

## Good Faith

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### Abstract

Good faith is a blanket clause under which courts develop standards of fair and honest behavior. It gives ample discretion to the judiciary and entitles a court to narrow down the interpretation of statutes or contracts and even to deviate from codified rules, from the wording in the law or the contract or to fill gaps. The law and economics literature relates bad faith to opportunistic behavior and it is accepted that in specific cases where the application of default or mandatory rules leads to opportunism or where both the law and the contract are silent on risk, the judge can resort to the good faith principle. As a result the parties may delegate part of the contractual drafting to the legal system in addition to having reduced apprehension regarding the possibility of opportunistic behavior from the other side. This allows them to keep contracts relatively short and reduces the costs of defensive strategies.

### Definition

Good faith is a blanket clause in civil law under which courts develop standards of fair and honest behavior in the law of obligations, especially in contract law and – to some extent – in the law of property. Courts also define legal consequences resulting from the violations of such standards, such as reliance damages, expectation damages, injunction, imposing a duty of conduct, and invalidation or validation of a contract. The good faith principle entitles a court to narrow down the interpretation of statutes or contracts and even to deviate from codified rules, from the wording in the law or the contract or to fill gaps. Courts use it as a last resort, if and only if the contract itself or the rules of contract law lead to grossly unfair results. “Good faith” also has found its way into jurisdictions other than those of civil law, as well as into the public international law of contracts and international law in general.

### Introduction

The roots of the good faith principle can be traced back to Roman times. Even today Cicero’s writing on good faith (*De Officiis* 3.17 (44 BC)) from more than 2,000 years ago reads as fresh as if it had just been published. It comes close to the modern description of “opportunistic behavior” that economists have developed in recent decades: “These words, good faith, have a very broad meaning. They express all the honest sentiments of a good conscience, without requiring a scrupulousness which would turn selflessness into sacrifice; the law banishes from contracts ruses and clever maneuvers, dishonest dealings, fraudulent calculations, dissimulations and perfidious simulations, and malice, which under the guise of prudence and skill, takes advantage of credulity, simplicity and ignorance” (quoted from Association Henri

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Capitant and Société de législation comparée 2008). The contemporary content of the principle is not well defined. Its scope is also subject to debate, with some scholars regarding it as a rule of contract law or of the law of obligations and with others relating it to the whole body of civil law.

Objective good faith is an objective standard of behavior, especially for contracting parties. Contract law, with its mandatory and default rules, tries to allocate risk and imposes contractual, pre-contractual, and post-contractual duties and risks fairly and honestly in the way self-interested parties would have chosen had they considered the problem *ex ante* at the time of contract formation. However, due to the features of a specific case, the application of these legal rules can possess unintended and absurd consequences in individual cases. And even though the black letter rule mostly leads to the desired consequences, it might lead to the opposite in some. In such cases, the good faith principle allows courts to deviate from the black letter rules of contract law or from the contract itself. If the courts find the application and the result of a legal norm in a specific case to be absurd, because they still allow opportunistic exploitation or grossly inefficient risk allocation, they can deviate by using the good faith principle. And they can give the law flexibility if unforeseen contingencies transform fairness into dishonesty and efficient into grossly wasteful allocation of risk. This not only provides adaptability to new circumstances but also saves the parties' transactions costs. More specifically, by knowing that a court has the option to intervene, parties are less inclined to write every contingency into the contract, thus making contracting less costly and defensive measures of parties less necessary.

The principle is not without pitfalls and therefore subject to criticism. Firstly, it gives ample discretion to the judiciary, which can be and has been misused for importing ideology, including totalitarian ideology, into contract law or for promoting private opinions of judges about what they regard as just. Secondly, it might foster judicial activism if the judiciary develops the law proactively in such a way that it replaces parliament. Thirdly, the principle might be inappropriately used to redistribute wealth from the rich to the poor party by adopting a deep pocket approach. Finally, following Hayek, judges who intervene in a contract might not as outside observers have the information for reliably acting in the *ex ante* interest of honest parties, even if they have the best intention in doing so.

## The Good Faith Principle in the Legal Doctrine

The good faith principle is widely used in all civil law countries, for instance, in Germany, Switzerland, Turkey, France, Italy, and the Netherlands. It is also recognized in the US Uniform Commercial Code as well as in unification instruments of private law, including the UN Sales Law, the UNIDROIT Principles for Commercial Contracts, and the Principles of European Contract Law. Good faith is relatively new in American law, but seemingly it also caught on quickly. On the other hand, English law does not recognize a general duty of good faith. In fact, English lawyers think that the courts should only interpret contracts and refrain from allocating risks by way of the good faith principle (Musy 2000; Goode 1992). This does not imply that English contract law cannot correct for absurd consequences of routine decisions, yet the English principles, such as "fair dealing," are narrower than the good faith principle and do not transfer the same amount of discretionary power to the judiciary. Scholars of comparative law have expressed the view that if one looks at how hard cases of contract law are actually decided in common law and civil law jurisdictions, the differences might be less pronounced than it seems on the surface (Zimmermann and Whittaker 2000). Judge Bingham expressed a similar view with the following words in *Interfoto Picture Library Ltd. v. Stiletto Ltd.* (1988) 2 W.L.R. 615 (p. 621): (England has no) "overriding principle that in making and carrying out contracts parties should act in good faith" but added that on the other hand "English law has, characteristically, committed itself to no such principle but has developed piecemeal solutions in response to demonstrated problems of unfairness."

A major point of critique of the principle of good faith is its generality and broad scope. This is also in close relationship with the critique that the judiciary can arbitrarily interfere with the contract by using this principle. However, it could be argued that the risk of intolerable legal insecurity and unpredictability is eliminated. In those jurisdictions where the principle is accorded an important role, it is split up into categories and subcategories (Hausheer and Jaun 2003; Grüneberg 2010). Through this subcategorization, an out-of-hand use of the principle by the courts in these jurisdictions is seldom, with each subcategory applying the facts of the case to a series of judge-made tests that possess particular legal consequences on passing the test.

In jurisdictions that recognize a general principle of good faith, there exists a variety of established legal dogmatic forms that define terms and conditions under which the principle of good faith is to be used. Moreover, they also define particular legal consequences if a defendant has violated a standard of behavior. These legal dogmatic forms, all of which are derived from the general good faith principle, provide it with an internal structure, which checks it against willful use. These subcategories are mainly as follows: culpa in contrahendo; contract with protective effects for a third party; liability for breach of trust; adaptation of the contract to changed circumstances (*clausula rebus sic stantibus*); side obligations from a contract (breach of which constitutes a case of breach of contract); obligation to contract; principle of trust in formation, interpretation, and gap filling of legal transactions; misuse (abuse) of rights; and forfeiture.

The well-established subcategories of good faith substantially eliminate the risk of a judge's arbitrary interference. As a matter of fact, there is a general scholarly agreement on the conditions for resorting to any of the subcategories as well as on the legal results that follow. Still, despite such concrete dogmatic forms, in the jurisdictions where the good faith principle is recognized, it is accepted that such general principles should be used as a last resort, if and only if the formal rules of the contract law lead to absurd consequences. If the good faith principle is a monster, as scholars (Zimmermann and Whittaker 2000) once claimed, it has been domesticated as a farm animal. From an economic perspective, this means two things. First, the good faith principle is a delegation norm for the judiciary. It entitles judges to manually control the law if it does not fulfill its functions. It serves parties if the judges are knowledgeable, loyal, and not corrupt but does a disfavor to them otherwise. Secondly, the development of a tight internal structure is a commitment by the judiciary to credibly signal to the legal community that it applies the principle with self-restraint and self-discipline, ruling out willful, ideological, or biased decisions.

## **The Good Faith Principle as a Norm to Curb Opportunism**

The law and economics literature mainly relates the good faith principle to the prevention of opportunism. According to Summers (1968), good faith is an excluder which “has no general meaning or meanings of its own, but which serves to exclude many heterogeneous forms of bad faith.” Burton (1980) relates bad faith to the exercise of discretion by one of the contractual parties concerning aspects of the contract, such as quantity, price, or time. Accordingly, “Bad faith performance occurs precisely when discretion is used to recapture opportunities forgone upon contracting – when the discretion-exercising party refuses to pay the expected cost of performance.” Similarly, while defining good faith, Miller and Perry (2013) refer to the enforcement of the parties' actual agreement. More specifically, the authors argue that the good faith principle protects the reasonable expectations of the parties, which they had while contracting. They criticize however that in the USA in contrast to definitions, courts often resort to community standards, based on what people actually do, and that this can undermine the function of contract. They argue that the good faith principle in US contract law should be based on normative ideas like welfare maximization or the golden rule and not on purely empirical observations. Mackaay (2009) defines bad faith as the legal term for opportunism. Richard Posner describes the principle in a similar way: “The concept of the duty of

good faith like the concept of fiduciary duty is a stab at approximating the terms the parties would have negotiated had they foreseen the circumstances that have given rise to their dispute. The parties want to minimize the costs of performance. To the extent that a doctrine of good faith designed to do this by reducing defensive expenditures is a reasonable measure to this end, interpolating it into the contract advances the parties' joint goal" (Justice Posner's opinion from the decision *Market Street Associates Limited Partnership v. Frey*, 941 F.2d 588, 595).

### **Elements of Opportunistic Behavior**

Williamson (1975) famously defines "opportunism" as "self-interest seeking with guile." In fact, strategic manipulation of information and misrepresentations are to be deemed as opportunistic. The same applies to hidden action aimed at reducing the quality of performance.

According to Dixit, opportunistic behavior is the "whole class of actions that tempt individuals but hurt the group as a whole" (Dixit 2004). Opportunistic behavior is inefficient because it increases transaction costs and reduces the net gain from the contract (Sepe 2010; Mackaay 2011). The risk of opportunism encourages parties to take defensive precautions and write longer contracts to prevent opportunistic behavior as well as the harms that might arise from it. Opportunistic behavior could even incentivize parties to take strict precautions, such as foregoing a contemplated contract altogether. If many contractors were to choose this option, this could destroy entire markets (Mackaay 2011).

Muris (1981) defines opportunism as behavior which is contrary to the other party's understanding of their contract – even if not necessarily against the implied terms of the contract – and which leads to a wealth transfer from the other party to the performer. Cohen (1992) defines it as "any contractual conduct by one party contrary to the other party's reasonable expectations based on the parties' agreement, contractual norms, or conventional morality." Similarly, Posner (2007) defines opportunism as taking advantage of the other party's vulnerability.

Mackaay and Leblanc (2003), who regard good faith as the opposite of opportunism, propose a test to operationalize opportunistic behavior: "an asymmetry between the parties; which one of them seeks to exploit to the detriment of the other in order to draw an undue advantage from it; the exploitation being sufficiently serious that, in the absence of a sanction, the victim and others like him or her are likely substantially to increase measures of self-protection before entering into a contract in the future, thereby reducing the overall level of contracting."

### **The Necessity to Curb Opportunistic Behavior with a Blanket Clause**

The role of contract law can be explained as an endeavor to guarantee the fairness of the contract in the sense of avoiding opportunistic behavior (Posner 2007; Kaplow and Shavell 2002) and through the cost-efficient allocation of risk (Harrison 1995; Schwartz 2003; Schäfer and Ott 2004). In accordance with the purpose of contract law, if the good faith principle were used exclusively to curb opportunistic behavior and to allocate risks in a cost-efficient way in cases in which the established rules of contract law permitted opportunism, it would be regarded as a valuable corrective mechanism giving flexibility and innovativeness to contract law without questioning its rationale for facilitating win-win constellations under fair conditions.

A court can enhance efficiency through the good faith principle in three ways: by (i) not applying a mandatory rule (for instance, by declaring a non-notarized real estate sales contract as valid), (ii) refraining from the application of a default rule (for instance, by declaring the rule under which partial delivery can be rejected as invalid), and (iii) allocating risks when the law or the contract is silent (for instance, by imposing a non-competition clause) (Schäfer and Aksoy 2015). In the first two cases, the

law specifies the risk, but it is clear that the specification of the risk in such a particular case is questionable and gives rise to opportunism. In other words: in such a specific case, applying the norm delivers absurd results, with the blanket clause of the good faith principle on the other hand providing the judge with flexibility that he would otherwise not have had. Finally, both contract and default rules may be silent on a matter consequentially leading to a result that may be neither fair nor cost-saving. In such cases, the principle of good faith can provide efficient risk allocation.

Finally, in line with the legal reasoning, Mackaay (2011) argues that good faith is a last resort tool for preventing opportunism. The author states that there are various anti-opportunism concepts in the law, but when none of these concepts manage to prevent opportunism, the judge will use the good faith principle. Economically speaking, the blanket clause of good faith is a delegation of decision-making authority to the judiciary. If contract law fails to fulfill its aim of curbing opportunistic behavior and allocating risk in a cost-efficient way, thus to guaranteeing fairness and honesty, the judiciary is given the competency for guaranteeing the rationale of contract law, even if this implies deviation from legal rules or from the contract itself. It is obvious that such a delegation norm can work only in jurisdictions in which judges are loyal to the spirit of the law, as well as knowledgeable and non-corrupt.

### **Good Faith and the “Social Function of Contract”**

The self-restriction employed by courts when using the good faith principle has contributed significantly to its international recognition, expansion, and widespread use in many countries and codes and has helped to silence criticism. It is used to maintain the fairness of the contract. It is employed as a last resort; it has developed a rich internal structure, thus preventing willful use. Under these conditions, the good faith principle saves transactions costs, and the business community as well as the whole legal community can regard it as a valuable service.

This proposition comes, however, with a caveat. In some civil law countries, including those of continental Europe, it has been argued that courts have sometimes used the good faith principle to achieve a proper distribution of wealth by interpreting the law or filling gaps in contracts in favor of parties such as consumers, employees, and tenants. Sometimes, such decisions can be interpreted as a correction of market failures, but sometimes they are indicative of a deep pocket approach, meaning redistribution of wealth to the poorer party, even if this neither corrects unfairness nor market failure and is contrary to the terms of the contract itself and to black letter law. This is motivated by distributive justice but comes at the cost of protecting only the insiders not the outsiders and increasing rather than decreasing the costs of using the market making it difficult or even impossible for people without reputation to make promises.

In some countries, the principle is openly used to promote the redistributive goals of social justice, which are usually achieved through the welfare state and statutory laws. In Brazil a case law is emerging in which the good faith principle is not merely used to maintain fairness in the sense of honesty. Under the legal principle of the “social function of contract” the good faith principle sometimes helps to achieve social justice by redistributing income *ex post*. This can destroy the mutual benefit from a fair contract in which all partners abstain from opportunistic behavior. It seems that such features of “good faith” can be found more often in countries without an effective welfare system or public and private insurance systems. If contracting parties must, however, expect that under certain conditions, in spite of their fairness and honesty, they are stripped from the benefits of the contract *ex post* by the use of the good faith principle, they might abstain from such contracts altogether. This can lead to dysfunctional markets and considerable costs for society. The unintended consequences of such interventions, for instance, price ceilings, have been widely discussed in the literature.

Timm (2008) has reviewed some of the Brazilian case law, which spans from not allowing interest on interest, imposing interest rates *ex post* which are lower than those for government bonds or an injunction requiring an insurance company to cover a surgery or treatment not provided according to the policy, or

even preventing an unpaid utility from cutting the supply of electricity. In a lawsuit initiated in Rio de Janeiro, a tenant failed to pay rent for consecutive months. Hence, the landlord sued the tenant bringing a claim for eviction from the property, which the tenant ran as an asylum for the elderly. Despite the Brazilian Landlord-Tenant Law (Law No. 12112/2009) which set forth that a failure to pay rent for consecutive months is a valid reason for eviction, the Appeal Court of Rio de Janeiro ruled for the prolongation of the deadline for an indefinite period of time in order to protect the elderly residents, thus making the landlord a charitable donator. Such decisions help the individual claimant, but not the poor as a group as they deny them the possibility to make credible promises and commitments making market transactions more difficult for them.

According to Nóbrega, the new 1988 Constitution brought about judicial activism by way of establishing a principle- and standard-oriented “social welfare legal order in which the judge had the mission of maintaining social justice (Nóbrega 2012). Consequently, the Brazilian Civil Code regulated both the good faith principle and the social function of contract. Within this scope, the social function of contract, which is derived from the principle of good faith, is regulated by Article 421 of the Brazilian Civil Code as follows: “the freedom to contract shall be exercised by virtue, and within the limits, of the social function of contracts.” Although the law refrains from defining the “social function of contract,” a prevailing definition of this broad concept is made by Diniz (2007) as a kind of contractual “super-principle,” comprising precepts of public order, good customs, objective good faith, contractual equilibrium, solidarity, distributive justice, etc. More specifically, the author argues that the social function of the contract should comprise every constitutionally and/or legally recognized value that might be said to have a “collective” or “nonindividualistic” character.

## Conclusion

The law and economics literature relates bad faith to opportunistic behavior, which increases transaction costs, reduces the net gain from the contract, and allows one party to achieve unfair re-distributional gains. Contract law is mainly the endeavor to curb opportunistic behavior and to maintain the cost-efficient allocation of risk. In specific cases where the application of default or mandatory rules leads to opportunism or where both the law and the contract are silent on risk, the judge can resort to the good faith principle. Its use allows for the correction of opportunistic behavior for all those cases in which the black letter law fails to do so. It provides ample discretion to the judiciary and has – from a historical perspective – been misused and heavily criticized. This has not, however, prevented it from becoming an important legal norm in a rising number of jurisdictions and codes.

The good faith principle lost its fearsome features mainly for three reasons. First, its contemporary use is constrained to preserve fairness and honesty among parties, but does not burden honest parties with obligations from community values or social justice in the sense of redistributing income *ex post* for social purposes. Some exceptions exist however: sometimes camouflaged, sometimes – like in Brazil – easily visible, and more explicit. Secondly, courts use the good faith principle as a last resort when all other routines of judicial decision-making are exhausted yet still lead to absurd legal consequences that allow for opportunistic exploitation or grossly inefficient risk allocation. Finally, the good faith principle has a deep interior structure with subcategories providing routines, tests, and legal consequences resulting from these tests. This makes it difficult for judges to misuse the principle for promoting private or ideological views about justice and becoming disloyal to the law. Decisions of an individual judge using the good faith principle without observing these self imposed dogmatic constraints are likely to be uplifted by a higher court. These features have led to the increasing confidence that the good faith principle provides a valuable service to parties and enables them to delegate part of the contractual drafting to the legal system.

Moreover, it has reduced their apprehension regarding the possibility of opportunistic behavior from the other side. This allows them to keep contracts relatively short and reduces the costs of defensive strategies. In comparison, in jurisdictions which either reject the principle (England) or in which the principle has no long-lasting tradition (USA), there is less delegation and contracts are extensive, are more expensive to draft, and contain long laundry lists of required or impermissible behavior from parties. In the literature, other reasons have been discussed as to why English and US private contract law implies less delegation to the judiciary. This is only one of them.

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