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Breaking down good faith: the importance of context

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English law does not have a general doctrine of good faith. Instead, it may imply a duty of good faith in certain categories of contracts (i.e., so-called ‘relational’ contracts¹), but otherwise parties are free to include express obligations of good faith in any contract. This, however, can create uncertainty as it then falls to the courts to interpret the scope of the duty of good faith contained in such a clause, which is what happened in the case of *Re Compound Photonics Group Ltd; Faulkner v. Vollin Holdings Ltd* ².

Facts

The case concerned two minority shareholder claimants, Dr Sachs and Mr. Faulkner, both of whom were removed from office as directors by the majority shareholders of Compound Photonics Group Limited (“**CPGL**” or “**the Company**”). The minority shareholders, bought an unfair prejudice petition against the majority shareholders, contending that the removal of their two appointed directors had unfairly prejudiced their rights as shareholders, in particular, due to a breach of a good faith obligation imposed on the majority shareholders in the shareholders agreement.

The High Court granted the petition, however, the Court of Appeal overturned the High Court’s decision, adopting a restrictive approach to the interpretation of the good faith clause.

Background and High Court decision

CPGL was founded in 2004 by Dr. Sachs and subsequently, Mr. Faulkner invested in the Company. Further funding was provided by three entities, including Vollin Holdings Limited. By 2013, Dr Sachs, Mr Faulker and 68 other minority shareholders held 7% of the Company and 93% of the Company was held by the three entities including Vollin (“**the Investor(s)**”). To reflect this, the Company’s articles of association provided that:

“7.8 ... the quorum for the transaction of business at any board meeting shall be three directors and shall include (insofar as they each remain a director) the [Mr Faulkner], [Dr Sachs] and, if one or more has been appointed, an Investor Director.

7.13 ... resolutions arising at any meeting of the Directors shall be decided by a majority of votes provided that both of [Mr Faulkner] and [Dr Sachs] must at all times form part of that majority...”

¹ *Yam Seng Pte Ltd v International Trade Corporation Ltd* [2013] EWHC 111 (QB); *Bates v Post Office Ltd* (No 3) [2019] EWHC 60 - ‘relational’ contracts are typically long-term contracts, which involve a high level of communication between the parties and otherwise show an intention of fidelity by the parties, amongst other non-exhaustive factors which are listed in these cases. Thus, whether a contract is relational or not is determined in its context. Recently, the Court of Appeal held in *Candey Ltd v Bosheh* [2022] EWCA Civ 1103 that a good faith obligation would only be implied in relational contracts in fairly restricted circumstances.

² [2022] EWCA Civ 1371

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The new shareholders agreement contained a good faith clause, clause 4.2, which provided that:

“Each Shareholder undertakes to the other Shareholders and the Company that it will at all times act in good faith in all dealings with the other Shareholders and with the Company in relation to the matters contained in this Agreement.”

In their claim, the minority shareholders asserted that the minority shareholder directors were entrenched in office (articles 7.1-7.13 of the Company’s articles) such that the majority shareholders were not entitled to vote them out, and that in doing so, they had breached the good faith obligation imposed on them by clause 4.2 of the shareholders agreement.

In the High Court, Mr. Justice Adam Johnson followed the approach of the court in *Unwin v Bond*,³ which set out a prescriptive checklist of ‘minimum standards’ required by a good faith obligation, including that the parties must:

- act honestly;
- be faithful to the parties’ agreed common purpose as derived from their agreement;
- not use their powers for an ulterior purpose;
- deal fairly and openly with the claimant; and
- have regard to the claimant’s interest but can consider and take into account their own interests.

Applying these ‘minimum standards’ to the Company’s articles and the shareholder’s agreement, the judge inferred that the parties’ ‘common purpose’ was that the minority shareholders would maintain control of the board through their shareholders, who were entrenched in their positions. As a result, the removal from office of these two directors was found to be a breach by the Investors of their good faith obligation, which required them to ‘be faithful to the parties’ agreed common purpose’.

The Investors appealed, claiming that the judge was too broad in his interpretation of the good faith clause.

Court of Appeal judgment

The Court of Appeal held that that there was no agreement that the minority shareholders were entrenched in office and that the Investors had not breached the good faith obligation.

In reaching this conclusion, Lord Justice Snowden, in his lead judgment, provided guidance on the correct interpretation of a good faith clause. He clarified that it would not be right to apply the ‘minimum standards’ set out in *Unwin v Bond* in a formulaic way to each case but rather, a good faith clause (like any other clause in a

³ [2020] EWHC 1768 (Comm)

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contract) is to be interpreted in the context in which it is used.⁴ He also determined that principles applied in cases decided on different facts are of limited value and must be treated with considerable caution. He went on to further clarify that since English law has resisted recognising a general duty of good faith, it would be wrong to refer to or rely on concepts in other legal systems (many of the cases referred to by the High Court judge were determined in other legal jurisdictions).

With reference to the case at hand, he determined that the judge was wrong in his assessment of the 'common purpose' of the parties. He stated that if the 'common purpose' was to have the minority shareholder directors entrenched in office, as the judge held, the shareholders agreement should have contained an express provision precluding the majority shareholders from voting at any general meeting in favour of the removal of them from office. In the absence of any such express provision, it was wrong of the judge to presume that the good faith clause prescribed how the parties behaved beyond, or in contradiction to, the objective intention of their agreed terms.

The net result, according to the Court of Appeal, was that the duty of good faith in clause 4.2 simply imposed on the shareholders the duty to act honestly towards each other and the company. It also included a duty not to act in bad faith towards each other (i.e., 'conduct that reasonable and honest people would regard as commercially unacceptable, but not necessarily dishonest').⁵

Comments

In light of the Court of Appeal judgment, parties to a contract will take comfort in the fact that good faith clauses, like any other clauses in a contract, will be determined with reference to their context and not a standardised checklist of obligations (as the High Court decision purported to do). However, the practical effect of this judgment remains that there is no defined scope of the duty of good faith under English law and that each case will turn on its own facts. It is still important to note that, at the very least, a party subject to a good faith clause must act honestly but whether the duty extends further will be determined in the context of the agreement.

As a result, parties seeking to impose specific obligations on other parties or restrict certain rights must clearly provide for these through express and unambiguous terms in their contracts. If parties choose to include a good faith clause to encourage another party to act honestly with regards to a common purpose, the common purpose should be clear from the express terms of the agreement so as to avoid the court interpreting the good faith clause in a way that does not benefit that party or indeed, in a way that neither party anticipated. As this remains an evolving area of the law, it will be interesting to see how the law develops in future cases.

⁴ See *Compass Group UK and Ireland Ltd (t/a Medirest) v Mid-Essex Hospital Services NHS Trust* [2013] EWCA Civ 200 at [109] and [150]- [151], where Jackson and Beatson LJ held that a duty to co-operate in good faith was 'heavily conditioned by its context'.

⁵ *Yam Seng Pte Ltd v International Trade Corporation Ltd* [2013] EWHC 111 (QB)