



The Enforceability of Escalation Clauses Providing for Negotiations in Good Faith Under English law

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Les clauses d'indexation qui prévoient des négociations de bonne foi ne sont plus des en-tentes pour négocier qui restent inexécutables, mais sont devenues des ententes exécutables sous certaines conditions. Cependant, les tribunaux anglais estiment la plupart du temps que quelques unes de ces conditions sont absentes, ce qui a pour conséquence d'empêcher l'exécution des clauses d'indexation. L'essai traite de l'idée générale de ces ententes, donne un aperçu de leur traitement par les tribunaux anglais, et souligne les éléments clés qui les empêchent d'acquérir un caractère exécutoire. Grâce à une analyse comparée des approches américaines et canadiennes concernant la bonne foi, l'essai cherche à clarifier la question du caractère exécutoire. Selon l'auteur, la décision récente dans l'affaire Emirates Trading v Prime Mineral, ainsi que les positions adoptées par des juges dans d'autres pays de common law, inspireront les tribunaux anglais à se montrer plus indulgent dans l'exécution des clauses d'indexation qui prévoient des négociations de bonne foi.

Escalation clauses providing for negotiating in good faith have evolved from mere unenforceable agreements to negotiate to agreements that could be enforced under certain conditions. English courts, however, have usually held some of these requirements to be missing which, in turn, precluded the enforcement of escalation clauses. The paper discusses the general idea of these agreements, gives an overview of their treatment before English courts, and emphasises the key elements that warrant their enforceability. Through a comparative analysis of the American and Canadian approaches to good faith, the paper aims to provide clarity on the issue of enforceability. In the author's view, the recent ruling in Emirates Trading v Prime Mineral, as well as judicial positions held in other common law countries, will inspire English courts to be more lenient in enforcing escalation clauses providing for negotiating in good faith.

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INTRODUCTION

“Escalation” clauses, also known as “multi-tiered” or “multi-step” clauses, are contractual clauses providing for a multi-level dispute resolution procedure.¹ Frequently, such clauses provide for initial negotiations to be held in good faith. In the case of controversies, the parties pass through different steps of dispute settlement, such as negotiation and mediation, before the final stage, normally either litigation before ordinary courts or arbitral proceedings before a tribunal, has been reached. However, it is not uncommon that the parties not only quarrel about substantial contractual obligations but also about the escalation clause itself and its legal effectiveness. It is a typical scenario that one party has lost any interest in this procedure and seeks to commence legal proceedings without further ado. In this event, the question of the enforceability of multi-step clauses becomes the centre of attention. Accordingly, this paper will appraise whether escalation clauses providing for negotiating in good faith are enforceable under English law. English courts have proven to be reluctant to recognise the enforceability of such clauses mainly for reasons of certainty. Recent decisions, however, suggest that the wind is turning and courts have become more receptive to enforcing these clauses.

The paper starts with illustrating the general idea and functioning of multi-tiered clauses, followed by three examples of escalation clauses. The substantial difference between these examples is that the first one explicitly includes the requirement of good faith in the context of negotiating, whereas the other two examples remain silent as to this condition.

After introducing the basic approach an escalation clause takes, the paper moves to the historical development of multi-step clauses before English courts. It elucidates the necessary key elements an escalation clause needs to include to be enforceable. Moreover, the idea of a *pactum de non petendo*, a mutual waiver of the right to sue, is explained and set into the context.

The focus then turns to the principle of good faith. The paper elaborates the legal basis of the principle of good faith, its meaning, and its content. It provides a comparative reference to Canada to determine the English position towards good faith in a globalised world.

Subsequently, considering the previous findings, this paper discusses whether good faith negotiation clauses are enforceable, taking recent English case law into account. It refers to the presented examples and gives details on, inter alia, the difference between pre- and post-contractual negotiations, the implied and explicit duty of good faith, and the impact of a *pactum de non petendo*.

The paper concludes with comments on the enforceability of stipulations that ensure good faith negotiations in a multi-step context, and an outlook on the future of the principle of good faith in English law.

¹ D Jason File, “United States: Multi-Step Dispute Resolution Clauses” (2007) 3:1 IBA Mediation Committee Newsletter 33 at 36, n 1; Gary B Born, *International Commercial Arbitration*, 2nd ed (Alphen aan den Rijn: Kluwer Law International, 2014) at 278, 279.

ESCALATION CLAUSES

A. The basic idea of an escalation clause

A multi-tiered procedure typically, but as will be shown not necessarily, commences with negotiations between the parties, followed by mediation or other ADR instruments and finds its end with proceedings before an arbitral tribunal or a court.² Since escalation clauses have their basis in party autonomy, such provisions can be drafted in diverse ways.³ Their precise content and function thus depend on their wording.⁴ The parties are generally free to agree on any procedure they deem appropriate for their purposes. Typically, multi-step clauses provide for a two- or three-stage procedure consisting of negotiation, mediation or other ADR instruments, finally followed by arbitration or litigation.⁵ The parties can agree on stipulations which provide for optional preliminary negotiations and ADR proceedings, or on terms which require these multi-level proceedings to be a mandatory condition precedent to further legal actions.⁶ In the latter case, proceedings at a higher stage are only permitted to the extent that the parties could not resolve the dispute at the antecedent level.⁷ By providing for a sequence of dispute resolution instruments, escalation clauses enhance the parties' chances for finding an effective solution; certain disputes can be filtered out at an earlier stage, prior to any further legal proceedings, which is both time- and cost-efficient.⁸ This applies particularly to cases in which corporate executives, who not only have the authority to negotiate but also the business incentive to come to an expeditious settlement, are directly involved.⁹

One typical field of application of such provisions is the area of construction contracts.¹⁰ Disputes relating to that type of contract often deal with technical questions, which typically relate to the project itself and its realisation. Problems arising in this context are better discussed by technicians or engineers already involved in the implementation of the project. The main reason for this is that these professionals are more knowledgeable with respect to certain matters than lawyers or other third parties.¹¹ Resolving the dispute by discussions between technicians is thus

2 Alexander Jolles, "Consequences of Multi-Tiered Arbitration Clauses: Issues of Enforcement" (2006) 72:4 *Arbitration* 329 at 329; Julian DM Lew, Loukas A Mistelis & Stefan M Kröll, *Comparative International Commercial Arbitration* (The Hague: Kluwer Law International, 2003) at para 8–62.

3 Gary B Born, *International Arbitration and Forum Selection Agreements: Drafting and Enforcing*, 4th ed (Alphen aan den Rijn: Kluwer Law International, 2013) at 103.

4 Simon Chapman, "Multi-Tiered Dispute Resolution Clauses: Enforcing Obligations to Negotiate in Good Faith" (2010) 27:1 *J Intl Arb* 89 at 90.

5 Paul D Friedland, *Arbitration Clauses for International Contracts*, 2nd ed (Huntington, New York: JurisNet, 2007) at 121, 126; Margaret L Moses, *The Principles and Practice of International Commercial Arbitration*, 2nd ed (New York: Cambridge University Press, 2012) at 51, 52.

6 Klaus Peter Berger, "Law and Practice of Escalation Clauses" (2006) 22:1 *Arb Int* 1 at 5; Born, *supra* note 3 at 103.

7 Michael Pryles, "Multi-Tiered Dispute Resolution Clauses" (2001) 18:2 *J Intl Arb* 159 at 159.

8 Klaus Peter Berger, *Private Dispute Resolution in International Business*, 1st ed (The Hague: Kluwer Law International, 2006) at para 2-70; Berger, *supra* note 6 at 1; Pryles, *supra* note 7 at 159; Doug Jones, "Dealing With Multi-Tiered Dispute Resolution Process" (2009) 75:2 *Arbitration* 188 at 188.

9 Moses, *supra* note 5 at 52.

10 Lew, Mistelis & Kröll, *supra* note 2 at para 8-68.

11 Catherine Bellsham-Revell, "Complex Dispute-Resolution Clauses: Has the Desire to Control the Dispute

more cost-effective than referring it to legal proceedings.¹² This fact makes this kind of disputes suitable for the implementation of an escalation clause.¹³

Clauses providing for an optional procedure lack any obligation for the parties and thus cannot be enforced. Therefore, this paper focuses on clauses that call for mandatory proceedings which require enforcement if one party refuses to comply with the agreement. It highlights the negotiation component of an escalation clause, given that in practice a solution may be reached through discussions in good faith, friendly discussions and an amicable settlement that takes place before any potential legal proceedings. It will be shown that the legal function of the term “good faith” is distinct from that of “friendly discussions” or “amicable settlement”.¹⁴ However, this much may be revealed at this point, although this difference is important for dogmatic reasons, it does not make a difference at the stage of enforcement.

B. Practical examples

The following examples serve to illustrate the idea and application of multi-step clauses. They can be found in individually agreed contracts but also in standard form contracts provided by the construction industry or organisations involved in the field of dispute resolution.¹⁵ The specific elements necessary for a valid escalation clause will be explained and discussed below. The present examples differ in one important point and can thus be divided in two categories of clauses: the first example explicitly includes the element of good faith. Examples two and three, on the other hand, provide for friendly discussions and amicable settlement but do not require the parties to act in good faith, at least not explicitly. This difference will be dealt with in depth when the legal principle of good faith is explained.

i. Example one

The following escalation clause is a model clause related to arbitration. Several organisations are active in the field of dispute resolution and provide guidance by drafting model documents. One of them is the Centre for Effective Dispute Resolution (“CEDR”). This international organisation, based in London and active in the field of mediation and alternative dispute resolution, aims at promoting alternative dispute resolution and has formulated various standard forms to attain this object. One of these documents, the “CEDR Model ADR contract clauses 2016” deals with escalation clauses and includes, *inter alia*, the model clause illustrated below.¹⁶ It refers to a widely used three-tier approach covering negotiation, mediation and arbitration/litigation and demands that the dispute firstly be negotiated by the parties meeting “in a good faith effort”. The use of the

Process Led to Increased Uncertainty?” (2008) *Intl Arb L Rev* 177 at 177.

¹² *Ibid.*

¹³ Ugo Draetta, “Dispute Resolution in International Construction Linked Contracts” (2011) *IBLJ* 69 at 80; Jones, *supra* note 8 at 188.

¹⁴ Compare Lew, Mistelis & Kröll, *supra* note 2 at para 8-70.

¹⁵ Tanya Melnyk, “The Enforceability of Multi-Tiered Dispute Resolution Clauses: The English Law Position” (2002) *5:4 Intl Arb L Rev* 113 at 113.

¹⁶ See “CEDR Model ADR Contract Clauses – Multi-tiered Process [2016 Edition]” (30 October 2015), online: CEDR <www.cedr.com/about_us/modeldocs/>.

term “will” leaves no room for discretion and suggests that a predetermined procedure must be followed.

“If any dispute arises in connection with this agreement, a director [...] will, within [14] days of a written request from one party to the other, meet in a good faith effort to resolve the dispute.

If the dispute is not wholly resolved at that meeting, the parties will attempt to settle it by mediation in accordance with the CEDR Model Mediation Procedure. [...]

No party may commence any court proceedings/arbitration in relation to any dispute arising out of this agreement until it has attempted to settle the dispute by mediation and either the mediation has terminated or the other party has failed to participate in the mediation [...].”

ii. Example two

The second example originates from the case of *Emirates Trading Agency v Prime Mineral Exports Private*¹⁷, one of the most recent decisions by the English High Court that dealt with escalation clauses and their enforceability. This two-level clause envisages negotiations at the first stage, which includes friendly discussions, elaborated below, and arbitral proceedings at the second stage. A duty of acting in good faith is not referred to explicitly. The use of the word “shall” demonstrates that the negotiation stage is mandatory and has to be completed prior to any arbitral proceedings. The importance of this consideration will be explained in detail further below as well.

“11.1 In case of any dispute or claim arising out of or in connection with or under this [contract] [...], the Parties shall first seek to resolve the dispute or claim by friendly discussion. [...] If no solution can be arrived at in between the Parties for a continuous period of 4 (four) weeks then the non-defaulting party can invoke the arbitration clause and refer the disputes to arbitration.

11.2 All disputes arising out of or in connection with this [contract] shall be finally resolved by arbitration in accordance with the Rules of Arbitration of the International Chamber of Commerce (“ICC”). [...].”

iii. Example three

The third and final example deals with a clause frequently used in the area of construc-

¹⁷ *Emirates Trading Agency LLC v Prime Mineral Exports Private Ltd*, [2014] EWHC 2104 (Comm) at para 3, [2015] 1 WLR 1145 (EWHC QB) [*Emirates*].

tion contracts. The construction industry has introduced various approaches for dealing with escalation clauses. One of the most well-known federations in this field, the International Federation of Consulting Engineers, or simply known as “FIDIC”, has developed several model contracts for the construction industry covering different aspects and areas. These include, for instance, the “Conditions of Contract for Construction”, known as the “Red Book” or the “Conditions of Contract for EPC/Turnkey Projects”, known as the “Silver Book”.¹⁸ Clause 20.5 of the FIDIC Red Book¹⁹ requires that contracting parties find an amicable solution. Initially, under clause 20.2 of the FIDIC Red Book, the dispute is referred to a third party, the Dispute Adjudication Board (“DAB”), which deals with the dispute.²⁰ Only if one of the parties is dissatisfied with the decision of the DAB, may they enter the subsequent stage and attempt to settle the dispute amicably by negotiating. The term “shall” demonstrates that the second stage is compulsory for the final stage of arbitration. However, this step is mandatory in the sense that the parties are only obliged to attempt to settle the dispute; they are not required to reach a consensual agreement.²¹

“Where notice of dissatisfaction has been given²² [...], both Parties shall attempt to settle the dispute amicably before the commencement of arbitration. However, unless both Parties agree otherwise, arbitration may be commenced on or after the fifty-sixth day after the day on which notice of dissatisfaction was given, even if no attempt at amicable settlement has been made.”²³

iv. Summary

All the aforementioned clauses provide for negotiations between the parties and require them to resolve the dispute in a specific manner, in good faith, by friendly discussion, or by an amicable settlement. One of the main questions discussed here is how such terms are to be interpreted and whether (and under what prerequisites) a clause providing for these conditions is enforceable under English law.

ESCALATION CLAUSES BEFORE ENGLISH COURTS

The effectiveness of a contractual clause depends on its enforceability. In relation to escalation clauses, the position of English courts is evolving.

¹⁸ See Ellis Baker et al, *FIDIC Contracts: Law and Practice* (London: Informa, 2009) at para 2.4 ff.

¹⁹ The International Federation of Consulting Engineers, *FIDIC Conditions of Contract for Construction for Building and Engineering Works Designed by the Employer*, FIDIC, 1999, ch 20.5 [*FIDIC Conditions*].

²⁰ Baker, *supra* note 18 at para 9.168; see also Oscar Aitken & Lyda Bier, “One Size Fits All: Dispute Adjudication Board Clauses in the FIDIC Conditions of Contract (Red Book)” (2010) 5:3 *Construction L Intl* 13 at 18.

²¹ Baker, *supra* note 18 at para 9. 175.

²² This prerequisite refers to a decision by the DAB under clause 20.4 FIDIC Red Book.

²³ *FIDIC Conditions*, *supra* note 19 at ch 20.5.

A. The development in England

Traditionally, the enforceability of multi-step clauses under English law was uncertain, particularly in relation to clauses providing for negotiating in good faith. However, recent decisions have clarified the issue.

Initially, English courts were reluctant to recognise a duty of good faith. The reason for this position can be found in one of the main principles of contract formation in common law.²⁴ A party is required to demonstrate a clear intention to enter into a legal relationship with regard to stipulations which are certain in nature.²⁵ Good faith, however, is a rather broad principle which courts were averse to refer to in common law unless it was statutory law.²⁶ In respect of agreements to negotiate in good faith, courts have been constantly reluctant to enforce them.

One of the first decisions in this context is *Courtney & Fairbairn v Tolaini Brothers*²⁷, where the Court of Appeal held that bare agreements to negotiate were not enforceable since they lacked certainty. This position was confirmed by the House of Lords in *Walford v Miles*, an English landmark decision dealing with the obligation to negotiate in good faith.²⁸ General principles of contract formation under common law require the parties of a contract to show a precise intent to enter into a relationship which is, as to its terms, sufficiently certain.²⁹ For a court, a party's rights and obligations, arising out of a rather broadly formulated clause, were too unclear and it was hard to determine whether the parties were complied with their duties.³⁰

This understanding began to change slightly and in *Cable & Wireless v IBM*³¹. The High Court of Justice held that a mediation clause, which presupposed the involvement of a third party, the mediator, was enforceable under English Law. The crucial point in this case was that the stipulation in question referred to a specific mediation procedure recommended by the CEDR. This fact was emphasised by the judge and was held to provide the clause with sufficient certainty as to its determinable procedure, particularly because the CEDR was active in the field of mediation and was clearly familiar with this concept.³² Following this decision, English courts attempted to establish certain guidelines for determining the requirements of an enforceable escalation clause.

²⁴ John Cartwright, *Contract Law: An Introduction to the English Law of Contract for the Civil Lawyer*, 2nd ed (Oxford: Hart, 2013) at 61.

²⁵ Leon E Trakman & Kunal Sharma, "The Binding Force of Agreements to Negotiate in Good Faith" (2014) 73:3 Cambridge LJ 598 at 599.

²⁶ Cartwright, *supra* note 24 at 62.

²⁷ *Courtney & Fairbairn Ltd. v Tolaini Brothers (Hotels) Ltd.* (1974), [1975] 1 WLR 297, [1975] 1 All ER 716, Lord Denning MR [*Courtney*]. ("If the law does not recognise a contract to enter into a contract [...] it seems to me it cannot recognise a contract to negotiate. [...] [I]t is too uncertain to have any binding force" at 301); Chapman, *supra* note 4 at 92.

²⁸ *Walford v Miles*, [1992] 2 A.C. 128 at 138, [1992] 2 WLR 174 (UKHL) [*Walford*].

²⁹ Trakman & Sharma, *supra* note 25 at 599.

³⁰ *Courtney*, *supra* note 27 at 301: "No court could estimate the damages because no one could tell whether the negotiations would be successful or would fall through: or if successful what the result would be".

³¹ *Cable & Wireless plc v IBM United Kingdom Ltd*, [2002] EWHC 2059 (Comm), [2002] 2 All ER (Comm) 104 [*Cable*].

³² *Ibid.*, at para 21.

In *Holloway v Chancery Mead*, Justice Ramsey expressed his view on this issue in an *obiter dictum* and identified three conditions for a multi-step clause to be enforceable:³³

“First, that the process must be sufficiently certain [...]. Secondly, the administrative processes for selecting a party to resolve the dispute and to pay that person should also be defined. Thirdly, the process or at least a model of the process should be set out so that the detail of the process is sufficiently certain.”

In *Wah & Anor v Grant Thornton International*³⁴, the English High Court ruled on the enforceability of a stipulation providing for negotiations in good faith and established a test for the enforceability of escalation clauses:

“The test ... is whether the obligations ... it imposes are sufficiently clear and certain to be given legal effect... [T]he test is whether the provision prescribes, without the need for further agreement: (a) a sufficiently certain and unequivocal commitment to commence a process; (b) from which may be discerned what steps each party is required to take to put the process in place; and which is (c) sufficiently clearly defined to enable the court to determine objectively (i) what under that process is the minimum required of the parties to the dispute in terms of their participation in it and (ii) when or how the process will be exhausted or properly terminable without breach.”

Considering these guidelines, the court held that the required conditions were not met and denied the enforceability. It ruled that the term good faith was “too open-ended” to determine a sufficiently certain procedure which was to be followed by the parties during the process of negotiating.³⁵ Despite this decision, English courts have not adopted such a formal test but instead consider multi-step clauses on a case-by-case basis.³⁶

In *Emirates*, Justice Teare considered the attempts made by English courts and listed specific key elements taken from English case law for an escalation clause to be enforceable as further illustrated below.³⁷ Moreover, and contrary to previous court decisions, he considered the

³³ *Holloway v Chancery Mead Limited*, [2007] EWHC 2495 (TCC) at para 81, 117 Con LR 30 [*Holloway*].

³⁴ *Wah (Aka Alan Tang) & Anor v Grant Thornton International Ltd. and others*, [2012] EWHC 3198 (Ch), [2012] CN 63 at para 60 [*Wah*].

³⁵ *Ibid* at para 57.

³⁶ Craig Tevendale, Hannah Ambrose & Vanessa Naish, “Multi-Tier Dispute Resolution Clauses and Arbitration” (2015) 1:1 Turkish Com L Rev 31 at 36.

³⁷ See e.g. *Walford*, *supra* note 28 at 138; *Wah*, *supra* note 34 at para 60; *Yam Seng Pte Limited v International Trade Corporation Limited*, [2013] EWHC 111 (QB) at para 123, [2013] 1 All ER (Comm) 1321 [*YSP*].

element of good faith. In his view, although it was not explicitly included in the contract, it was implied in the clause. Moreover, he found it to be sufficiently certain for the escalation clause to be enforceable.³⁸

B. The key elements of an escalation clause

Even though there is no formal test, in line with *Holloway* and *Emirates* an enforceable escalation clause must meet the following conditions: it must be certain as to its procedure, be drafted in a way which makes its compliance mandatory, and include a precise time period.³⁹

i. Certainty

The element of certainty is of overriding importance in the context of escalation clauses. Certainty means that the procedure, the escalation process itself, must be of sufficient definiteness.

Firstly, the parties must be able to understand their respective contractual rights and obligations in the context of the expected procedure.⁴⁰ Any opportunity for the parties to rely on a lack of clarity as to the clause must be avoided, to prevent them from refraining from the agreed-upon procedure and submitting the case directly to the tribunal.

Secondly, certainty is needed for the reason of enforcement since such a clause is not self-executing.⁴¹ The instrument of enforcement depends upon a decision by the court and is applied when one party seeks to neglect its contractual obligation. In this context, some uncertainty entails a lack of enforceability since “a court would have insufficient objective criteria to decide whether one or both parties were in compliance or breach of such a provision.”⁴² The clause should, for example, determine whether the parties are to be referred to negotiation and/or mediation, in which manner negotiations are to be held, and, in the case of mediation, how the mediator is to be appointed. In short, the procedure relevant to the parties must be objectively determinable.⁴³ Clauses referring to rules and proceedings established by organisations active in the field of dispute resolution usually meet this requirement.⁴⁴

ii. Mandatory procedure

Escalation clauses either provide for a mandatory or a non-mandatory approach. Whether it is the former or the latter depends on the answer to the following question. Did the parties intend negotiation/mediation proceedings to be a mandatory step prior to arbitration/litigation

³⁸ *Emirates*, *supra* note 17 at para 64.

³⁹ Compare *Holloway*, *supra* note 33 at para 81; *Emirates*, *supra* note 17 at paras 52, 64.

⁴⁰ Compare *Sulamérica Cia Nacional de Seguros SA v Enesa Engenharia SA*, [2012] EWCA Civ 638 at para 36, [2012] 1 Lloyd’s Rep 671 [*Sulamerica*].

⁴¹ Compare *Civil Procedure Rules*, SI 2015/1881 at r 26.4 [*CPR*]; Mindy Chen-Wishart, *Contract Law*, 4th ed (Oxford: Oxford University Press, 2012) at 29–30; Cartwright, *supra* note 24 at 239–240.

⁴² Justice Colman in *Cable*, *supra* note 31 at para 23; compare *Petromec Inc & Ors v Petroleo Brasileiro SA Petrobras & Ors*, [2005] EWCA Civ 891 at para 116, [2006] 1 Lloyd’s Rep 121 [*Petromec*].

⁴³ *Wah*, *supra* note 34 at para 57.

⁴⁴ Compare the reference to CEDR in *Cable*, *supra* note at para 21.

or a mere non-binding option? In other words, are these negotiation/mediation proceedings a condition precedent to any further legal actions?⁴⁵ The mandatory character of each stage must arise out of the contract.⁴⁶ To avoid ambiguity, the language of the escalation clause should clearly show that the process set forth is compulsory. In this context, for instance, the word “shall” is to be preferred to “may”; the latter term is too ambiguous and the parties run the risk to delay the dispute settlement process, which can result in unnecessary expenses for the parties disputing about their original intention.⁴⁷

iii. Time period

An effective multi-step clause typically includes a time frame within which the parties are prevented from taking any legal action regarding the dispute. The purpose of this element is to clearly demarcate the start of negotiations and the beginning of the period for conducting further legal proceedings.⁴⁸ Under the CEDR model clause above, the parties are to meet to resolve the dispute within fourteen days of a written request from one party to the other. Example two provides for friendly discussions for a continuous period of four weeks before the dispute can be referred to arbitration. *Prima facie*, this time component only seems to have the function of providing further certainty and clarity since it refines the parties’ rights and obligations and separates the different steps of procedure from each other. However, a second look reveals that this element has an additional meaning to be distinguished from the multi-step clause as an instrument of multilayer proceedings.

iv. The mutual agreement not to sue

The time component of an escalation clause does not only add certainty. It also includes a second element, which can greatly impact the enforceability of a negotiation clause. This impact will be discussed in detail later on.⁴⁹ Initially, this section deals with the element itself. An agreement that precludes the parties from taking any legal measure for a precise period of time is not only part of the escalation clause, but can be considered to be a free-standing contract.⁵⁰ Under English law, this agreement has a twofold effect, consisting of a procedural and a contractual component.⁵¹

English civil procedure law is a good starting point. In the context of proceedings before state courts, the effect would be as follows: the English Civil Procedure Rules (“CPR”) include specific provisions dealing with ADR mechanisms. Rule 1.4 of Part 1 CPR states that the duty of the court is to manage the case. This includes encouraging the parties to work together and to refer to ADR instruments.⁵² Furthermore, pursuant to rule 26.4 CPR, the court is empowered to order a

45 Berger, *supra* note 6 at 5.

46 Friedland, *supra* note 5 at 123.

47 *Ibid.*

48 Compare Pryles, *supra* note 7 at 160.

49 See below under V. 2. c).

50 Thomas Arntz, “Die missglückte Eskalationsklausel” (2014) SchiedsVZ 237 at 237 [translated by author].

51 Compare *Cable*, *supra* note 31 at para 34.

52 See *CPR*, *supra* note 41 at r 1.4 (2) (e).

stay of the proceedings, if there is a chance for the parties to settle their case outside the courtroom by referring to ADR-related instruments.⁵³ *A fortiori*, the court will stay any proceedings where the parties have contractually agreed on pre-litigation ADR-proceedings; such an agreement simply shows the common intention of the parties to stay the proceedings and will be respected by the court.⁵⁴ This stay is a procedural instrument arising out of the CPR giving specific effect to the parties' agreement.⁵⁵ It prevents the parties from commencing legal actions before that court.

Besides that, such a stay can be the result of the agreement itself. The parties can agree to waive their right to take legal measures for a specific period of time. Such a contract implicitly includes the "*pactum de non petendo*", which imposes an obligation on the parties to refrain from suing during this period.⁵⁶ If, for instance, arbitral proceedings are commenced in violation of this obligation, the tribunal will stay the respective proceedings and refer the parties to the agreed-upon procedure, i.e. negotiations. The tribunal may also dismiss any legal action that is taken by one of the parties as currently inadmissible.⁵⁷ In this second case, a reference to the CPR is not necessary for the agreement to have legal effect.

C. Summary

Effective escalation clauses must fulfil specific requirements, particularly the element of certainty. Furthermore, such a clause typically includes a separate agreement according to which the parties agree not to take legal measures for a specific period of time. In this context, the following question arises: assuming that the escalation clause lacks certainty, and with that enforceability, what is the effect of this implicit agreement? Does it still prevent the parties from taking legal measures? This will be discussed later on.⁵⁸ Initially, the focus is on the principle of good faith.

THE INSTRUMENT OF GOOD FAITH AND ITS INTERPRETATION

The present examples include a further component by providing for friendly discussions, amicable settlements, or meetings in good faith. These requirements are formulated rather broadly and are open to interpretation. Good faith is, due to its legal function, has a distinct meaning. The question is what exactly such clauses provide for and whether these clauses are enforceable under English law.

⁵³ Stuart Sime, *A Practical Approach to Civil Procedure*, 17th ed (Oxford: Oxford University Press, 2014) at 176; *CPR*, *supra* note 41 ("A party may, when filing the completed directions questionnaire, make a written request for the proceedings to be stayed while the parties try to settle the case by alternative dispute resolution or other means. [...] If the court otherwise considers that such a stay would be appropriate, the court will direct that the proceedings [...] be stayed for one month, or for such other period as it considers appropriate" at r 26.4 (1)-(2A)).

⁵⁴ *Ibid* ("If all parties request a stay the proceedings will be stayed for one month [...].") At r 26.4(2)).

⁵⁵ *Cable*, *supra* note 31 at para 34.

⁵⁶ "Agreement not to sue"; Berger, *supra* note 6 at 6.

⁵⁷ Jolles, *supra* note 2 at 336; Dyala Jimenez-Figueres, "Multi-Tiered Dispute Resolution Clauses in ICC Arbitration" (2003) 14:1 ICC Bull 71 at 78; *Cable*, *supra* note 31 at para 34.

⁵⁸ See under V. 2. c).

A. The legal basis of the principle of good faith

Good faith is not only a rather broad term open for interpretation but also a well-known legal concept with a specific function, particularly in the context of contractual relationships. Provided that the principle of good faith is recognised by the respective jurisdiction, it establishes a specific duty to be observed by the parties.⁵⁹ This duty is hard to define. However, this is one of the main advantages of this notion and one of the reasons why parties constantly refer to it. Its vague yet not uncertain. The parties can freely interpret its meaning, which further allows them to adapt their procedure of negotiating to the actual circumstances.⁶⁰

At the outset, the legal basis of the concept of good faith will be explained to introduce to the legal principle of good faith. Afterwards, the paper will address the actual meaning and content of good faith, with special emphasis on the enforceability of a clause that imposes duty to negotiate in good faith. Although this illustration applies to example one, mentioned above, it may also be characteristic of examples two and three.

i. Common law

The common law position on the duty of good faith has developed differently in England, the United States, and Canada.

England

Under modern English law, there is no generally recognised obligation to fulfil contractual obligations in good faith.⁶¹ In fact, English law has created a concept consisting of “piecemeal solutions in response to demonstrated problems of unfairness”.⁶² Even though good faith plays a greater role (especially when imposed by European Regulations), this concept is to be considered an autonomous European Union approach rather than an original English concept and is therefore of less interest.⁶³

In relation to a requirement to negotiate in good faith, Lord Ackner pointed out in *Walford* that “the concept of a duty to carry on negotiations in good faith is inherently repugnant to the adversarial position of the parties when involved in negotiations. Each party [...] is entitled to pursue his [...] own interest”.⁶⁴ This essentially refers to negotiations which take place in a

⁵⁹ The Honourable Mr Johan Steyn, “The Role of Good Faith and Fair Dealing in Contract Law: A Hair-Shirt Philosophy?” (1991) 6 Denning LJ 131 at 131.

⁶⁰ Compare Baker, *supra* note 18 at para 9.171.

⁶¹ Sir Jack Beatson, Andrew Burrows & John Cartwright, *Anson’s Law of Contract*, 29th ed (New York: Oxford University Press, 2010) at 347.

⁶² *Interfoto Picture Library Ltd v Stiletto Visual Programmes Ltd*, [1988] 2 WLR 615 at 621, [1988] 1 All ER 348 [*Interfoto*].

⁶³ Beatson, Burrows & Cartwright, *supra* note 61 at 213; Ewan McKendrick, *Contract Law: Text, Cases and Materials*, 5th ed (New York: Oxford University Press, 2012) at 495.

⁶⁴ *Walford*, *supra* note 28 at 138; see Reinhard Zimmermann & Simon Whittaker, “Good Faith in European Contract Law: Surveying the Legal Landscape” in Reinhard Zimmermann & Simon Whittaker, eds, *Good Faith in European Contract Law* (Cambridge: Cambridge University Press, 2000) 7 at 15, 40.

pre-contractual situation. It was deemed that in this case, the parties had no reason to fear any interference from the courts.

In contrast, recent decisions suggest that English courts tend to acknowledge a duty to comply with specific promises in good faith which have their basis in an existing contract.⁶⁵

One of the most recent rulings in this regard was the case of *Compass Group UK v Mid Essex Hospital Services*, where the Court of Appeal held “that there is no general doctrine of good faith in English contract law” but “[i]f the parties wish to impose such a duty they must do so expressly”.⁶⁶

An even more extensive approach arguing for a duty of good faith can be found in the decision of *Yam Seng Pte v International Trade Corporation*, where Justice Leggatt ruled that “there seems to me to be no difficulty, following the established methodology of English law for the implication of terms in fact, in implying such a duty in any ordinary commercial contract based on the presumed intention of the parties.”⁶⁷ As to the parties’ intention the court continued that “as the basis of the duty of good faith is the presumed intention of the parties and meaning of their contract, its recognition is not an illegitimate restriction on the freedom of the parties to pursue their own interests. The obligations which they undertake include those which are implicit in their agreement as well as those which they have made explicit.”⁶⁸ Justice Leggatt concluded that “the traditional English hostility towards a doctrine of good faith in the performance of contracts, to the extent that it still persists, is misplaced.”⁶⁹

This development towards recognising a duty of good faith has been continued in *Emirates*, where the English High Court referred to *YSP* and held a clause providing for negotiations to include an implied duty to act in good faith. The court held: “The obligation to seek to resolve disputes by friendly discussions must import an obligation to seek to do so in good faith. In traditional terms such an obligation goes without saying and is necessary to give business efficacy to the contract. In modern terms that is what the contract would be reasonably understood to mean.”⁷⁰

The discussion on the recognition of a duty of good faith is particularly significant for escalation clauses not including an explicit reference to such a duty as it is the case with the examples two and three. The question arising in this case is whether the parties are required to act in good faith anyway. In this regard, example one is of less concern: the parties are required to act in good faith since they have explicitly agreed on such a duty. However, even an explicit reference does not necessarily mean that the clause is enforceable.⁷¹

65 Trakman & Sharma, *supra* note 25 at 601, 604; compare *Philips Electronique Grand Public SA v British Sky Broadcasting Ltd*, [1995] EMLR 472 (EWCA Civ).

66 *Compass Group UK and Ireland Ltd (t/a Medirest) v Mid Essex Hospital Services NHS Trust*, [2013] EWCA Civ 200 at para 105, [2013] CN 403.

67 *YSP*, *supra* note 37 at para 131.

68 *Ibid* at para 148.

69 *Ibid* at para 153.

70 *Emirates*, *supra* note 17 at para. 51.

71 Cartwright, *supra* note 24 at 63, 72.

United States

The situation is partly different in the United States, where the duty of good faith is recognised as a general principle of contract law being implied in every contract.⁷² Section 205 of the American Restatement (Second) of Contracts⁷³ states that “[e]very contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement.”⁷⁴ Comment (a) to section 205 defines good faith as “faithfulness to an agreed common purpose and consistency with the justified expectations of the other party.”⁷⁵ In contrast, the Uniform Commercial Code⁷⁶ defines good faith as “honesty in fact and the observance of reasonable commercial standards of fair dealing.”⁷⁷ In the case of a merchant, section 2-103 UCC defines good faith as “honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade.”⁷⁸ Such a duty, however, is limited to cases where the respective parties have already concluded a contract and focus on its performance; the situation in which two parties negotiate a contract is different and is covered neither by the Restatement 2nd nor the UCC.⁷⁹ Moreover, neither of these statutes has binding power, as they are only instruments for harmonising law.⁸⁰

Well before the enactment of the Restatement 2nd and the UCC, the New York Court of Appeals rendered a landmark decision on the implied covenant of good faith. In *Kirk La Shelle v Paul Armstrong*, it ruled that “in every contract there is an implied covenant that neither party shall do anything which will have the effect of destroying or injuring the right of the other party to receive the fruits of the contract, which means that in every contract there exists an implied covenant of good faith and fair dealing.”⁸¹

The contract law in the United States does not recognise a duty to act in good faith in the context of negotiation unless the parties have concluded an explicit agreement.⁸² The main reason for this is, similar to the English position, the conviction that a general duty of good faith is contrary to the freedom of negotiations, where each party seeks the best deal by hard bargaining

72 Steven J Burton, “Breach of Contract and the Common Law Duty to Perform in Good Faith” (1980) 94 Harv L Rev 369 at 369, 371; Harold Dubroff, “The Implied Covenant of Good Faith in Contract Interpretation and Gap-Filling: Reviving a Revered Relic” (2006) 80:2 St John’s L Rev 559 at 568.

73 *Restatement (Second) of the Law of Contracts* § 205 (1981) [*Restatement*].

74 *Ibid*; compare Emily MS Houh, “Critical Interventions: Toward an Expansive Equality Approach to the Doctrine of Good Faith in Contract Law” (2003) 88:4 Cornell L Rev 1025 at 1025, 1035 ff. The Restatement 2nd followed the original Restatement of Contracts which included specific references to good faith but no universal obligation, see Dubroff, *supra* note 72 at 566–567.

75 *Restatement*, *supra* note 73, comment (a).

76 UCC (2001).

77 *Ibid* § 1-201(20) (2001).

78 *Ibid* § 2-103(1b) (2002).

79 *Restatement*, *supra* note 73, comment (c); Emily MS Houh, “The Doctrine of Good Faith in Contract Law: A (Nearly) Empty Vessel?” (2005) Utah L Rev 1 at 3; Dubroff, *supra* note 72 at 593.

80 William Tetley, “Good Faith in Contract: Particularly in the Contracts of Arbitration and Chartering” (2004) 35:4 J Mar L & Com 561 at 585, n 121.

81 *Kirk La Shelle Co v Paul Armstrong Co*, 188 NE 163 (NY 1933).

82 Gregory Klass, *Contract Law in the United States*, 2nd ed (Alphen aan den Rijn: Kluwer Law International, 2012) at para 40; Dubroff, *supra* note 72 at 561.

without any contractual liability, only subject to fraud, duress, or the like.⁸³

*Canada*⁸⁴

The Canadian position as to the duty of good faith has been described in a landmark case of *Bhasin v Hrynew*. Justice Cromwell, *inter alia*, held that: “Canadian common law in relation to good faith [...] is piecemeal, unsettled and unclear.”⁸⁵ In fact, Canadian courts have, traditionally, been reluctant to accept a general duty of good faith. However, they recognised such an implied duty in specific cases, like in the context of employment or insurance law.⁸⁶ In *McKinlay Motors v Honda*, the Newfoundland Supreme Court held that “it [was] obviously an implied term of any such agreement that the parties act toward each other in their business dealings, in good faith.”⁸⁷ This original approach was refined in *Bhasin*, where the Supreme Court of Canada moved away from an implied duty and developed a more general principle of honesty in contractual performance.⁸⁸ This development was considered to be necessary to enhance coherence and justice of common law. In this context, according to Justice Cromwell, two distinct steps were required to be taken. The first step towards a general principle of good faith was to recognise the existence of such a principle which manifested itself in various doctrines dealing with contractual performance; it did not constitute a “free-standing rule,” the breach of which was enforceable.⁸⁹ The second step consisted of recognising that parties were obliged to perform their contractual duties in compliance with a specific standard of honesty and reasonableness.⁹⁰ In this context, acting honestly means that the parties are required not to “lie or otherwise knowingly mislead each other about matters directly linked to the performance of the contract.”⁹¹ Nonetheless, such a duty must not limit the parties’ freedom in respect of their contractual relationship; this is, however, unlikely to happen since they will hardly agree on a dishonest performance of their obligations.⁹² This fact suggests that the good faith principle is an instrument for the courts to come to a right and just result.

Canadian common courts, as U.S. courts, recognise a general principle of good faith primarily in the context of the performance of contracts.⁹³

83 Compare Melvin Eisenberg, “The Duty to Negotiate in Good Faith in American Law” in Colin Lockhart, ed, *Misleading or Deceptive Conduct: Issues and Trends* (Sydney: The Federation Press, 1996) 110 at 110; E Allan Farnsworth, “Precontractual Liability and Preliminary Agreements: Fair Dealings and Failed Negotiations (1987) 87:2 Colum L Rev 217 at 221; *Feldman v Allegheny International Inc*, 850 F (2d) 1217 at 1223 (7th Cir 1988).

84 This paper deals with Canadian common law.

85 *Bhasin v Hrynew*, 2014 SCC 71 at para 75, [2014] 3 SCR 495 [*Bhasin*].

86 See Shannon Kathleen O’Byrne, “The Implied Term of Good Faith and Fair Dealing: Recent Developments” (2007) 86 Can Bar Rev 193 at 210, 220; see *Wallace v United Grain Growers Ltd.*, [1997] 3 SCR. 701 at para 98, [1997] SCJ No. 94 (the case deals with employment law); *Fidler v Sun Life Assurance Co. of Canada*, 2006 SCC 30 at para 63, [2006] 2 SCR 3 (the case deals with insurance law).

87 *McKinlay Motors Ltd v Honda Canada Inc*, [1989] 46 BLR 62 at para 80, 1989 CanLII 4918 (NLSC).

88 *Bhasin*, *supra* note 85 at para 75.

89 *Ibid* at paras 63-64.

90 *Ibid* at para 63.

91 *Ibid* at para 73.

92 *Ibid* at para 496.

93 See Gerald H Fridman, *The Law of Contract in Canada*, 5th ed (Toronto: Carswell, 2006) at 540.

A brief comparison

The previous illustration shows differences as to the degree in which the principle of good faith is recognised by the courts. English courts are clearly more reluctant in accepting this doctrine than Canadian and U.S. courts. While English courts refer to an implied duty, the Canadian Supreme Court has made a more progressive step towards a general principle of good faith. However, it also demonstrates common ground: firstly, there is no statutory binding law providing for an overarching duty of good faith; such a duty is mainly recognised by the respective courts. Secondly, these courts have developed specific guidelines to deal with the issue of good faith. Particularly the Canadian position underlines that the decision to approve such a duty mainly depends on the facts of each case. Lastly, courts have recognised a duty of good faith more and more frequently. However, a recognition has been made primarily in the context of the performance of a contract, not in a pre-contractual situation.

B. Meaning and content of good faith

After clarifying the legal basis for the duty of good faith, it is time to determine the specific content of such a duty. After all, this is what becomes subject of subsequent enforcement proceedings. The problem is, in essence, what the principle of good faith requires the parties to do. The question whether the term of good faith is sufficiently certain to be enforceable can only be answered, if its content has been specified. In this context, a brief illustration of the situation in other common law countries is helpful because these countries provide a legitimate and suitable source for an English judge.⁹⁴

i. Good faith under common law

England

English law does not recognise an overriding principle of good faith; nonetheless, as it has been shown above, it has been relied upon in various situations. The main problem in relation to good faith is its meaning and content: as of now, there is no widely accepted definition, at least not in relation to a contractual context. One reason for this is the term's lack of certainty.⁹⁵ However, various courts have made an attempt to find one.

In *Interfoto*, Lord Justice Bingham held in relation to good faith that “its effect is perhaps most aptly conveyed by such metaphorical colloquialisms as “playing fair”, “coming clean” or “putting one’s cards face upwards on the table”. It is in essence a principle of fair open dealing.”⁹⁶ The English High Court ruled in *CPC v Qatari Diar* “that the content of the obligation of utmost good faith [...] was to adhere to the spirit of the contract, which was to seek to obtain planning consent [...] in the shortest possible time, and to observe reasonable commercial standards of

94 Compare *YSP*, *supra* note 37 at paras 125-30 where the court considered the legal situation in the U.S., Canada, Australia, New Zealand, and Scotland, *YSP*, paras. 125–130; compare *United Group Rail Services v Rail Corporation New South Wales*, [2009] NSWCA 177 [*United Group*] (referred to in *Emirates*, *supra* note 17).

95 Cartwright, *supra* note 24 at 73.

96 *Interfoto*, *supra* note 62 at 439; compare George Applebey, *Contract Law* (London: Sweet & Maxwell, 2001) at para 14.22.

fair dealing, and to be faithful to the agreed common purpose, and to act consistently with the justified expectations of the parties.”⁹⁷ In *Bristol Groundschool v Intelligent Data Capture*, Lord Neuberger MR referred to *YSP* and ruled that “[i]t is clear [...] that good faith extends beyond, but at the very least includes, the requirement of honesty.”⁹⁸ In *YSP*, Justice Leggatt developed an objective test to determine the term of good faith more precisely and pointed out that the specific meaning of good faith depended on the circumstances of each individual case: “Although its requirements are sensitive to context, the test of good faith is objective in the sense that it depends not on either party’s perception of whether particular conduct is improper but on whether in the particular context the conduct would be regarded as commercially unacceptable by reasonable and honest people.”⁹⁹

In summary, the English courts seem to define good faith as being synonymous to honesty, fair dealing, or reasonableness.¹⁰⁰ The questions arising out from this interpretation are, firstly, whether this understanding is applicable to the act of negotiating and, secondly, whether it is sufficient to recognise a duty to act in good faith as being enforceable under English law.

United States

Both the UCC and the Restatement 2nd define good faith. Nevertheless, this does not really clarify the term since both definitions are rather vague.¹⁰¹ Furthermore, they are slightly inconsistent. While the approach taken by the Restatement 2nd focuses on the other party’s expectations, and therefore suggests a rather objective test, section 1-201 UCC emphasises the intent of the acting person and thus provides a rather subjective approach.¹⁰² However, in the case of a merchant, section 2-103 UCC concentrates on “the observance of reasonable commercial standards of fair dealing” and by this requires the parties to align their conduct on a public standard; contrary to section 1-201 UCC, this is more an objective reference.¹⁰³ Neither the UCC nor the Restatement 2nd are binding law. The UCC is required to be adopted by the single states.¹⁰⁴ The law of Michigan, e.g., defines good faith as “honesty in fact and the observance of reasonable commercial standards of fair dealing.”¹⁰⁵

The U.S. courts have adopted the position of the UCC and the Restatement 2nd and specified it in various decisions. In *City of Rome v Glanton*, the U.S. District Court for the Eastern District of Pennsylvania found that the specific content of the principle of good faith would depend on

⁹⁷ See *CPC Group Ltd v Qatari Diar Real Estate Investment Company*, [2010] EWHC 1535 (Ch) at para 246.

⁹⁸ *Bristol Groundschool Ltd v Intelligent Data Capture Ltd & ors*, [2014] EWHC 2145 (Ch) at para 196.

⁹⁹ *YSP*, *supra* note 37 at para 144.

¹⁰⁰ See Edwin Peel, “Agreements to Negotiate in Good Faith” in Andrew Burrows & Edwin Peel, eds, *Contract Formation and Parties* (New York: Oxford University Press, 2010) at 52; Tetley, *supra* note 80 at 563; Trakman & Sharma, *supra* note 25 at 612.

¹⁰¹ Klass, *supra* note 82 at para 41.

¹⁰² *Ibid*; see also *Restatement*, *supra* note 73, comment (a).

¹⁰³ *Restatement*, *supra* note 73, comment (a).

¹⁰⁴ Pamela R Tepper, *The Law of Contracts and the Uniform Commercial Code*, 2nd ed (New York: Delmar Cengage Learning, 2011) at 283; compare Dubroff, *supra* note 72 at 609.

¹⁰⁵ Michigan Compiled Laws § 440.1201(2)(t) (2006); the UCC has been adopted by all 50 states but with variations, see Tepper, *supra* note 104 at 283 (the UCC has been adopted by all 50 states, but with variations).

the circumstances of each individual case.¹⁰⁶ Relating to the performance of a contract this meant an “evasion of the spirit of the bargain, lack of diligence and slacking off, wilful rendering of imperfect performance, abuse of a power to specify terms, and interference with or failure to cooperate in the other party’s performance.”¹⁰⁷ The Supreme Court of Oregon ruled in *Uptown Heights Associates Limited Partnership v Seafirst* that the duty of good faith “is to be applied in a manner that will effectuate the reasonable contractual expectations of the parties,” but “only the objectively reasonable expectations of [the] parties” will be taken into consideration.¹⁰⁸ A further suitable interpretation was given by the United States Court of Appeals in *Market Street Associates v Frey*, where Judge Posner held that “a contract obligates the parties to cooperate in its performance in good faith to the extent necessary to carry out the purposes of the contract.”¹⁰⁹

In essence, good faith in a contractual context is mainly connected with terms such as honesty, intention of the parties, or fair dealing. The exact scope, however, depends on the specific circumstances of each individual case.¹¹⁰

Canada

Contrary to the United States, there is no statutory definition of good faith in Canadian common law. The general perception is that it is connected with a specific conduct depending on the circumstances of each individual case; it aims at protecting the parties’ expectations without limiting their freedom in a contractual relationship.¹¹¹ If a contract provides for an obligation of good faith, each party is expected to behave in a certain way; the specific conduct being expected might, for example, depend on circumstances such as the custom in that industry or community. On this basis, Canadian courts have refined the meaning and content of good faith and added some colour to it.

In *Molson Canada v Miller Brewing*¹¹², the Ontario Superior Court of Justice held that the duty of good faith during negotiations “must be interpreted in accordance with the intention of the parties in the context in which the agreement was negotiated and executed.” It continued that “[t]he issue is not whether a court should imply an obligation to negotiate in good faith as a matter of commercial morality but rather whether the parties themselves understood from the circumstances in which an express commitment to negotiate in good faith was given, and intended in those circumstances, that any breach of the specific commitment was to have some legal consequences.”¹¹³ In *SCM Insurance Services v Medisys*¹¹⁴, the same court held that an obligation

106 *Rome (City of) v Glanton*, 958 F. Supp. 1026 (E.D. Pa. 1997), 1038 [*City of Rome*].

107 *Ibid.*

108 *Uptown Heights Associates Limited Partnership v Seafirst Corp*, 873 P (2nd) 438 (Or App Ct 1994).

109 *Market Street Associates Limited Partnership v Frey*, 941 F (2nd) 588 at para 25 (7th Cir 1991); compare Todd Rakoff, “Good Faith in Contract Performance: Market Street Associates Ltd. Partnership v. Frey” (2007) 120:5 Harv L Rev 1187 at 1191–92.

110 Compare Dubroff, *supra* note 72 at 571.

111 John Swan, *Canadian Contract Law*, 1st ed (Markham: LexisNexis, 2006) at 245.

112 *Molson Canada 2005 v Miller Brewing Company*, [2013] ONSC 2758 (“*Molson*”).

113 *Ibid* at para 108.

114 *SCM Insurance Services Inc. v Medisys Corporate Health LP*, [2014] ONSC 2632, 2014 OJ No. 2639 [*SCM*].

of good faith required the parties “to act reasonably in the performance of [their] obligation” and “to refrain from adopting a negotiating position that “eviscerates or defeats the objectives of the agreement that [the parties] have entered into.”¹¹⁵

The Supreme Court of Canada ruled in *Bhasin* that “[t]he organizing principle of good faith exemplifies the notion that, in carrying out his or her own performance of the contract, a contracting party should have appropriate regard to the legitimate contractual interests of the contracting partner.”¹¹⁶ This requires a party to act in a specific manner, namely honestly, candidly, forthrightly or reasonably contractual performance.¹¹⁷

These decisions show that a duty of good faith requires the parties to observe a specific conduct. This includes the obligation to respect the core of the agreement, to act with honesty, and to behave reasonably. However, a duty of good faith does not require a party “to put the interests of the other contracting party first” but a party must not undermine the interest of the other party in bad faith.¹¹⁸

ii. Summary

English courts consider the term of good faith to include elements such as honesty, fair dealing, and reasonableness. The situation in other common law jurisdictions does not greatly differ. Thus, the remaining question is whether this understanding entails sufficient certainty for the purpose of enforcement.

C. Interim conclusion

English law recognises the principle of good faith, at least in cases where the parties have explicitly agreed to follow it. In addition, recent case law reveals a clear tendency toward the acceptance of a duty of good faith even in cases where the parties have not agreed to a relevant provision but their intention suggests so. In this case, a duty of good faith is implied in the contract. This does not only apply to England but also to the United States and Canada where the legislature and the courts even seem to be more inclined towards this development.

THE ENFORCEABILITY OF GOOD FAITH PROVISIONS

This section mainly deals with two questions. The first is whether the duty of good faith is to be implied in clauses such as example two and three provide for. Recent case law shows that the implication of such a duty is connected with the intention of the parties. Such an implication is a necessary prerequisite for the second issue: the question whether clauses including the element of good faith, whether explicitly or by implication, are enforceable. According to English case law, this depends on the certainty of this term.

¹¹⁵ *Ibid* at para 36.

¹¹⁶ *Bhasin*, *supra* note 85 at para 65.

¹¹⁷ *Ibid* at para 66.

¹¹⁸ *Ibid* at para 65.

A. Implied duty

As aforementioned, English case law distinguishes between the duty to act in good faith in the context of negotiations and in the context of performance. Thus, the first issue to be dealt with is whether the procedure provided for by example two and three is about negotiations or performance. If a duty of good faith can be implied, the second question is what are the prerequisites for this implication.

i. Pre-contractual negotiations or post-contractual performance

The examples provide for negotiations between the parties. However, an implied duty of good faith has since been recognised particularly in the context of contractual performance.¹¹⁹ On the other hand, English courts are more reluctant to approve such a duty in the context of negotiations.¹²⁰ The question arises whether example two and three deal with negotiations, as the wording might suggest at first glance, or with contractual performance. The term of negotiation is equivocal and can be interpreted in different ways. Its actual meaning depends on the stage the parties are at; this stage has an impact on the extent of the parties' duties. Negotiations can take place at a pre-contractual stage, like in *Walford*, or in the context of an existing contract, as it was the case in *YSP* or *Emirates*.

Negotiations at a pre-contractual stage aim to create a common basis for a prospective contractual relationship. The parties attempt to agree on the key elements, the “*essentialia negotii*”, of the future contract. Negotiations at this stage are to be considered as mere negotiations with a view to a potential contractual agreement. The parties are not yet bound by any agreement and thus have a relatively high level of freedom in negotiating their prospective relationship.¹²¹

On the other hand, negotiations taking place in the context of an existing contractual relationship as agreed upon, are rather comparable to the performance of a contract. The obligation to negotiate is an independent contractual promise to be fulfilled by the promisor; the obligation is not pre- but post-contractual since it requires a valid contract.¹²² The parties' duties are determined by the contractual relationship, particularly by their specific agreement. This relationship does not only oblige the parties to keep promises which were given explicitly but also to respect implied obligations, like the duty of good faith, unless agreed otherwise. This catalogue of duties applies to parties fulfilling their obligations, whether it is transferring goods, providing services or conducting negotiations.

Both examples two and three provide for negotiations dealing with disputes that arise out of a contract. The focus is therefore on the performance of a contractual obligation being made by negotiating.

119 Compare *YSP*, *supra* note 37 at paras 125, 153; Trakman & Sharma, *supra* note 25 at 605.

120 Cartwright, *supra* note 24 at 64, 72; Trakman & Sharma, *supra* note 25 at 599; see above under IV. 1. a).

121 Compare *Walford*, *supra* note 28 at 138.

122 Trakman & Sharma, *supra* note 25 at 604.

ii. Prerequisites for the implication of good faith

The question is which prerequisites must be fulfilled by a clause that impliedly provides for a duty of good faith. English case law suggests that they mainly depend on the parties' intention¹²³ Typically, their intention is largely determined by the wording of the contract.¹²⁴ In relation to the examples two and three, the focus is on the phrases of "*the Parties shall first seek to resolve the dispute or claim by friendly discussion*" and "*both parties shall attempt to settle the dispute amicably.*" Although the terms of friendly discussion and amicable settlement are more of descriptive nature and do not carry such a legal meaning with them as good faith does, they suggest that the parties seek to agree on a specific conduct which is to form the basis for the negotiations. Focusing purely on the wording reveals that both terms resemble the meaning of good faith being connected with terms such as honesty, fair dealing, or reasonableness. This argues for the implication and the applicability of the requirement of good faith also in such clauses. Furthermore, recent case law shows that the intention to act in good faith can be considered as a default rule.¹²⁵ This rule applies if the parties have not modified their agreement in a way that limits or excludes a duty of good faith.¹²⁶ Such modification of the duties would be set forth explicitly to prove an unexpected abnormal arrangement.¹²⁷ Typically, each party expects the other party to act in accordance with the contract, not least to provide the contract with business efficacy.¹²⁸ Neither example two nor example three suggests arguing against the implication of a duty to act in good faith. Therefore, both examples require the parties to act in good faith. The final question is whether this duty is enforceable.

B. Enforceability

The core question of this paper is whether a clause providing for negotiations in a post-contractual context, whether it explicitly includes or implies the requirement that these negotiations be conducted in good faith, is enforceable under English law.

This mainly depends on the certainty of such clauses. Certainty does not only refer to the term of good faith but to the clause as a whole.¹²⁹ The key for assessing the enforceability of such clauses is to conduct an overall appraisal of all circumstances. The requirement of certainty enables the court to determine on the basis of objective criteria whether one or both parties complies or breached the agreement.¹³⁰ This ability was disputed in various decisions.¹³¹ In relation to the present examples, such a certainty, and thus enforceability, can be assumed for the following

123 See IV. 1. a) i) above.

124 Cartwright, *supra* note 24 at 65; compare Dubroff, *supra* note 72 at 568, 572.

125 *YSP*, *supra* note 37 at para 148.

126 *Ibid* at para 149.

127 *Ibid*.

128 See *YSP*, *supra* note 37 at para 137, Leggatt J: "In particular the requirement that parties will behave honestly is so obvious that it goes without saying. Such a requirement is also necessary to give business efficacy to commercial transactions"; see also *Emirates*, *supra* note 17 at para. 51.

129 *Walford*, *supra* note 28 at 138; *Cable*, *supra* note 31 at para 23; *Emirates*, *supra* note 17 at para 64.

130 *Cable*, *supra* note 31 at para 23; compare Ned Beale & Cara Gillingham, "Dispute Escalation Clauses in England and Wales: A New High Water Mark" (2015) 3 *Intl Co & Com L Rev* 102 at 103.

131 Compare *Walford*, *supra* note 28 at 138; *Sulamerica*, *supra* note 40 at para 36; *Wah*, para. 57.

reasons.

i. Minimum standard of conduct

The meaning of good faith has a significant effect on the determination of the whole clause as sufficiently certain to be enforceable. It is the general perception of common law courts that the term of good faith is associated with a specific kind of conduct, such as honesty, fair dealing, or reasonableness, also considering the intention of the parties. However, the kind of conduct to be expected depends on the situation the parties are in. It is necessary to distinguish a pre-contractual context from a post-contractual relationship. In the former case, the focus is primarily on the prospective terms of a possible contract; each party seeks to negotiate as hard as possible at the expense of another.¹³² Such a connection does not offer much foundation to determine any duties of the parties involved.¹³³ The latter situation, however, is shaped by a distinctly closer relationship and an independent contractual obligation to negotiate. The parties' intention, to settle any dispute in a stepped manner, as expressed in the agreement, gains in importance. This leads to a higher degree of consideration for the other party. Good faith has a refined connotation in the context of commercial dealing and commercial men.¹³⁴ The parties are required to act reasonably, observing a commercial standard. Such a standard is, contrary to the decisions in *Walford* or *Wah*, measurable. The court is very well able to determine the conduct expected from the parties by analysing the specific circumstances of the case. This includes, *inter alia*, the industry in which the parties are active, their previous relationship, and the contract itself. This determination is the first step. The second step follows when the court considers whether the parties have deviated from this expected conduct. In the case of such a deviation, the concerned party has violated its duty to act in good faith.¹³⁵ There might be problems in the context of proving such a failure; this is, however, a more inherent issue in law generally, rather than a problem only related to good faith. Any uncertainty as to proof does not necessarily mean that there is no real obligation to be observed by the parties carrying real content with it.¹³⁶

A further argument is closely connected with the intention of the parties: the purpose of an escalation clause is, *inter alia*, to avoid other cost-intensive proceedings. Thus, the agreement ought to be upheld as far as possible to enable the parties to mutually benefit from their agreement to co-operate prior to any further legal actions.¹³⁷ Otherwise, the parties might find themselves before a court or a tribunal, although the escalation clause proves a downright contrary intention of the parties; the present examples show that the parties are in fact highly interested in avoiding legal proceedings and the respective expenses.

ii. Contradictory conduct as violation of the principle of good faith

¹³² Compare *Walford*, *supra* note 28 at 138.

¹³³ *Ibid.*

¹³⁴ Johan Steyn, "Contract Law: Fulfilling the Reasonable Expectations of Honest Men" (1997) 133 Law Q Rev 433 at 441.

¹³⁵ Compare *Emirates*, *supra* note 17 at para. 54.

¹³⁶ See *United Group*, *supra* note 84 at para. 74; compare *Petromec*, *supra* note 42 at para 119.

¹³⁷ *YSP*, *supra* note 37 at para 148.

The requirement of good faith obliges the parties to a specific conduct. This, however, does not only apply to the act of negotiating but to the contractual relationship as a whole. Once the parties' intention has become clear, a party claiming lack of certainty and thus enforceability would contradict itself. Its conduct would be classified as the opposite of a fair and honest dealing: this is hardly what a reasonable commercial businessman would be expected to do.¹³⁸ The only purpose of this conduct would be to disengage from a binding contract. It would be contradictory to the idea of good faith if one party benefitted from its own abusive acting.¹³⁹ Moreover, it would also run contrary to public interest. Obligations freely assumed by commercial business people are expected to be enforced, particularly when alternative proceedings entail clearly increased expenses.¹⁴⁰ Such an abusive and contradictory conduct is clearly determinable and represents nothing but the other side of the coin of good faith. This approach provides a judge with a further instrument to qualify the parties' duties and to determine whether these duties have been fully observed.

iii. Impact of the *pactum de non petendo*

The present examples include a covenant setting forth that the parties are refrained from commencing arbitration proceedings for a specific period of time. Such an agreement is an independent commitment entered into by the parties to the multi-level clause. Irrespective of the question whether the term of good faith is sufficiently certain for the escalation clause to be enforceable, the *pactum de non petendo* has a different objective: it aims to prevent the parties from commencing any legal actions for a specific period of time, even if the multi-level clause is not enforceable.¹⁴¹

This covenant has the function of a safeguard: if one party attempts to ignore the negotiation clause and its own will as previously expressed and commences legal actions, the *pactum de non petendo* protects the other party for at least the period of time the parties agreed upon. An arbitral tribunal would reject the request for arbitration as inadmissible.¹⁴² Proceedings before an English court could be stayed under rule 26.4 CPR. This agreement does not add more certainty to the term of good faith, but provides the party acting in accordance with and in reliance on the contractual agreement with an appropriate instrument to uphold the obligation to negotiate.

iv. Interim conclusion

There are several arguments in favour of considering clauses which provide for good faith negotiations to be sufficiently certain and, thus, enforceable under English law. Good faith is known as a certain standard of conduct which can be precisely determined and concretised by the court. In this context, the intention of the parties plays a crucial role. Thus, clauses such as the present examples providing for negotiating in good faith are neither unclear nor incomplete. However, it is a matter of the specific circumstances of the case.

138 Steyn, *supra* note 134 at 441.

139 Compare Peel, *supra* note 100 at 52.

140 Compare *Emirates*, *supra* note 17 at para 64.

141 Berger, *supra* note 6 at 6; Arntz, *supra* note 50 at 237 [translated by author].

142 Jolles, *supra* note 2 at 336; Jimenez-Figueres, *supra* note 57 at 78; *Cable*, *supra* note 31 at para 34.

Regardless of the enforceability of good faith provisions, the separate *pactum de non petendo* protects the party acting faithfully. Any request to arbitration or litigation running counter to it faces the risk of being rejected.

CONCLUSIONS

This paper has demonstrated that the principle of good faith has proven to be a legal element of paramount importance in the context of a contractual relationship. It is a well-used instrument referred to in negotiation clauses for mainly two reasons. On the one hand, it is a sufficiently broad term to provide the parties with a certain degree of flexibility to structure their negotiations. Thus, the parties can consider any particularities which otherwise would not be taken into account. On the other hand, simultaneously, it introduces a specific legal meaning sufficiently certain to be enforceable, depending, however, on the individual circumstances. The recent decision made in *Emirates* continues the series of decisions arguing for the enforceability of good faith negotiation clauses and is suitable to add further substance to the discussion.

Drafting an escalation clause is a challenging task. The competent person is required to act with foresight and in accordance with the parties' expectations. Even if such a clause lacks enforceability, parties can be indemnified against unfaithful contracting parties by implementing the element of a *pactum de non petendo*. This element protects the parties' idea of initial negotiations by prohibiting any other further legal proceedings for a specific period of time. One crucial prerequisite for this is the intention of the parties to have mandatory negotiations.

The comparison between England and other common law jurisdictions has revealed that the English position towards a general principle of good faith is rather restrained. Canada and the United States are more inclined to recognise such a principle. The current tendency in England is to follow these jurisdictions and adopt a more open position towards this principle. This progress is a facilitating factor in the world of international business since a more and more comparable understanding and interpretation of globally used principles, such as good faith, simplify commercial intercourse. In a globally developed economy, England will neither want to lose influence nor fall out of the loop.