GOOD FAITH IN CONTRACTUAL LAW: A "LAW AND ECONOMICS" PERSPECTIVE

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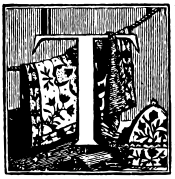
INTRODUCTION



his presentation aims to take an introductory look at the way common law systems conceive the principle of good faith and how the notion of opportunistic behaviour, developed by law and economics, may concur to a wider acceptance of good faith in those legal orders.

It also examines the lessons that civil law systems can learn from law and economics as this approach presents useful analytic insights that, in a combined and complementary way, enrich the large doctrinal and jurisprudential interpretation on the scope and limits of good faith.

COMMON LAW AND CIVIL LAW SYSTEMS

Even in our days, although courts in common law juridical systems recognize the existence of a duty of good faith while contracts are in force, they hesitate to consider it during the period of contractual negotiations. Nevertheless the principle of good faith, as a conduct pattern parties should observe when engaged in negotiation processes, is progressively making its way in certain countries[1].

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[1] In U.S. law good faith was incorporated, in the 1950s, into the Uniform Commercial Code (Section 1-304), and codified as Section 205 of the Restatement (second) of Contracts (1981). Most U.S. jurisdictions apply only the notion of breach of contract, that gives rise to ordinary contractual damages; hence, they don't recognize

The resistance and the reservations towards the good faith doctrine are based on the fear that its acceptance might threaten the fundamental principles of private autonomy and freedom to contract. Another set of objections stresses the moral dimension inherent to the notion of good faith and therefore rejects it, in order to avoid a "moralization of civil law".

A paradigmatic example of this perspective can be found in the *Walford v. Miles*[2] case where the court ruled that pre-contractual duties, derived from good faith, are contrary to the prosecution of self-interest and to contractual freedom which encompass the possibility of ending negotiations, at all time. This decision expresses an idea of "all or nothing", that is to say, that nothing exists before the formalization of a contract and that obligational relations are only created from that moment forward[3].

In civil law systems this decision would surely have been different since Roman-Germanic legal tradition orders have long ago accepted the notion of *culpa in contrahendo*, developed by Jhering in the 19th century. This perspective is based upon the specificity of the negotiation period, in which relations of trust are born and expectations - often with a significant patrimonial expression – are created. Therefore it is recognized the existence of an obligational relationship that doesn't encompass the primary or nuclear obligations aimed by the contract but originates other duties, such as the duty to inform and the duty to indemnify. The latter, is conceived as a duty of compensating in order to re-establish the situation held by the counterpart prior to the beginning of the negotiation process.

As it is well known, in common law legal orders con-

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the existence of a general duty of good faith which, in case of violation, would give rise to tort liability (compensatory damages and punitive damages).

[2] House of Lords, *Walford v. Miles 1992, 2 A.C. 128*.

[3] Menezes Leitão, L. (2000), "Negociações e Responsabilidade Pré-Contratual nos Contratos Internacionais", *ROA*, 60, p. 49.

tracts – namely commercial contracts - are far more extensive and exhaustive than contracts in civil law legal orders[4]. In the first case, transaction costs are higher as a larger amount of time is expended in negotiations and direct costs, such as layers and legal advisers fees, are also more significant. On the other hand, in civil law systems contracts have fewer stipulations because contracting parties seem to trust that the existing legal and jurisdictional mechanisms are able to fill in the gaps or revise the contract when unforeseen circumstances occur. Ultimately, they trust that judicial decisions will have the ability to understand the immediate aims expressed by the parties but, above all, the substantive goals underlying the contract. Thus, a general principle of good faith, established by law, enables parties to delegate in the judicial system the interpretation and revision of contracts according to their best interests. Confidence is strengthened by the existence of a general rule of honesty and loyalty that functions as a conduct criteria and as the legal basis for courts to interpret the will that led to the agreement and to fulfil the gaps in contracts.

Summarizing, in civil law systems the principle of good faith ensures several functions: (i) preserves loyalty and honesty in contractual relations, saving the parties from the burden of specifying all imaginable contingences; (ii) constitutes the juridical basis for not applying positive rules (either imperative or subsidiary rules) that would lead to absurd or unfair results; (iii) constitutes the juridical basis for courts to (re)allocate risks according to what would have been the parties *ex ante* will if they had foreseen a certain situation and (iv) has a deterrence effect on disloyal and unfair behaviour. At a first glance, the scope of this principle might seem "dangerously" wide that is why a comprehensive analysis of the good faith principle shouldn't ignore that: (i) its application in Roman-Germanic

[4] Cordero-Moss, G. (2014), *International Commercial Contracts*, Cambridge Univ. Press, p. 11.

legal tradition orders is accompanied by a strong doctrinal development which limits its scope and, in many cases, has led positive law to establish legal categories that confine its applicability[5]; (ii) the general clause of good faith is used as a last resource; and (iii) it has been cautiously applied by judges as, in general, it is not used as a basis for ideologically oriented decisions.

On the other hand, some legal systems resist to establish and apply a general principle of good faith, based on the arguments that such a clause (i) would empower the judiciary with an inadmissible discretion, paving the way for decisions guided by ideological bias and redistributive purposes[6]; (ii) would introduce or reinforce judiciary activism, undermining legislative functions; and (iii) that even if judges are solely and genuinely concerned with the parties best interest, they are unable of reaching the true incentives and the actual circumstances that determined contractual will.

Based on the previous considerations, courts' attitude towards a general principle of good faith in contract interpretation can be simplified and synthetized according to two paradigms.

Common law systems tend to adopt a *literal interpretation* of contracts, that is to say, an interpretation of the will expressed by the parties in the contract; therefore, this approach is sceptical to accept good faith as a general duty or standard of

[5] The principle of good faith - in its various configurations - is widely present in Portuguese civil law (CC Civil Code): "*culpa in contrahendo*" (article 227 (1) CC), "integration" (article 239 CC), "changed circumstances" (article 437 CC), "intra obligational complexity" (article 762 (2) CC) and, mostly in the notion of "abuse of rights" (article 334 CC), conceived as an inadmissible exercise of rights embodied in conducts characterized as "*exceptio doli*", "*venire contra factum proprio*", "*suppression*", "*surrectio*", "*tu quoque*" "unlawful allege of formal aspects" and "unbalanced exercise"; Menezes Cordeiro, A, (2012), *Tratado de Direito Civil I*, Almedina, p. 958. Menezes Cordeiro, A. (2013), *Da Boa Fé no Direito Civil*, Almedina.

[6] Schäfer, H. & Aksoy, H. (2014), "Alive and Well: The Good Faith Principle in Turkish Contract Law" (http://ssrn.com/abstract=2483685).

contractual behaviour because it might open a door to a benign paternalism exogenous to contracts.

In civil law systems its dominant a *contextual interpretation* paradigm according to which the principle of good faith is a "safety valve" that allows judges to go beyond the written words of contracts, completing the gaps and rearranging the outcomes in accordance to what would have been the parties' will. This ensures the protection of legitimate expectations and the substantive interests underlying the contract.

Another attitude towards the principle of good faith can be characterized as an *hyper contextual interpretation* paradigm that adopts a broad and distorted notion of good faith, conceived not as a mere duty between parties but as duty of parties towards society. Objective good faith is melted into a meta-principle, such as the social function of contracts, which becomes the legal basis to pursue not *intra partes* justice but social justice, according to certain ideological orientations. As it will be examined, such a way of understanding and applying the good faith principle cannot be justified either in terms of a correct juridical approach of its scope, either by a law and economics perspective. In fact, it is a distorted view of its meaning that ignores all the application requirements developed by doctrine and, often, transposed to law, in Roman-Germanic tradition legal systems; additionally, it generates dysfunctional markets and, as a consequence, negative effects on welfare.

LAW AND ECONOMICS APPROACH

Law and economics has draw attention to the notion of good faith through the negative concept of "contractual opportunism"[7]. In fact, both notions encapsulate an equivalent idea

[7] For an overview of the law and economics approach: Sepe, S. (2010), "Good Faith and Contract Interpretation: A Law and Economics Perspective", SIMPLE Paper No. 42/06 (http://ssrn.com/abstract=1086323)

although defined in a reverse way. As Mackaay states "good faith is the exact opposite of opportunism. To act in good faith is to abstain from opportunistic acts (…) Opportunism is characterized in law as bad faith, or at least the absence of good faith"[8], "it's anti-opportunism"[9]. Good faith is not trying to "take advantage of the other party, based on the vulnerabilities created by the sequential character of contractual performance"[10].

Law and economics scholars refer opportunism as a strategic behaviour to capture an advantage not assigned in the original agreement[11]. An opportunistic behaviour can be defined as the lack of honesty in transactions; an incomplete and distorted disclosure of information or a "self-interest seeking with guile"[12].

According to an economic view, contract law enables and reinforces cooperation making possible for market agents to maximize their welfare and, as a consequence, maximize the welfare of society. Law of contracts has the purpose of reducing transaction costs and avoid opportunism.

Good faith, as other principles and rules of contract law, is not considered and assessed by law and economics as a value in itself but in its suitability to increase the value of exchanges and hence welfare[13]. The acceptance of a general duty of good

[8] Mackaay, E. & Leblanc, V. (2003), "The Law and Economics of Good Faith in the Civil Law of Contract" p. 11. (https://papyrus.bib.umontreal.ca/xmlui/bitstream/handle/1866/125/Article%20papyrus.pdf)

[9] Mackaay, E. & Leblanc, V. (2003), p. 26; Mackaay, E. (2009), "The Economics of Civil Law Contract and Good Faith", p. 12. (https://papyrus.bib.umontreal.ca/xmlui/bitstream/handle/1866/3016/Mackaay_Trebilcock-Symposium%20_3_.pdf)

[10] Posner, R. (2003), *Economic Analysis of Law*, Aspen Pub., p. 95.

[11] Mackaay, E. & Leblanc, V. (2003), p. 10.

[12] Williamson, O. (1985), *The Economic Institutions of Capitalism*, New York, Free Press, p. 47.

[13] Chirico, F. (2010) "The Economic Function of Good Faith in European Contract Law", in Pierre Larouche, Filomena Chirico, (eds.), *Economic Analysis of the*

faith is justified in a consequentialist perspective: the combat of opportunistic conducts is a way to obtain welfare gains. Diminishing opportunistic behaviour reinforces confidence among parties and, therefore, the number of transactions and the correlative net benefits of exchange increase. In a trustful environment contracts become simpler and shorter, lowering transaction costs.

The dissemination, by law and economics, of the idea of opportunism has a singular relevance in common law systems; since they are not so familiar with a traditional and positive recognition of good faith the justifications provided by economic analysis, showing the negative effects of bad faith upon efficiency, pave the way for an acceptance of the notion or principle of rightfulness or good behaviour in contractual relations. Thus, law and economics presents compelling arguments that undermine sceptical perspectives towards the usefulness of a general clause of good faith. As it is plain to see, the role of law and economics, in this domain, has much less importance in civil law systems where good faith is a core principle of contractual law.

LESSONS TO BE LEARNED: TESTING BAD FAITH CONDUCTS

The scepticism in accepting the principle of good faith led law and economics not only to demonstrate the negative consequences of opportunism on welfare, but also to define objective criteria to its applicability.

Such criteria would prevent a misuse of that notion, namely, as the basis to introduce "corrective changes" in contracts according to moral or ideological purposes. In civil law orders the doctrine has also expressed its concern towards

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DCFR: The work of the Economic Impact Group within CoPECL network of Excellence, Sellier, p. 35.

"moral or ideological corrections" and rejects the use of good faith as a legitimation clause for judges to introduce *ex post* changes in contractual arrangements. Good faith imposes collaboration duties to the parties, thus altering the liberal notion of contract. Nevertheless, it cannot function as a legal way to promote an "ideally fair equilibrium" because that would turn Law into an authoritarian order that imposes abstract interests. Abstract formulations of "fairness" are not a concretization of the good faith principle; from good faith cannot be deduced, for instance, a generic idea "of protection of the weaker contracting party" which would hinder the applicability of that rule to situations where a counterparty with superior bargaining and economic power suffers damages caused by a disloyal behaviour of a weaker party.

Although civil law systems conceive good faith as a general principle of contract law and are traditionally familiar with its application by courts, lessons can be learn from law and economics. In fact, this approach furnishes a set of relevant analytical mechanisms that, in a complementary way, can be very useful to civilian scholarship and judges.

According to an economic view, a three-step test allows a more accurate identification of opportunistic behaviour. Opportunism occurs in (i) an asymmetrical relationship, (ii) when one party takes advantage of the other, (iii) to a significant degree that exceeds a certain threshold of tolerance[14].

Asymmetric information among contracting parties will always exist and, to certain extent, it's the intrinsic basis of contracts as buyers are only willing to acquire resources when they possess the knowledge to use them in a more valuable way. In other words, transactions occur when the seller attributes a lower value to a resource than the value attributed by the buyer that, in turn, depends on an informative advantage in

[14] Mackaay, E. & Leblanc, V. (2003), p. 2, pp. 12-15.

how to give it a more efficient destination[15]. But, in some cases, informational asymmetries matter because they allow one of the contracting parties to mislead the other into an arrangement that wouldn't be accepted in the presence of a correct picture of all significant facts, or because when engaged in a contractual relationship asymmetries are used by one party to change and impose the other a risk allocation different from the original one.

Thus opportunistic behaviour due to asymmetry can be analysed in an *ex ante* perspective or from an *ex post* point of view. The latter concerns situations where contracts generate a monopoly (in time or place) relation and, therefore, one of the parties is economically dependent of the other, which uses this leverage to take advantage.

In civil law systems these cases are subject to the generic framework of the "abuse of right" prohibition: contractual rights must be exercised within the limits of good faith, hence, a disproportional and unbalanced use of a right is abusive[16]. *Ex ante* opportunism is qualified as an unlawful conduct contrary to good faith because parties are obliged to pre-contractual information duties (*culpa in contrahendo*)[17]. However, law and economics provides a useful insight to understand the scope of those pre-contractual information duties. The idea has a simple formulation but contains a very powerful yardstick to establish the boundaries of disclosure obligations. In a law and economics perspective, if the acquisition of information implies relevant costs its use cannot be considered a form of opportunism. Accessing the value of asymmetric information, considering transaction and opportunity costs, becomes a filter to determine whether or not a no disclosure conduct is contrary to good faith.

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[15] Schafer, H. & Claus Ott (2004), *The Economic Analysis of Civil Law*, Edward Elgar, p. 385.
[16] As in Article 334 Portuguese Civil Code.
[17] As in Article 227 Portuguese Civil Code.

The other two requirements of the test refer to the existence of an undue advantage and to a behaviour not covered by legal and contractual "normal" safeguards: a conduct that exceeds the threshold of tolerance. In such a context parties will take measures to protect themselves and, as a consequence, contracts will be more costly diminishing the number of contractual relations[18]. This way, socially relevant advantages of exchange are lost, due to the lack of confidence, affecting social efficiency. Thereby, preventing opportunism plays a social function as enhances the welfare gains that result from transactions.

A careful distinction must be made between the social role of good faith, in the sense described above, and the legal principle of "social function of contract" as established, for example, in Brazil[19]. Determining the scope of this principle and distinguishing it from the principle of good faith in contracts is not an easy task since definitions of "social function of contract" tend to encompass the prohibition of abusive conducts or objective good faith[20]. Nevertheless, it's essential to draw that distinction in order to preserve the rational underlying good faith and its function as a mechanism of contractual equilibrium.

When courts apply the principle of good faith, the judicial decision must be in accordance to what would have been the parties will *ex ante*, that is to say, in the moment the con-

[18] Mackaay, E. (2013), *Law and Economics for Civil Law Systems*, Edward Elgar, p. 430. Schäfer, H. & Aksoy, H. (2014).

[19] Article 421 Brazilian Civil Code.

[20] "The "social function of contract" imperative determines that it cannot be transformed in an instrument for abusive activities": Reale, M. (2003), "Função Social do Contrato" (http://www.miguelreale.com.br/artigos/funsoccont.htm).

The "social function of contract" is a general clause that imposes a revision of the principle of contract relativity regarding third parties (...) reduces the scope of contractual autonomy in the presence of metaindividual interests or individual interests related to human dignity": Diniz, M. H. (2010), *Código Civil Anotado*, Ed. Saraiva, p. 365.

tract was formed. Thus, judges' decisions should reflect the risk allocation parties - in a pre-contractual situation - would have agreed upon if they possessed certain relevant information or if they could have foreseen certain hypotheses. In synthesis, good faith is, by no means, a legal foundation to alter contractual clauses in order to impose an arrangement that the parties would never have accepted.

On the other hand, a principle of the "social function of contract" seams to have been shaped as the legal basis for "corrective redistributions", allowing courts to change the outcome of a contractual relation. It is a gateway for modifying the final resource allocation according to ideological purposes, such as the protection of the poorer or weaker part. This represents an *ex post* correction, imposed by a "third party", who supposedly has a comprehensive understanding of what's best for society and alters the contract in a way parties would not have agreed. By doing so judicial decisions undermine confidence in contractual relations, creating a context that affects the parties' freedom and private autonomy, decreases contracts as a mutual gain mechanism and, therefore, reduces social welfare.

In syntheses, the notions of good faith or opportunism, as its negative equivalent, aim to protect the confidence and the material aspects of contracts and, by doing so, they ensure that more contractual relations take place, achieving socially relevant outcomes. The scope of good faith, regarding its social role, must be strictly interpreted in this way: by preserving an environment of trust and confidence in contracts, more transactions occur, increasing welfare or social efficiency. Good faith - or no-opportunism – is a conduct principle intrinsic to contractual relationships that sets behaviour patterns among the parties themselves, it cannot be confused with a "social duty of good faith" in the sense of a general obligation impending on contractual parties to pursue collective interests.

CONCLUSION

Law and economics defies civil law scholars to study good faith in a different perspective, presenting a new semantic for well known categories but, above all, introducing relevant analytical instruments to determine the scope of that general duty of conduct.

In our view, the two most important contributions concern the length or "measurement" of pre-contractual duties and the social relevance of contracts. Through the framework of asymmetrical information, law and economics allows the definition of a criterion to assess disclosure obligations and, by stressing the role of contracts in welfare increase, restates the rational of good faith.

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