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Cathay Pacific Airways Limited v. Lufthansa Technik AG - the extent to which contractual rights be limited by considerations of good faith or a duty to act "rationally"?

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A recent case determined by the Chancery Division of the High Court of England and Wales – *Cathay Pacific Airways Limited v. Lufthansa Technik AG* [2020] EWHC 1789 (Ch) - provides an interesting insight as to the circumstances and manner in which apparently unfettered rights of parties under commercial contracts may or may not be constrained by the implication of terms. In particular, it considers whether the exercise of contractual rights may be constrained by the implication of terms, including as to "good faith" and or whether they may be subject to considerations to act rationally.

The case demonstrates that in the context of a complex commercial agreement agreed between sophisticated parties who have been aided by lawyer, a right granted to one party that appears to be absolute and unqualified may indeed be just that. However, it highlights the potential for the outcome to be different and demonstrates the need for commercial parties drafting contracts to give thought to that possibility and to take care to seek to exclude terms that would impose constraints on otherwise absolute contractual rights.

The case arose out of a contract by which Lufthansa Technic AG ("**LHT**") was to provide aircraft engine maintenance services on a long-term basis to Cathay Pacific Airways Ltd ("**CX**" as it was defined in the judgment) (the "**Agreement**"). A dispute arose about the sum due under the Agreement and whether an amount was to be paid by CX to LHT or by LHT to CX. This issue arose upon the exercise by CX of an option under clause 21.2 of the Agreement which allowed it to remove engines from what was called the "Flight Hour Service programme" ("**the Option**").

The relevant part of clause 21.2 provided:

> *"CX may at its option remove Engines from the Flight Hours Service programme prior to the completion of the Term. A financial reconciliation will be performed with respect to each engine removed from the Flight Hours Service programme in accordance with Schedule 13…"*

LHT's contentions – advanced with the aim of constraining CX's entitlement to exercise the Option

LHT contended that it did not owe any sum to CX because the Option was not validly exercised by CX. LHT advanced three main arguments:

a. that on its true construction, alternatively by way of necessary implication, the Option only operated to allow CX to remove engines for "operational reasons" from the fleet. It was common ground that the engines had not been removed for operational reasons.

b. that the exercise of the Option is subject to a "*Braganza/Socimer"* type limitation (named after *Braganza v. BP Shipping* [2015] UKSC 17 and *Socimer International Bank v. Standard Bank London* [2008] 1 Lloyd's Rep 558) such that it may not be exercised in an arbitrary and/or unreasonable manner and that the Option was in fact exercised in such a manner by CX.

c. the Agreement is a "relational contract" and therefore the Option is subject to a more general good faith limitation. LHT contended that this meant the Option could only be exercised in a way that will be regarded as commercially acceptable by reasonable and honest people and that it was in fact not exercised in such a manner.

CX's contentions – advanced in support of its contention that its entitlement to exercise the Option was unconstrained

CX's position was that all of the above was wrong. It contended that this was a straightforward unilateral option that gave it the absolute right to remove engines from the programme (it was not limited to being able to only do so for operational reasons) with the result that a sum was payable to it by LHT in accordance with the Agreement. There was no *Braganza/Socimer* limitation on the Option or good-faith restriction of any kind on CX's right to remove engines from the fleet.

The judgment

In the event, CX's contentions were vindicated.

It is interesting, however, to consider the basis on which the court refused to find for LHT because it casts light on the limitations of contentions as to the existence of good faith obligations or other constraints on what are otherwise apparently absolute rights in the context of commercial contracts.

1. The proper construction of the provision as to the Option

The judge noted that *"on its face and as a matter of ordinary language, the clause appears to grant CX a unilateral option to withdraw any number of Engines from the Flight Hours Services Programme at any time prior to the Term".* Then looking to the language of the contract and its other provisions, the judge found no basis to construe the express provisions of the Option differently so as to impose any qualification on the Option along the lines suggested by LHT that engines could only be removed for operational reasons. Having considered whether there was any mutual understanding between the parties as to the meaning of the provision (rejecting that there was, but also having already determined that any evidence of this was inadmissible), and having looked at the factual matrix and again having rejected the contention that this led to the Option being construed such that engines could only be removed for operational reasons, the judge determined that:

> *"in short, there is no ambiguity in the language of Clause 21.2. There is nothing in the admissible factual matrix, or in the genesis of the Option which causes me to interpret it as containing a qualification that it may only be used in [sic] for Engines removed for operational purposes from the Fleet, as contended by LHT".*

2. Implied terms

Only for "operational reasons"?

The judge then went on to consider whether the Option was qualified by any implied terms.

LHT sought first to establish that the Option was qualified by an implied term that CX was entitled to remove engines only for operational reasons.

The judge applied the standard test for implying terms, namely whether the term sought to be implied was "so obvious as to go without saying" or that it is necessary to give business efficacy to the contract. The judge found that there was no basis to imply any such term.

Was there a *Socimer/Braganza* implied term?

LHT argued for a second implied term. Namely that the Option may not be exercised "in an arbitrary and/or capricious and/or unreasonable way".

This contention was founded upon the two cases mentioned above – *Socimer* and *Braganza* – and a number that followed these which established that sometimes contractual rights are subject to what has come to be known as a duty to act rationally in the exercise of them.

The judgment contains a reminder that this line of cases represents an exception to the general rule of English law that *"it has never been the law that a person is only entitled to enforce his contractual rights in a reasonable way, and that a court will not support an attempt to enforce them in an unreasonable way…"* (this was stated in *White & Carter (Councils) Ltd V McGregor [1963] AC 413*).

Having reviewed the authorities that provide the exception to the general rule, the judge determined that:

> i. the Option was much closer in nature to the types of clauses which have been held by the courts *not* to be subject to a *Socimer/Braganza* type implied term than to those which have been held to be subject to such a term.
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> ii. the option was closely analogous to the clause considered in the recent case of *TAQA Bratani Limited v. Rockrose* UKCS8 LCC [2020] EWHC 58 (Comm)[1] which concerned a contractual provision in a joint operating agreement ("JOA") which provided for the operator under that agreement to be removed by the other parties to the JOA. In that case, the court had considered such a provision to be comparable to a provision allowing a party to terminate a contract and had held that the provision was not one that should be restrained by the implication of any such term concerning the circumstances in which the right could be exercised.
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> iii. the Option did not involve CX undertaking an assessment of whether a particular state of affairs existed or not as was the case in *Braganza*.
>
> iv. this was a provision drafted for the benefit of CX and, at least where it was clearly drafted, (as the judge held this Option was) it should usually take effect in accordance with its terms.
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> v. the Agreement had been drafted by lawyers for sophisticated commercial parties. There was therefore no justification for the court to qualify what the parties had agreed.

The above being the case, the judge held that there was no *Braganza/Socimer* implied duty as to CX's exercise of the Option.

[1] https://www.haynesboone.com/publications/nerush-wong-on-reluctance-to-imply-terms-for-contractual-interpretation

Was this a relational contract that required a duty of good faith/to act in a commercially acceptable manner to be implied?

LHT had contended that the Agreement with CX was "a relational contract" and that, as such, a term should be implied into it requiring the parties to deal with each other in good faith. LHT contended this meant that the Option could only be exercised in a commercially acceptable manner as determined by reasonable and honest people.

The judge considered the cases concerning relational contracts and whether or not terms were to be implied into them as a matter of law (i.e. as a consequence of the agreement being a particular type of agreement) and/or a fact (based on the presumed intention of the parties).

He found that there was authority to the effect that a contract in the nature of a relational contract was susceptible to a term being implied as a matter of law (i.e. on account of the nature of the contract), but that the characteristics of the Agreement were that it was not such a relational contract. Hence there was no basis to imply any term as a matter of law.

He then considered whether such a term as LHT sought to have implied was so obvious or necessary to give the contract business efficacy (this being the standard test as to whether a term should be implied as a matter of fact). He determined that this was not so. In so doing he rejected LHT's contention on a number of bases, including because this was a carefully drafted commercial agreement on which there was very little for a good faith obligation on the part of CX "to bite". Further, this was not an agreement that involved collaboration or was akin to a joint-venture. It worked perfectly well without any obligation of good faith. It provided for a clear balance of risks and rewards between the parties and the implication of a duty of good faith would upset that balance. It was an impersonal agreement which was not dependent on the good faith of the contracting parties or their employees. This was not a type of contract that was an obvious candidate for the implication of a good faith obligation. It was simply a standard commercial contract to provide services and it was hard to see why good faith should enter into the picture at all. If a good faith obligation was to be implied into this agreement, the judge indicated it will be hard to see why it would not be implied into every maintenance contract.

The above being the case the judge held that he did accept that a mutual obligation of good faith is obviously what the parties to the agreement intended or that such term is necessary to give business efficacy to the agreement.

Take-away points

During the drafting process, parties to commercial contracts should give consideration to whether they intend rights granted under their commercial contract to be freely exercisable, particularly when the consequences of a decision to exercise the right in question may be significant.

If not, then it is always better for the parties to *expressly* provide in their contract for any limitations on the right to exercise any contractual right that the contract grants.

To avoid costly disputes about whether a right is, despite not being expressly constrained, nevertheless subject to some implied qualification, parties should consider providing as fully as possible for the exclusion of implied rights. This is particularly so if the contract in question has the characteristics of a "relational contract" or if a contract grants a party the right to make determinations amongst a number of possibilities that will affect the rights of the parties to the contract. This is because, in these instances, English law may otherwise more readily find for the implication of some limiting term.