

Parallel Controls of Contractual Discretion: The Duty of Rationality and Good Faith

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INTRODUCTION

Imagine placing the entire weighing scale of a critical decision solely in one party's hands: that is essentially contractual discretion. It gives them the sole legal power to make certain decisions which affects the rights of both parties.² It does sound risky – the temptation to pull the trigger for their own gain is huge, leading to potential abuse.³ To prevent abuse of power and protect fidelity to bargain, English courts have been deeply suspicious in recognizing the existence of unfettered discretionary power. Two primary implied duties now limit contractual discretion: the duty of rationality or the *Braganza* duty (stemming from *Braganza v BP Shipping Ltd*⁴) and the duty of good faith.

But contractual discretion raises more interest than a random area of contract law. It is vexed and special – under the paramount concern for contractual freedom which minimizes judicial interference on commercial bargains, English courts have contrarily taken a path less chosen by imposing implied duties in a paternalistic way. This article dwells on the high risk of abuse of power and frustration of contractual purpose behind contractual discretion as the fundamental reason for this special area of law. Section 1 addresses the duty of rationality. It first analyses the doctrinal development of the courts' approach, arguing they readily impose this duty through broad interpretation. It then defends the *Wednesbury* test as the appropriate benchmark and addresses associated criticisms. Section 2 explores the duty of good faith. Moving beyond the "relational

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² Terrence Daintith, "Contractual Discretion and Administrative Discretion: A Unified Analysis" (2005) 68(4) MLR 554 [555]

³ Hugh Collins, "Discretionary Powers in Contracts" In Campbell, D., Collins, H., & Wightman, J. (Eds.). *Implicit dimensions of contract: Discrete, relational, and network contracts* (2003 Bloomsbury Publishing Plc)

⁴ See n 3

contract" category established in *Yam Seng Pte Ltd v International Trade Corporation Ltd*,⁵ it advocates for implying a duty of good faith in law within contexts involving contractual discretion and rejects the proper purpose doctrine as an inadequate alternative. Section 3 concludes.

I. THE DUTY OF RATIONALITY

The duty of rationality, or the *Braganza* duty, was summarized by Lady Hale in the landmark case of *Braganza*. It requires a party to “exercise contractual discretion honestly and in good faith as well as in a manner that is reasonable and not irrational, arbitrary or capricious.” This duty was not brand new – in fact, it has been built on a long line of precedents in which courts controlled contractual discretions using standards of irrationality and arbitrariness.⁶

1) Issue one: Justification of “rationality” and the Wednesbury test

i. Defining the duty of rationality

In tackling the precise requirement of “rationality” in the context of contractual discretions, courts have not reached a clear and unified definition.⁷ Nevertheless, it could be distilled from case law that rationality requires actions in line with contractual purpose. In *British Telecommunications Plc v Telefónica O2 UK Ltd*, Lord Sumption defined the duty of rationality as normally meaning “must be exercised consistently with its contractual purpose”.⁸ This corresponds with his later comments in *Hayes v Willoughby* where he once again referred to “limiting the decision maker to some relevant contractual purpose”. Once a decision maker’s power is limited within the

⁵ [2013] EWHC 111

⁶ Some examples include *Abu Dhabi National Tanker Co v Product Star Shipping Ltd (The “Product Star”) (No 2)* [1993] 1 Lloyd's Rep 397, *Socimer International Bank Ltd v Standard Bank London Ltd* [2008] EWCA Civ 116, *British Telecommunications Plc v Telefónica O2 UK Ltd* [2014] UKSC 42.

⁷ There seems to be some confusion of “rationality” with “reasonableness”, given that these two words have been used interchangeably in cases, e.g. see *Socimer International Bank Ltd v Standard Bank London Ltd* [2008] EWCA Civ 116 at [66] where Rix LJ substituted the more modern expression “rationality” with “reasonableness”. Rix LJ continues to explain that “rationality” does not refer to the objective standard of reasonableness, but only refers to reasonableness in the Wednesbury sense in which “the decision remains that of the decision-maker”. Therefore, the two words could only be used interchangeably when reasonableness is measured by Wednesbury standards.

⁸ [2014] UKSC 42 at [37]

boundaries of contractual purpose, the courts can then ensure that the power will not be abused.⁹ Therefore, the duty of rationality should not be interpreted intuitively as a blunt, external requirement from public law coming out of nowhere – on the contrary, it has its roots within the purpose of the contract itself.

ii. *Justification for the Wednesbury test*

In addition to the doubts regarding the origins of rationality, another interesting and debatable point is the transplant of *Wednesbury* standard in evaluating rationality of parties.¹⁰ Lady Hale in the *Braganza* case provided that both limbs of the *Wednesbury* test are to be adopted in the rationality test, citing Lord Greene from *Wednesbury*: “The first limb focuses on the decision-making process-whether the right matters have been taken into account in reaching the decision. The second focuses upon its outcome – whether even though the right things have been taken into account, the result is so outrageous that no reasonable decision-maker could have reached it. The latter is often used as a shorthand for the *Wednesbury* principle, but without necessarily excluding the former.”

This approach has sparked debate over the appropriateness of transplanting public law standards into private contracts. Scholars such as Paul Davies challenge its utility by arguing that private law need not restrict self-interested actions absent public-good considerations.¹¹ Nevertheless, the exceptionally high threshold of *Wednesbury*'s second limb has been deliberately moderated to accommodate the flexibility demanded by diverse commercial contexts. Jason Varuhas has comprehensively analyzed this variable "unreasonableness" threshold, noting its application with contextually dependent intensity. For instance, courts have lowered the *Wednesbury* threshold in cases of relatively unsophisticated commercial parties with less market experience, and the contrary where parties are well-advised.¹²

⁹ According to one version offered by Hugh Collins in his article ‘Discretionary Powers In Contracts’ as in n 2, the definition of “abuse of power” is exercising power in a way which is inconsistent with contractual purpose.

¹⁰ Michael G. Bridge, ‘The exercise of contractual discretion’ (2019) 135 *Law Quarterly Review* 227

¹¹ Paul Davies, ‘Excluding Good Faith and Restricting Discretion’ In Davies, P and Raczynska, M, (eds.) *Contents of Commercial Contracts: Terms Affecting Freedoms* (Hart Publishing: Oxford, UK 2020)

¹² E.g. *Barclays Bank Plc v Unicredit Bank AG* [2014] EWCA Civ 302, [24]

Therefore, from the above analysis, it could be concluded that the duty of rationality arose not as an external or intrusive standard, but as an internal standard which requires compliance with contractual purpose. Thus, although it has its roots in public law, the *Wednesbury* test has nevertheless transformed itself to an applicable doctrine that fits within the realm of private commercial context.

2) Issue two: the extent of implying the duty of rationality

As mentioned before, the two requirements which needs to be satisfied in order for a case to be classified as one of contractual discretion is set out by Lady Hale in the *Braganza* case: one which 1) affects the rights of both parties to the contract, and 2) gives rise to a conflict of interest. Upon doctrinal analysis, courts have adopted a relatively broad interpretation in interpreting requirements such as “conflict of interest”. In *HFFX LLP v Revenue and Customs Commissioners*,¹³ the court dealt with the issues of whether reallocations of a member’s own property, which would lead to conflicts of money distribution between members of the association and other individuals amount to “conflict of interest”. The court adopted a broad interpretation, holding that a "conflict of interest" does not necessitate a legal interest; the *Braganza* duty arises even where unfulfilled expectations merely cause adverse practical consequences without crystallizing into legal rights.¹⁴

3) A normative discussion: why prevent abuse of power?

It is submitted that the courts' attitude stems from the distinctive power dynamics inherent in relationships involving contractual discretion. These dynamics carry a high risk of power abuse and contractual purpose frustration due to a significant, yet often unsupervised, power imbalance; furthermore, misuse of these powers would often lead to incalculable consequences. Commercial cases where the *Braganza* duty has been implied demonstrate the above power dynamics. From a doctrinal analysis, courts have played an active role in implying *Braganza* duty to limit such power,

¹³ [2023] STC 678

¹⁴ *Ibid* at [80]

in order to prevent power abuse and protect fidelity of parties' bargains. Cases such as *BHL v Leumi*¹⁵ and *Lehman Brothers Finance AG (in liquidation) v Klaus Tschira Stiftung GmbH*¹⁶ demonstrated this pattern.

This active judicial intervention in cases of contractual discretions seemingly contradicts the orthodox reluctance to control contractual discretion rooted in freedom of contract. A growing number of academics, though still in the minority, have been advocating that contract law also needs to represent other values such as social fairness.¹⁷ The active attitude taken by courts in contractual discretion is likely influenced by such normative development of contract law. Therefore, in special categories such as contractual discretions, where the risk of abuse of power and frustration of contractual purpose is high, courts have taken a generous approach in implying restrictions to safeguard fairness and protect fidelity to the bargain. This provides a normative explanation in the courts' active attitude in implying the *Braganza* duty – in special areas of contract law where risk of power abuse is high and fidelity of bargain is fragile, the pendulum between freedom and equality of contract seems to be gradually tilting towards the latter. As the fundamental values of modern contract law governing contractual discretions move towards fairness and social justice, it is therefore reasonable for English courts readily to imply terms and to impose limitations over them.

II. THE DUTY OF GOOD FAITH

1) Flaws of the current law: an incoherent landscape

In contrast with the law on the *Braganza* duty, where the Supreme Court has firmly established the application of the *Wednesbury* unreasonableness test, the law on good faith remains unsettled and inconsistent. Analysis of case law over the past few decades reveals significant judicial

¹⁵ [2018] 1 All ER (Comm) 965

¹⁶ [2019] EWHC 379 (Ch)

¹⁷ For example, see the authors of articles cited below in the next paragraph such as William D. Louis, Barry J. Reiter and Florian Rödl.

discretion in the area, with courts adopting an unsystematic and fluctuating approach to imply duties in good faith.

It is submitted that this systematic incoherence primarily stems the fact that good faith has been both implied in fact and in law, depending on the specific context of each case. This distinction is crucial due to differing thresholds: terms will only be implied *in law* in standard legal relationships,¹⁸ which is viewed as more intrusive than implying *in fact*, as courts may imply good faith without going into the details of each fact pattern. The absence of a unified doctrine for implying good faith invites divergent standards, particularly where contractual category boundaries are ambiguous.

One typical example is the category of relational contracts, in which the courts will imply a duty of good faith according to Leggatt J in *Yam Seng PTE v International Trade Corp Ltd*¹⁹: “Under English law, a duty of good faith is implied by law as an incident of certain categories of contract, for example, contracts of employment and contracts between partners or others whose relationship is characterized as a fiduciary one.” Fraser J later provided guidelines in *Bates v Post Office*²⁰ for identifying relational contracts. While the framework introduced by Fraser J provided guidance as to drawing the boundaries of a relational contract, it is by no means exhaustive and “no single one is determinative except for the first”, thereby creating ambiguity in its application. The framework as a result has been applied strictly in *Cathay Pacific Airlines v Lufthansa Technik*²¹ but more loosely in *Essex City Council v UBB Waste (Essex) Ltd (No 2)*²².

2) Towards an implied duty of good faith in law

Lord Leggatt in *Yam Seng* has defined good faith as comprising two elements: 1) adherence not only to honesty but also to “standards of commercial dealing which are so generally accepted that the contracting parties would reasonably be understood to take them as read without explicitly

¹⁸ E. Peel, *Treitel's Law of Contract*, (13th ed. 2011), [6-041]–[6-045]

¹⁹ See n 7 at [131]

²⁰ [2019] EWHC 606 QB

²¹ [2020] EWHC 1789 (Ch)

²² [2020] EWHC 1581 (Tcc)

stating them in their contractual document”. He exemplified such standards by prohibiting conduct described as ‘improper’ ‘commercially unacceptable’ or ‘unconscionable’; 2) fidelity to the parties’ bargain. Lord Leggatt has explained the second point as to promote the purpose expressed in the contract, which is in line with Paul Davies’ “proper purpose test”.

From the above analysis, it could be concluded that courts have been wary and incoherent in implying terms in good faith. However, this section challenges the current reluctance to imply good faith, and advocates for implying good faith in law to control the use of contractual discretions, by analogy with relational contracts. This is justified because both categories exhibit higher risks of deviation from contractual purpose and frustration of fidelity to parties’ bargain, in which courts are placed in the right role to promote business efficacy.

3) Implying good faith in law: an analogy with relational contracts

This section contends that good faith should be implied in law for contractual discretion. It examines the profound parallels between contractual discretion and relational contracts, identifying a shared core characteristic: an elevated risk of contractual purpose frustration. By analogy to relational contracts, it is submitted that good faith should be recognized as a principle of law in circumstances of contractual discretion. The inherent nature of party relationships in discretionary contexts creates heightened risks of power abuse and purpose frustration absent a general fairness standard, undermining business efficacy, which could be mitigated effectively by implication of a general good faith duty in law.

Before diving into the comparison, it is essential to explore the rationale of implying a general standard of good faith in relational contracts. This has been nailed down in *Yam Seng* by Lord Leggatt: “Such ‘relational’ contracts, as they are sometimes called, may require a high degree of communication, co-operation and predictable performance based on mutual trust and confidence, and involve expectations of loyalty implicit in the parties’ understanding and necessary to give business efficacy to the arrangements.”²³ However, it is often practically unattainable for parties

²³ Ibid.

in a relational contract to expressly spell out specific obligations of cooperation and loyalty. This stems from their typical long-term nature, which renders exhausting details in future obligations difficult. As a result, the tension between a high requirement for loyalty and cooperation and contractual incompleteness creates risks of frustrating contractual purpose if one party behaves opportunistically in the absence of express restraints. Courts thus impose good faith in law to uphold business efficacy.

Here is where the parallel kicks in: a duty of good faith in law is equally necessary in contractual discretion cases due to a comparable risk of purpose frustration. Since one party has the right to make decisions which would affect rights of the other but there are no express terms to set its limits (reasons of which are analyzed above citing Collin's economic analysis on why parties would agree to discretions), there is a higher risk that the party granted with discretionary powers would abuse such power and act arbitrarily.

This heightened risk of abuse increases the likelihood that discretionary powers will be exercised beyond their intended scope. Indeed, the standard of abuse of power is defined by statutory standards as exercising power to deliver performance substantially diverging from reasonable expectations, i.e., frustrating contractual purpose.²⁴ As Lord Leggatt indicated in *Yam Seng*, courts consistently prioritize "fidelity to the parties' bargain," actively promoting "values and purposes expressed or implicit in the contract." This underscores why contractual discretions are long recognized as non-absolute.²⁵ Like relational contracts, they face greater risks of contractual purpose frustration and practical limitations on exhaustive express terms. Shared logic thus justifies implying good faith in law for contractual discretion.

III. CONCLUSION

²⁴ This definition is offered by Hugh Collins in his article 'Discretionary Powers In Contracts'. It could be likely inferred from his article that he drew the standard of abuse of power from the Unfair Contract Terms Act 1977 s (3)(2)(b)(i), which provided that "no party could by reference to any contract term claim to be entitled to render a contractual performance substantially different from that which was reasonably expected of him."

²⁵ Jason NE Varuhas, 'Three Issues in the Law of Contractual Discretion' (2022) 42 Oxford J Legal Stud 787

This article advocates for the control of contractual discretions through implied terms, a special corner of contract law where risk of power abuse and frustration of contractual purpose is high. Analyzed from recent cases, the law in this special area of contractual discretion has gradually shifted towards collective values of fairness and social justice despite the prominence of freedom of contract. Two principal categories of implied terms have been employed by English courts to control contractual discretion: the duty of rationality and the duty of good faith. Even though the duty of rationality and *Wednesbury* test derives from public law standards, rationality in commercial context is not as an external requirement but defined as acting within contractual purpose. Also, given that the *Wednesbury* test has also been modified to flexibly adapt to diverse commercial contexts, it should be recognized as a proper test in commercial context instead of a mechanical adoption of public law standards. Regarding good faith, contractual discretions also share an inherent vulnerability to frustration of contractual purpose with relational contracts. Therefore, the duty of good faith should also be implied in law in contractual discretions just like relational contracts, which could also improve certainty and coherency in the law on good faith. In conclusion, the duties are distinct, non-interchangeable doctrines operating in parallel, each fulfilling complementary and discrete functions in constraining the exercise of discretionary power.