Good Faith, Unconscionability and Reasonable Expectations

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The expression 'good faith' makes frequent appearances in contract law. The concept is firmly established in American jurisdictions because of its inclusion in the Uniform Commercial Code,[1] and the Restatement of Contracts.[2] It is in the new Quebec Civil Code.[3] It forms an important part of many other civil law systems, and appears in a number of international documents applicable in common law jurisdictions.[4] Several cases in Commonwealth jurisdictions have adopted it in various contexts.[5]

There has been much academic writing on good faith. English and Commonwealth writers have been divided in their opinions on whether the adoption of a general concept of good faith would be desirable.[6] American writers, however, rarely discuss this question: the concept is sufficiently firmly fixed now for this to be of theoretical interest only.[7] The focus of American writing is on what meaning should be given to the expression, and how it applies in different contexts.

On a question of this sort, where the law is in many jurisdictions apparently in the process of change, two levels of analysis are necessary. It is of interest to examine the probable effect and utility of adopting, in English and Commonwealth law, a general doctrine of good faith. This process involves the identification of problems likely to be caused by the doctrine. It is of theoretical as well as of practical interest, and might well tend to suggest caution on the part of law reformers, legislative, judicial, and academic. But since the concept of good faith has found favour in several jurisdictions where it is unlikely to be decisively rejected, an equally important function of analysis is to suggest ways in which the problems of integrating good faith with other contractual concepts can be minimised. The perspectives of this

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1 UCC s 1-203.

2 American Law Institute, *Restatement of Contracts Second*, (1961), s 205.

3 Article 1375.

4 Convention on the International Sale of Goods, art 7(1), *Principles of International Commercial Contracts*, UNIDROIT, International Institute for the Unification of Private Law, Rome, 1994, art 1.7, European Council Directive on Unfair Terms in Consumer Contracts, art 3(1).

5 See *Renard Constructions (ME) Pty Ltd v Minister of Public Works* (1992) 26 NSWLR 234, 263-71 (per Priestley JA).

6 See, for example, M Bridge, 'Does Anglo-Canadian Law need a Doctrine of Good Faith?', (1984) 9 *CBLJ* 385, R Brownsword, 'Two Concepts of Good Faith' (1994) 7 *JCL* 197. The present writer has counted himself with the sceptics in respect of precontractual duties of disclosure: S M Waddams, 'Pre-contractual duties of disclosure', in P Cane and J Stapleton (eds), *Essays for Patrick Atiyah*, (Oxford, 1991).

7 See E A Farnsworth, 'Good faith in contract performance' in J Beatson and D Friedmann, eds, *Good Faith and Fault in Contract Law*, ch 6, Oxford, 1995: "but then if one could start afresh, I would abandon the term 'good faith' entirely in connection with performance and use it only in connection with purchase. For me, 'fairness' says all that needs to be said in connection with performance. But, alas, it is too late in the day to start afresh".

essay, therefore, will be twofold: insofar as good faith has not yet been accepted, to suggest caution, and insofar as it has, to ask how the concept relates to other concepts of contract law, and how confusion of thought, where that seems to be a danger, can be avoided.

The first point to be noted is that the expression 'good faith' is used in a number of different contexts, with very different meanings in each. The best established use of the expression is in reference to the state of mind of a buyer of property, or of the holder of bill of exchange, as in such expressions as 'good faith purchaser without notice of defects in title'. Here 'good faith' means ignorance of the interest or claim of another person. Secondly, the expression is used to describe the high level of duty owed by agents to their principals, and, more generally, by fiduciaries. Here it means a duty to prefer another's interest to one's own, and not to permit a conflict of duty and self-interest. A third use of the expression is in the context of pre-contractual negotiation, where there may be a duty to bargain in good faith. In this context the meaning of good faith is not so clear. It does not, for example, exclude the frank and open pursuit of self-interest, because it is clear that a prospective seller may usually break off negotiations on the ground that the price offered is inadequate. Also in the field of pre-contractual negotiations, but capable alternatively as being viewed as a contractual defence, is the duty of pre-contractual disclosure, which is often described also as a duty of good faith. Here 'good faith' means a positive obligation to reveal to the opposite party facts adverse to one's own interest.

In their important task of implying terms into contracts, courts often make reference to the parties' duties of good faith. There are, I think, two meanings here of 'good faith', not always clearly distinguished from each other: sometimes the phrase is used to assist the courts in determining what the parties probably in fact intended; at other times it is used to determine what terms are, in the opinion of the court, fair and reasonable in the circumstances. The expressions 'good faith performance' and 'good faith enforcement' suggest that contractual rights, in some circumstances, may not be exercised for motives of self-interest, or for reasons that may be called extraneous or opportunistic.[8] To these usages may be added the concept of 'bad faith breach' of contract, which has been used in several cases to support the punishment of contract breakers by an award of exemplary damages.[9]

Sir Frederick Pollock, in the preface to his *Principles of Contract,* wrote that:

> The law of Contract may be described as the endeavour of the State, a more or less imperfect one by the nature of the case, to establish a positive sanction for the expectation of good faith which has grown up in the mutual dealings of men of average right-mindedness.[10]

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8 See E G Anderson, 'Good Faith in the Enforcement of Contracts', 73 *Iowa LR* 299 (1988) distinguishing between good faith in performance (as part of the definition of contractual rights) and good faith in enforcement (as restraining the exercise of the rights).

9 *Adams v Confederation Life Insurance Co* [1994] 6 WWR 662 (Alta QB).

10 Quoted from preface to fourth edition, 1885.

Lord St Leonards, in *Lumley v Wagner*[11] took an equally expansive view of good faith, saying, in granting an injunction to restrain a singer from singing elsewhere than at the plaintiff's theatre,

> The exercise of this jurisdiction has, I believe had a wholesome tendency towards the maintenance of that good faith which exists in this country to a much greater degree perhaps than in any other.[12]

These words seem a little strange to a modern reader because of their suggestion that English law is more ready than is the law of other jurisdictions to make orders of specific enforcement of contracts. But the relevant point in the present context is that Lord St Leonards, like Sir Frederick Pollock, considered that good faith underlay the whole of contract law, and that it was the enforcement of contracts that primarily manifested respect for good faith.

Good faith, it will be seen, is a multifarious concept, capable of enlarging, or restricting contractual obligations, as occasion may require. It is capable of creating obligations where the parties have not entered into a contract at all, and it offers an overall theory of contract law itself. How, one might ask, can we have neglected for so long a tool that is capable of doing so many useful things? On the other hand, a sceptic might object, there is reason to suspect the claims of tools supposed to be capable of performing so many different tasks.

In some codified systems of law, the doctrine of good faith has been used as a means to support the development by the courts of doctrines not expressly included in the code. It has been said that in German law the doctrine of good faith (*Treu und Glauben*) 'serves as a basis of interstitial law-making by the judiciary' and provides the basis for the award of damages for breach of contract, and for defences equivalent to those of frustration and mistake.[13] No doubt this is a useful consequence in a system where an express codified provision must form the basis of every legal decision. But the idea of good faith is not needed for this purpose in uncodified common law systems, and in other civil law systems it has played a narrower role.

In common law systems it often occurs that the same problem is dealt with by a variety of different techniques, under different names. In such a case the law often develops by the writings of commentators, and by the judgments of courts, which draw attention to the various, apparently disparate, legal techniques, and suggest that they should be brought together under the heading of a single concept. It is arguable that such a development has occurred, or might usefully occur, in respect of unconscionability, or unfairness.[14] That is a case of what is fundamentally the same problem being dealt with in different ways and under differently named doctrines. But, in

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11 (1852) 1 DeG M & G 604.

12 Id at 619.

13 Werner F Ebke and Bettina Steinhauer, 'The doctrine of good faith in German contract law' in *Good faith and fault in contract law*, ch 7, supra n 7.

14 Lord Denning made a generalisation of this sort in *Lloyd's Bank v Bundy* [1975] QB 326, 339. I attempted something similar in 'Unconscionability in Contract' (1976) 39 *Mod LR* 369.

respect of good faith, we observe the opposite phenomenon, viz, quite different legal problems to which the same name is sought to be applied. As the discussion above has suggested, good faith in bargaining cannot mean the same as the good faith owed by an agent to a principal. If all the problems mentioned are to be resolved in terms of good faith, an immediate need arises to subdivide the meaning of the expression. The problem is not just that good faith has a vague meaning (like unconscionability or unfairness) but that it has quite different meanings in different contexts.

There is a linguistic difficulty here, and a consequent danger of circularity of thought. It is possible to explain a result where no duty of good faith is imposed, either on the ground that there is no duty of good faith in the circumstances, or on the ground that there is a duty but no breach of it.[15] A universal duty of good faith, in other words, will not necessarily lead to predictable results in particular cases. At its most general, indeed, the concept of good faith tends to merge with that of justice or equity.

An analogy with these wider concepts may, therefore, be useful. It can truly be said of the present law in all jurisdictions that no legal right may be exercised in a manner that is inequitable, because, if equity will grant relief, the right is thereby restricted. Lord Denning suggested the same relation between legal rights and justice itself when he wrote in 1979 that:

> a judge aims at preventing a party from insisting upon his full legal rights when it would be unjust to allow him to enforce them.[16]

The circularity here is obvious to us, and so, for example, a modern lawyer would not say that a person had a legal right to enforce a contract, where the contract was voidable in equity for misrepresentation. Equity, regularly administered, becomes part of the law itself. The same can be said of another related concept, common in civil law systems, that is, abuse of rights. If rights cannot be enforced in certain circumstances, because enforcement would constitute an abuse, then it may accurately be said that the right, to the extent that it is not enforceable, is restricted. Similarly, a contractual right that is only enforceable in good faith, may be said to be restricted to the extent that it is not enforceable. This is not to say that the concept of good faith is meaningless or useless, any more than the concepts of equity or of justice are meaningless or useless. But it is to suggest that the relationship between a right and a principle restricting the exercise of the right is more complex that might at first appear.

Good faith, unconscionability and reasonable expectations are concepts that sound somewhat similar, and the terms are sometimes used together to signify (usually with approbation) what might be summarised as a flexible approach to contract law, avoiding rigid rules, and emphasising justice in the individual case, even at the cost of stability and predictability. However, I would suggest that good faith is related in very different ways to each of the other two

15 The Second Restatement of Contracts, for example, while imposing a duty of good faith, does not envisage that it would require disclosure, by a buyer of land, of valuable mineral deposits unknown to the seller. See illustration 10 to s 161.

16 *The Discipline of Law*.

concepts mentioned. None of the three concepts is precise, but reasonable expectations and fairness, as basic concepts, have an understandable content. It is more difficult to say the same of good faith.

The reasonable expectations of the promisee are commonly taken to define the scope of contractual obligation. Good faith, as understood, for example, by Pollock and by Lord St Leonards in the passages mentioned above, would tend to favour protection of the promisee's reasonable expectations, and enforcement of the obligations of the promisor accordingly. It is, certainly, inherent in the expression 'reasonable expectations' that expectations should be protected only so far as reasonable, but this has nothing to do with the motives of the promisee. An unreasonable expectation is not protected however much the promisee honestly and in good faith believes that she is entitled to it. Noone has proposed that we should substitute for the reasonable expectation test, one based on the subjective expectation or motives of the promisee.

Here it is of interest to consider the cases on written documents and the admission of extrinsic evidence. In a variety of cases the courts have admitted evidence to prevent a party from relying on the terms of a written document. The clearest example is rectification, or reformation, which (in the simplest case) prevents a party from taking advantage of a clerical error in a document. It might perhaps seem attractive to explain such a result as an instance of application of a doctrine of good faith. However, the right to rectification does not depend on the bad faith of the promisee. A promisee wholly ignorant of the error, and therefore, morally speaking, wholly innocent, still cannot enforce the document. In *Paget v Marshall*[17] the court declined 'in charity and justice to the defendant . . . to impute to him the intention of taking advantage of any incorrect expression' in the document. Nevertheless the defendant was not permitted to enforce the document, and the result, though it has been doubted,[18] may be defended on the ground that the court found that the defendant had no reasonable expectation that the document embodied the true intent of the promisor.

In other cases, signed documents have been avoided by use of the doctrine of equitable fraud, in order to prevent a party from using a document contrary to the parties' understanding.[19] Again, no proof is required that the party seeking to rely on the document was in any way fraudulent, or lacking in good faith, at the time of the contract. The objection to enforcement is the same, whether the promisee intended all along to deceive the promisor, or whether the promisee decided only after the document had been executed to attempt to enforce it according to its terms. The fraud, insofar as there is any actual fraud, may be said to be a fraud on the court in seeking the aid of the court to enforce a document that must now be conceded not to represent the promisor's true intention. In this sense, the concept of equitable fraud tends to merge with the concept of equity itself, or justice.

17 (1884) 28 Ch D 255.
18 See *Riverlate Properties Ltd v Paul* [1975] Ch 133 (CA).
19 *Farah v Barki* [1955] SCR 107, *Long v Smith* (1911) 23 OLR 121 (Div Ct) .

In many cases it has been held that a promisee may not effectively accept an offer known to be mistaken in its terms.[20] Again, it might seem tempting to explain these cases as instances of a principle of good faith, and indeed the legal rule does, incidentally, tend to prevent bad faith. But the principle is wider. The test is not whether the promisee acted in bad faith, but whether the promisee had a reasonable expectation. However honest and pure the motives of the promisee, she cannot enforce terms that were not reasonably to be attributed to the promisor. All the cases of mistake in contractual terms, including the cases on written documents, are cases in which good faith might be said to be enforced, but it is enforced incidentally, by means of the wider, more stable, and more predictable principle of protecting only reasonable expectations.

Unconscionability, or unfairness, in jurisdictions where it is recognised as a general defence, supplies a defence to contractual obligation. The explanation of such a defence can only be found in the notion that there are values that have to be weighed against the values that favour enforcement of contracts. Even though the promisee has a reasonable expectation, the promisor may yet escape liability for sufficient countervailing reason. This countervailing reason is widely taken to be the avoidance of unjust enrichment. Our concept of freedom of contract tolerates enrichment, by the enforcement of profitable bargains, to a considerable extent, but when the enrichment is very great, and when bargaining power is very unequal, the values that favour contract enforcement eventually face a serious challenge.

This view of unconscionability is not universally held,[21] but if it is accepted it will be seen that a principle of good faith is no substitute. If a contract, to use a well known definition of unconscionability, causes the promisee to derive an immoderate gain from an inequality of bargaining power, it ought to be set aside, whether or not the promisee can be said to have acted in good faith. The enrichment is the same whether the promisee cynically calculated the gain, or whether he naively thought he was paying full value, and it is the same whether or not the promisee knew of the weakness in the promisor's bargaining power. The substitution of good faith as a criterion would tend to weaken the protection given to weaker parties.

This consideration points to a possible difficulty in the terms of the European Council Directive on Unfair Terms in Consumer Contracts:

> 3(1) 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 and obligations arising under the contract, to the detriment of the consumer.

There is much to be said, where there is inequality of bargaining power, for giving the courts power to set aside a contractual term that 'causes a significant imbalance in the parties' rights and obligations, to the detriment' of the weaker party. But, if these conditions are satisfied, it should not be

20 *Smith v Hughes* (1871) LR 6 QB 597, *Taylor v Johnson* (1983) 151 CLR 422.

21 Some modern cases and commentators have used the word 'unconscionable' with reference to conduct. The older usage, however, and that of the Uniform Commercial Code (s 2-302), applies the word unconscionable to the contract itself, or a clause of it, not to the conduct of the party seeking enforcement.

necessary, in my view, for the weaker party to establish what was the stronger party's state of mind, or what were her motives. The phrase 'contrary to the requirement of good faith', therefore, seems superfluous, and potentially damaging to the interests of the consumer. How damaging in practice will depend, of course, on the interpretation given to the phrase and in a jurisdiction where the Directive is binding, the arguments just made would necessarily be recast in the form of arguments in favour of an objective interpretation of the phrase, to mean something like 'commercial standards of fair dealing'.[22] But, it may be observed, this is very far from the ordinary meaning suggested by 'good faith'.

In *Interfoto Library Ltd v Stilletto Ltd*[23] the question was of the notice necessary for the incorporation into a contract of an onerous clause in an unsigned document. The English Court of Appeal held that the clause was not incorporated because insufficient notice of it had been given. Bingham LJ suggested that this problem would in other jurisdictions, and might with advantage in English law, be resolved by a principle of good faith. He added:

> The well-known cases on sufficiency of notice are in my view properly to be read in this context. At one level they are concerned with a question of pure contractual analysis, whether one party has done enough to give the other notice of the incorporation of a term in the contract. At another level they are concerned with a somewhat different question, whether it would in all the circumstances be fair (or reasonable) to hold a party bound by any conditions or by a particular condition of an unusual and stringent nature.[24]

Good faith, however, is something different from a test either of reasonable notice, or one of fairness. The clause in the *Interfoto* case would have been equally unfair, and the notice of it would have been equally insufficient, if the plaintiff had acted throughout in the honest (but erroneous) belief that the clause was perfectly fair and reasonable, and that ample notice of it had been given. If the court recognises that reasonable notice of the clause must be given, and that the clause must be fair and reasonable, a principle of good faith is not needed, and to rest the result on good faith might suggest the additional need for the defendant to establish misconduct or bad motive on the plaintiff's part.

Perhaps the longest established use of concepts of good faith is in the implication of contractual terms. As I have already suggested, an attempt to determine what the parties actually intended tends to merge with the implication of terms that are fair and reasonable in the view of the court. It is inevitable that such a merger should occur. The curious ambiguity in the word 'construction', derived alternatively from the verbs 'construe' and 'construct' is significant. No words, even those that we call express, have meanings that are perfectly clear: construction in the sense of interpretation will always involve a certain amount of construction, in the sense of new building. Many

22 See UCC s 2-103 (1)(b). This is similar to the interpretation of the Directive suggested by S A Smith, 'Contract' [1994] *CLP* 5, 8. Substantially different views of the meaning of the phrase are taken by H Collins, 'Good Faith in European Contract Law' (1994) 14 Ox JLS 229, 253-4, and by E McDonald [1994] *JBL* 441, 157.

23 [1989] 1 QB 433 (CA).

24 Id at 439.

well-known cases have held that terms are to be implied into contracts that parties will cooperate with each other, and obligations have been imported in order to make the contract operate in a way that is fair and reasonable. It cannot be doubted that concepts of good faith have played a very important part in this branch of the law.

Nevertheless, the results reached by the courts by the technique of implied terms could not be satisfactorily rested on good faith, in the ordinary sense of the expression. The actual motives and intention of the promisor, at the time of the contract, and at the time of performance, are, and surely must be, irrelevant. Consider the leading English case of *Liverpool City Council v Irwin*,[25] where the House of Lords held that a landlord impliedly undertook, in its contract with a tenant, to maintain the common areas of an apartment building. The actual motives of the landlord were irrelevant. It may not have thought of the question at the time of the contract, or it may have thought (honestly but mistakenly) that it had no such duty. At the time when performance was sought, the landlord may well have thought, again in perfect good faith, that it had no such obligation as was alleged. This would have been quite a reasonable thing to think, since it required litigation in the House of Lords to establish the contrary. The result of the case is highly defensible, but the defence rests on considerations of the reasonable expectations of the tenant, linked in the way I have suggested with considerations of fairness. Good faith is not a satisfactory explanation of the result; or, to adopt the alternative level of analysis that runs through this essay, if we should be compelled to rest the result on good faith we would have to define good faith in such a way as, in effect, to incorporate considerations of reasonable expectations and of fairness.

A related point is that contractual liability is strict. The obligation imposed in *Liverpool City Council v Irwin* was only an obligation to use reasonable care, but this is judged objectively. The landlord will be in breach of the implied obligation if the standard of reasonable care is not met, however much the landlord may think in good faith that it is doing enough for its tenants. In other cases, even the use of due care will be insufficient, as is well established by the cases imposing strict liability on sellers of defective goods.[26]

Good faith is often discussed in the context of termination of contracts. It sounds attractive to say that the parties have a duty of cooperation, and therefore that a right of termination can only be exercised in good faith. But the entering into a contract with a person does not and cannot import a duty to cooperate with that person for all time and in all spheres: the duty can only be to cooperate within the scope established by the contract itself. The contract creates the duty, and the contract can limit it, as, of course, all contracts do, because contractual obligations terminate by reason of the definition of the scope of the contract, by the effluxion of time, and by the occurrence of reasons for termination set by the terms of the contract itself.

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25 [1977] AC 239 (HL).

26 *Frost v The Aylesbury Dairy Co* [1905] 1 KB 608 (CA), *Henry Kendall and Sons v William Lillico and Sons* [1969] 2 AC 31, at 84 (per Lord Reid), *Buckley v Lever Bros* [1953] 4 DLR 704.

To say that parties to a contract envisage, or ought to envisage, nothing but cooperation would be an oversimplification, even within the sphere in which the contract operates. Frequently adversity of interest is foreseen, and attempts are made in contracts to provide for it in various ways. Almost all contracts include provisions, express or implied, that they shall terminate in certain circumstances. Since the contract is the sole source of the parties' obligations, there can be no objection in principle to such provisions. There would be a circularity in treating reliance on such a provision as, in itself, a breach of a duty of cooperation, because the duty can only be to cooperate to the extent agreed by the contract itself.

Termination of a contract earlier than expected often causes disappointment to the opposite party, and may cause a forfeiture. For these reasons the courts quite readily accept arguments against termination, based on interpretation and fairness. These are methods by which the courts, as I have suggested, protect the reasonable expectations of the parties, and prevent unconscionability. As has been pointed out, these protections are available even against a party who acts throughout in good faith. In order to test the proposition that a right of termination can only be exercised in good faith, we must suppose a right of termination that has passed the tests of interpretation and unconscionability, in other words, a termination clause that is clear, fair and reasonable, and agreed for adequate consideration between parties of equal bargaining power.

The motive of a party seeking to terminate a contract almost always includes a large element of self-interest. Suppose a contract provides that the party to whom a payment is due may give notice, and on failure of payment within ten days, may terminate the contract. The motive of the party terminating under such a clause is almost always that the contract is unprofitable. Can such a motive be described as bad faith, or, putting the question another way, is there any principled reason why the party (apparently) entitled to terminate should not do so?

The notion that a contractual right that is clear fair and reasonable nevertheless cannot be exercised involves theoretical problems of circularity, as suggested earlier. There would also be a practical problem in a rule that termination is permissible only if the motives of the party seeking to terminate are not self-interested, or if they do not include considerations extraneous to the breach itself. It would scarcely be a workable rule that the party to whom payment was overdue could terminate only if her true motive were love of punctuality. Such a rule, if it could even be seriously contemplated, would involve costly enquiries into the state of mind of the party purporting to terminate, and would create perverse incentives. The party seeking to terminate would presumably be advised to think very hard, while writing the crucial letter, about the evils of unpunctuality, and to think not at all about the balance sheet disclosing the unprofitable nature of the contract.

Insurance contracts are contracts where good faith is undoubtedly required for purposes of disclosure of relevant facts. Indeed, they are said, rather colourfully, to be contracts of the very richest good faith (uberrimae fidei). But no-one doubts that an insurer (with proper notice, and after expiration of grace periods) can terminate an insurance contract for non-payment of premiums, even if, as is usually the case, the insurer's motive is that the risk has become uninsurable, or undesirable at the premium previously agreed.

Even in cases where contracts are terminated for bad motives in the sense that the party terminating gives a wholly improper reason that does not entitle her to terminate, the termination is valid if there was in fact some other ground justifying termination. Conversely, if termination is not, by the terms of the contract, justified, a purported termination is invalid, however benign the motives of the party purporting to terminate. Good faith, therefore, seems an unsatisfactory basis for this branch of the law.

The decision of the English Court of Appeal in *Cehave NV v Bremer Handelgesellschaft mbH*[27] may offer an illustration. Here goods were delivered that, though damaged, could still be used for their intended commercial purpose. The buyer purported to reject the goods, which it then repurchased through judicially ordered proceedings at about one-third of the contract price. The court held that the buyer's purported rejection was ineffective, on the ground that rejection was only permitted in case of serious breach, and the seriousness of the breach was to be judged by its commercial consequences. It may seem attractive to explain this case as depending on a principle of good faith, but the reasoning of the court did not depend on the buyer's state of mind. The buyer would not have been entitled to reject even if the buyer had honestly, but mistakenly, thought that the damaged goods were worth only a third of the contract price. Some business persons, or their legal advisers, might support the old rule on this point (any defect justifies rejection); others might favour the new rule (it depends on the commercial consequences of the breach); few would, I think, be inclined to favour a rule that the right to reject should depend on the actual motives of the buyer, a rule that would involve costly enquiries and create incentives to assemble unreliable and self-serving evidence of good motive.

An option must be exercised according to its terms, and so it would usually be held that a purported exercise of an option after the time limit had expired was ineffective, and that the option granter could deny liability. As with termination, the motive of the option granter in such cases is usually that she now regrets the terms of the option. She is entitled to act from motives of self-interest in rejecting the late exercise of the option, just as she would be entitled to refuse, for reasons of self-interest, to enter into a new contract with anyone else. Few would say that such a motive constituted bad faith. The exercise of a right of termination, it may be suggested, is similar in principle.

27 [1976] QB 44.

A right to renew a contract is indeed often expressed in the form of an option, and an option in one party to renew on certain conditions may be precisely equivalent to a right in the other party to terminate in the absence of those conditions.

At this point we come to the question of a duty to negotiate in good faith. It was said in *Walford v Miles*[28] that 'a duty to negotiate in good faith is as unworkable in practice as it is inherently inconsistent with the position of a negotiating party'. A duty to negotiate in good faith is, however, recognised in some contexts, for example in labour law, where an employer and a union may have a statutory duty to negotiate in good faith. Good faith in this context does not exclude self-interest, and it is generally accepted that employers and unions, while bound to listen to proposals, may refuse those that they consider unsatisfactory. This would seem to be a necessary feature of a duty to negotiate in good faith. Entering into negotiations would be a very dangerous step if it carried with it an inability to withdraw.

The cases on contract modification, where one party demands a higher price for a performance already promised, would be affected by a duty to negotiate, or renegotiate in good faith. Several recent cases have held that where a contract is renegotiated in such circumstances, the promise to pay the higher price is, in the absence of duress or its equivalent, enforceable.[29] In considering these cases in the light of good faith, it might at first be supposed that it is the party seeking the modification who might be said to be acting in bad faith, and the terms opportunism and strategic behaviour have been used in connection with that party's behaviour.[30] It has always been assumed in discussion of these cases that the party resisting modification is entitled to insist on his strict contractual rights, and to sue for damages in case the threat of breach is implemented. But if there is a duty to renegotiate in good faith, these cases will appear in an entirely new light. In the typical case of this kind there is an agreement to render a performance for a certain sum, followed by a threat of breach by the party promising performance coupled with a demand for an increase in the contract price. If there really is a duty incumbent on the paying party to renegotiate in good faith, there may be an obligation at least to give serious consideration to such proposals. It is not very easy, however, to reconcile this notion with the principle, always assumed in the modification cases, that the original contract is fully binding.

Some of the difficulties here alluded to may be seen in a 1990 decision of the US Seventh Circuit Court of Appeals, *Kham and Nate's Shoes, No 2 v First Bank of Whiting*.[31] A bank granted a $300,000 line of credit to a lender, reserving the right to terminate financing on five days' notice. After advancing $75,000, the bank gave the notice, and refused to lend any more money. The District Court held that the bank was in breach of a duty of good faith. The Court of Appeals reversed, Judge Easterbrook saying:

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28 [1992] 2 AC 128.

29 See *Williams v Roffey Bros and Nicholls (Contractors) Ltd* [1991] 1 QB 1 (CA).

30 See V A Aivazian, M J Trebilcock, and M Penny, 'The law of contract modifications: the uncertain quest for a benchmark of enforceability', (1984) 22 *Osg HLJ* 173.

31 908 F 2d 1351 (CA-7, 1990).

> Although courts often refer to the obligation of good faith that exists in every contractual relation . . . this is not an invitation to the court to decide whether one party ought to have exercised privileges expressly reserved in the document. . . . When the contract is silent, principles of good faith . . . fill the gap. They do not block use of terms that actually appear in the contract. . . . The $300,000 was the maximum loan, not a guarantee. The bank exercised its contractual privilege after loaning debtor $75,000 . . . It had the right to do this for any reason satisfactory to itself. . . . The bank was entitled to advance its own interests.[32]

This decision was vigorously criticised by an academic writer, Professor Patterson, on the ground that Judge Easterbrook had confined himself to too literal an interpretation of the words of the contractual document.[33] It may be conceded to Professor Patterson that interpretation is not a simple task, and *does not depend solely on what may be supposed to be the literal meaning of* written words. As is apparent from this essay, I would concede also that a contractual clause should not be enforced if unfair (and, despite the imprecision of the concept, it is possible to imagine that such clauses might be unfair). But, if those two questions are decided in the bank's favour, surely Judge Easterbrook must be right. His conclusion may be paraphrased by saying that there is no contractual principle on which the bank can be held liable for not lending money when it had not promised to do so. This is so, whatever may be the motives of the bank.

There are many cases deciding that when money is repayable 'on demand', the creditor cannot expect or require instantaneous repayment: even the most conservative courts have held that, at the very least, the debtor must be allowed the minimum time that a solvent person would require to raise the sum in question. Professor Patterson is right to this extent. Literal interpretation of the phrase 'on demand' would be impossible: the debtor is not expected to have the total amount of the debt at all times in cash in her back pocket. But this example shows that the proper interpretation of the words of the contract does not depend on the motives of the creditor, but on the parties' reasonable expectation. However honest the creditor in demanding instant repayment, the debtor's obligations will not be enlarged. On the other hand, if the creditor has not promised (on a fair interpretation of the contract) to extend further credit, there is no contractual principle on which it can be compelled to do so, any more that it could be compelled to make an initial loan in the absence of any contractual relationship at all.

Here we come to the vexed question of excludability of a duty of good faith. It is common for proposals for a principle of good faith to be combined with a provision to the effect that the duty of good faith cannot be excluded.[34] The

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32 Id at 1357-1358.

33 D M Patterson, 'A fable from the Seventh Circuit: Frank Easterbrook on good faith', 76 *Iowa LR* 50 (1991).

34 See Ontario Law Reform Commission, *Report on Amendment of the law of contract*, (Toronto, 1987), *Principles of International Commercial Contracts*, (UNIDROIT, 1994), art 1.7 (2) ('The parties may not exclude or limit this duty').

Uniform Commercial Code provides that the duty may not be disclaimed by agreement, adding however the significant words, 'but the parties may by agreement determine the standard by which the performance of [their] obligations is to be measured if such standards are not manifestly unreasonable'.[35]

The exclusion by contract of what would otherwise be contractual rights is not in itself objectionable. There is no obligation (generally speaking) to enter into contract in the first place, and so no wrong is done to the promisee if the promisor uses language that has the effect of first describing a large obligation and then detracting from it. As Professor Brian Coote pointed out in 1964, this is simply a technique of defining the scope of the obligation.[36] Provided that it is clear and (I would add) not unfair, it is a wholly legitimate and often very useful way of defining obligations.

Difficulties arise at this point with the notion that a duty of good faith cannot be excluded. Let us consider again the term implied in *Liverpool City Council v Irwin* to the effect that the landlord was obliged to maintain the common areas of an apartment building. Let us suppose further that this case is decided in a jurisdiction that recognises a duty of good faith, and that the conclusion is based on that principle. Suppose now a subsequent case in which the principal tenant in a mixed-use building is a large commercial enterprise, and the lease contains a clause that the tenant will maintain the common areas of the building. Let us suppose that this is clearly expressed and understood by the parties, and that it is perfectly fair and reasonable, the parties being of equal bargaining power, and the tenant assuming this obligation as a matter of convenience to both parties, and for an appropriate reduction in rent. According to ordinary contractual principles that promise ought to be enforceable, for it represents the reasonable expectation of the promisee, and it is not unfair. But if, in former cases, the landlord's usual obligation to maintain the common areas has been rested on a duty of good faith, it will be arguable that the clause now contemplated is void as excluding a duty of good faith. One would hope, of course, that such an argument would fail, and such a proviso as that in the Uniform Commercial Code to the effect that the parties may set standards of performance would tend to assist in this objective. But the necessity of the proviso, and the uncertainty of its scope, show the danger of confusion of thought on this question.

The question whether there is, or should be, a doctrine of good faith in English and Commonwealth law is, it will be seen, more complicated that it might at first appear to be. Good faith, Pollock might have said, is everywhere in English contract law. But if it is everywhere, it cuts both ways on all difficult questions. For whenever it can be said that one party must act in good faith in exercising contractual rights, it can, with equal force, be said that the other party must also act in good faith in not attempting to claim a contractual performance that has not been promised. My conclusion is that good faith plays an important part in determining the reasonable expectations of the parties, and in determining the fairness of their agreements, but that an

35 UCC s 1-102.

36 B Coote, *Exception Clauses*, (London, Sweet & Maxwell, 1964).

overriding duty of good faith, independent of the concepts of expectation and fairness, needs to be handled with care.