good faith" in the Unfair Terms in Consumer Contract Regulations 1999 (**"UTCCR"**). Regulation 5(1) states

> "*a contractual term which has not been individually negotiated shall be regarded as unfair if, contrary to the requirement of good faith, it causes a significant imbalance in the parties' rights… to the detriment of the consumer*".

The leading authority on the interpretation of this regulation is to be found in *Director General of Fair Trading v. First National Bank Plc*.[41] Giving the leading judgment, Lord Bingham stated:

> "*The requirement of good faith in this context is one of open and fair dealing. Openness requires that the term should be expressed fully, clearly and legibly, containing no concealed pitfalls or traps… Fair dealing requires that the supplier should not, deliberately or unconsciously, take advantage of the consumer's necessity, indigence, lack of experience, unfamiliarity with the subject matter of the contract, and weak bargaining position*".[42]

This analysis of good faith is to be commended, not only is it clear and precise but it highlights the sort of activities (in a broad sense) which would constitute a lack of good faith. At face value, it appears that this definition will go a considerable way to eliminating the traditional concerns regarding good faith. However, we cannot be certain that problems will not arise in the future because there has been a lack of case law on the UTCCR generally and, more specifically, on good faith. There are, however, still academics who are hostile

39 Regulation 4(1)
40 Bradgate, Commercial Law, p.117
41 [2001] UKHL 52
42 *Director General of Fair Trading v. First National Bank plc* [2001] UKHL 52, para 17

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towards a notion of good faith, even in consumer contracts. Teuber stated "*the (in)famous European Consumer Protection Directive 1994 transplanted the continental principle of bona fides directly into the body of British contract law where it has caused a great deal of irritation*".[43]

The evidence shows a mixed, and confusing picture on good faith in English commercial law, and especially within sales transaction. No definitive answers can be given on whether there should be a general principle of good faith but the weight of the academic argument against the principle is convincing. Judges and academics have been at pains to point out that English commercial law, unlike many European civil law systems, is based on certainty and that good faith is anything but certain. Despite the hostility and emotion which the subject arouses there is no denying the fact that good faith is within commercial law. Several key areas either recognise, or are based upon, principles of good faith. But even where good faith has been recognised, the reception it has received by English judges has been poor; judges will often go to great lengths to avoid the principle in an attempt to uphold certainty.[44] The evidence shows that the only area of commercial law which is effectively recognising good faith is consumer contracts; a key reason for this is because of the pressure placed on the UK from the European Union, a strong advocate of good faith.

It is respectfully submitted that the current state of good faith in English commercial law is favourable but that any further incorporation would cause damage beyond repair. English law prides itself on certainty and predictability which has been fundamental to its international success. The position is forcefully and articulately stated by Lord Ackner: "*the concept of a duty to carry on negotiations in good faith is inherently repugnant to the adversarial position of the parties when involved in negotiations. Each party to the negotiations is entitled to pursue his own interest, so long as he avoids making misrepresentations…A duty to negotiate in good faith is unworkable in practice*".[45]

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43 Teubner. G., "Legal Irritants: Good Faith in British law or How Unifying Law Ends Up in New Divergencies", (1998) 61 Modern Law Review 11, p.11

44 An example of this is *Shogun Finance v. Hudson* [2004] 1 A.C 919

45 *Walford v. Miles* [1992] 2 A.C 128, p.138

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