

## The importance of good faith in contract law

"Discourage litigation. Persuade your neighbours to compromise whenever they can. Point out to them how the nominal winner is often a real loser-in fees, expenses and waste of time." - Abraham Lincoln, July 1, 1850.

Black's Law dictionary defines "good faith" in several ways:

A state of mind consisting in (1) honesty in belief or purpose; (2) faithfulness to one's duty or obligation; (3) observance of reasonable commercial standards of fair dealing in a given trade or business, or (4) absence of intent to defraud or to seek unconscionable advantage. (Black's Law Dictionary (2d pocket ed., St, Paul, Minn. 2001 at p. 307))

In contract law, the implied covenant of good faith and fair dealing is a general presumption that the parties to a contract will deal with each other honestly, fairly, and in good faith, so as to not destroy the right of the other party or parties to receive the benefits of the contract. It is implied in a number of contract types in order to reinforce the express covenants or promises of the contract. A lawsuit (or a cause of action) based upon the breach of the covenant may arise when one party to the contract attempts to claim the benefit of a technical excuse for breaching the contract, or when he or she uses specific contractual terms in isolation in order to refuse to perform his or her contractual obligations, despite the general circumstances and understandings between the parties. When a court or mediator interprets a contract, there is always an "implied covenant of good faith and fair dealing" in every written agreement.

Indeed, this principle is ingrained in the Maltese Civil Code:

Contracts to be carried out in good faith.

**993.** Contracts must be carried out in good faith, and shall be binding not only in regard to the matter therein expressed, but also in regard to any consequence which, by equity, custom, or law, is incidental to the obligation, according to its nature.

As outlined in her thesis<sup>1</sup>, Dr Stephanie Vassallo cites, that most European civil codes contain a general good faith provision<sup>2</sup>. In addition, some codes contain specific rules in which reference is also made to the concept of good faith. Moreover, many specific rules in the codes are said to be special applications of good faith<sup>3</sup>.

Briefly defining 'good faith', Powers describes it as 'an elusive term best left to lawyers and judges to define over a period of time as circumstances require'<sup>4</sup>.

Good faith is a concept developed from principles of fairness, reasonableness and honesty. There can be little doubt that the doctrine of good faith is as fundamental in contract law as the doctrine of pacta sunt servanda – indeed they are complementary and the dictates of the doctrine of good faith itself requires that contractual terms are to be honoured and respected. However, as we will see further on, in a number of cases which have recently been decided before the Maltese Courts, in applying the doctrine of good faith, the principle of pacta sunt servanda appears to have been pushed aside – in most cases citing the more elusive concept of good faith as the reason for displacing the time honoured principle of pacta sunt servanda<sup>5</sup>.

More importantly, it held that article 1122 (which deals with abatement or mitigation of penalty) needs to be read and applied in the light of good faith

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<sup>1</sup> The Principle of Good Faith in the Negotiation and Performance of Contracts: A Comparative Perspective, Stephanie Vassallo, University of Malta, Faculty of Laws, June 2010

<sup>2</sup> Vide Art. 1134, Section 3 French Civil Code; article 242 German Civil Code; Art. 2 Swiss Civil Code

arts. 1175 and 1375 Italian Civil Code; Art. 762, Section 2, Portuguese Civil Code; arts. 6:2 and 6:248

Dutch Civil Code. Vide also Art. DUTC and Art. 1.201 PECL

<sup>3</sup> Towards a European Civil Code", University of Amsterdam - Centre for the Study of European Contract Law (CSECL) [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1098856](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1098856) last accessed 2<sup>nd</sup> May 2019

<sup>4</sup> PJ Powers, 'Defining the Indefinable: Good Faith and the United Nations Convention on the Contracts for the International Sale of Goods' (1999) 18 J.L. & Com. 333

<sup>5</sup> Pacta sunt servanda and good faith in contracts – re-visited - Id Dritt Volume XXIII, Malta Law Students' Society (GHSL) 03/04/2013

requirement set out in article 993 of the Civil Code and, therefore, in the light of the maxim 'in omnibus quidem, maxime tamen in jure, aequitas spectanda sit'.

In Malta, besides the legislative framework governing the field of arbitration in Malta, such framework contains a number of international conventions such as the UNCITRAL Model Law on International Commercial Arbitration (First Schedule to the Arbitration Act) and the 1958 New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards (Second Schedule to the Arbitration Act). Arbitration is being appreciated as an alternative method for settlement outside the courts and is regarded as equally binding. The efficiency and expediency of the whole process are its most attractive features. However, all depends on the inclusion of arbitration clauses in commercial contracts. Once an award is registered with the Centre, it constitutes an executive title and can be enforced as a judgement.

In general business trade agreements, under normal circumstances, there is 'an expectation of each party to a contract that the other will honestly and fairly perform his duties under the contract in a manner that is acceptable in the trade community'<sup>6</sup>. Like the principle of *pacta sunt servanda*, good faith is an internationally recognised and accepted doctrine and is often associated with the legal rules of honesty, reasonableness and fairness, including that of *pacta sunt servanda*<sup>7</sup>.

As lawyers are constantly reminded, the duty to act in good faith is infused in the law. Parties commonly agree to mediate a dispute with the expectation that all parties intend to engage in the mediation process in a good faith effort to resolve the issues between them. Good faith is integral to the process of mediation - It would be difficult if not impossible for mediation to succeed without it. Submitting a dispute to mediation is usually voluntary between two parties who wish to

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<sup>6</sup> PJ Powers, 'Defining the Indefinable: Good Faith and the United Nations Convention on the Contracts for the International Sale of Goods' (1999) 18 J.L. & Com. 333

<sup>7</sup> William Tetley, 'Good Faith in Contract' (2004) 35 JMLC 561-616; JF O'Connor describes good faith as 'a fundamental principle derived from the rule *pacta sunt servanda*, and other legal rules, distinctively and directly related to honesty, fairness and reasonableness, the application of which is determined at a particular time by the standards of honesty, fairness and reasonableness prevailing in the community which are considered appropriate for formulation in new or revised legal rules'.

preserve a relationship or find an amicable resolution to an issue, however if these two parties are in animosity with each other and find it difficult to mediate between themselves particularly if they are forced through mandatory participation would result in bad faith participation.

The whole idea behind alternative dispute resolution as a means to settle disputes in the parties' interest, it is of utmost importance that good faith is practiced during the sessions and such sessions are not used to:

- a) Delay litigation (one goes through mediation procedure to gain time and avoid a lengthy court case)
- b) Seek information from the other party (one applies to mediation to try to fish out for information prior to going to court)
- c) Increase overall costs associated with the dispute (a weaker party might struggle to hire lawyers due to the fees involved if faced with a more prepared party, likewise, also face increased emotional frustration).

Other advocates of mandatory good faith participation profess that mandatory good faith participation is a part of an overall voluntary process, even though the parties are forced to the table and that good faith requirements preserve the end goals of mediation. In support of this assertion these advocates cite the parties' mutual right to decline settlement within a good faith mediation session preserves the fundamental fairness and voluntariness of traditional mediation.<sup>8</sup>

Critics of mandatory good faith mediation participation attack the presumption that forced participation has minimal impact on the parties, the quality of mediation or on the quality of the dispute resolution process through traditional litigation. Conflicts with established policies regarding confidentiality, third-party neutrality, due process, and party autonomy are the immediate concerns arising from forced participation<sup>9</sup>. But perhaps the concern is a lack of a concrete definition for good-faith participation which is synonymous in understanding the

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<sup>8</sup> David S. Winston, Comment, Participation Standards in Mandatory Mediation Statutes: "You Can Lead A Horse to Water...", 11 Ohio St. J. on Disp. Resol. 187, 189 (1996)

<sup>9</sup> Maureen A. Weston, Checks on Participant Conduct in Compulsory ADR: Reconciling the Tension in the Need for Good-Faith Participation, Autonomy, and Confidentiality, 76 Ind. L.J. 591, 615 (2001).

requirements for party participation, court expectations and the when and how agreements are correctly applied.

The mediator cannot unilaterally mandate or force parties who no longer believe they can handle the conflict alone to resolve their differences and enforce a decision. Mediation is an extension of the negotiation process that involves the intervention of an acceptable third-party who has limited or no authoritative decision-making power. So in reality, differences in trust and relationship building is more difficult when people have different intentions - in such cases sometimes it is impossible to resolve and need to go to court. In fact, the first flaw is that there needs to be good faith. From my working experience, people tend to go into contracts without "reading the contract". Some firms are more prepared and work with lawyers to draft bullet-proof contracts, on the other hand inexperienced people are willing to close a deal without reading the "fine" print. This fine print does not implicate bad faith dealing but clearly for those people who complain of disputes it might look that they have been deceived. The mediation process will not resolve any issue that occurred due to bad faith, unless the good faith principle is in-built in the contract from the beginning, mediation will fail to succeed, actually the person will realise that he has been fooled by the other party who is not honouring the agreement. In such case mediation will be futile because even though the method is conciliatory, if the party in breach does not want to remedy, the only option would be to go do the courts (unless there is good faith and both parties try to resolve amicably).

The problem with mediation is that it involves personalities on both sides who both think the same – that the other side is negotiating in bad faith. When parties are in mediation negotiations, the mediator learns that the party making the accusation does not mean it literally but rather is trying to negotiate for strategic purpose to obtain or sway the opponent or negotiations in a certain direction in their own terms. When parties accuse each other, they are in reality saying that the other side is asking too much or offering too little, thus deviating from the purpose of the original negotiation. When one party makes a big move and its adversary does not reciprocate, the mediator will likely hear that the adversary is negotiating in "bad faith." In voluntary mediations, this charge often reflects a mismatch between parties' expectations after agreeing to mediate, and the actual proposals exchanged at the mediation. When a party receives a proposal that it

regards as unreasonable, it will question why the other side agreed to mediate in the first place. But that does not mean that the parties do not wish to seek a resolution to their problem. A party may resort to a very unreasonable settlement proposal to reflect a negotiating style – to show who’s in control or to instill fear in the opponent or send a message about fundamentally different views about the merits of the case and fair settlement value. Obviously going down hard on the opponent might create a new stumbling block, because the opponent would not be willing to negotiate and move to court. Similarly, the opponent would understand the strategy and work with a similar strategy and would harden the positions of both sides, with a lower chance to achieve successful problem-solving dialogue.

Bad faith in mediation is rare, and good faith usually prevails when mediation is achieved. And when parties believe it is affecting the mediation, they tend to get distracted from the actual negotiation problem at hand and instead of focusing on resolutions, get bogged down in trading blows.

Good faith in mediation can be achieved if parties try to understand each other, identify the problem, more likely, the causes – such as hard bargaining, dissatisfaction with one’s own proposals, differing case evaluations, or lack of information. These are likely the real obstacles to settlement that the mediator can help the parties work through, and hopefully resolve, during the mediation process.

“I believe in dispute resolution alternative because they are built on the premise that when people – clients, lawyers, neutral facilitators, mediators and experts – intentionally and by design collaborate in good faith towards finding a good solution, they will find a better resolution than when they fight each other until one loses.” – Michael A. Zeytoonian

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