Court of Appeal Clarifies Approach to Contractual "Good Faith" Clauses

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The Court of Appeal judgment in the case of *Re Compound Photonics Group Ltd; Faulkner v Vollin Holdings Ltd* [2022] EWCA Civ 1371 provides welcome clarification on the scope of the duty of good faith in the context of an unfair prejudice petition. For a recent example of a successful unfair prejudice petition, please see our previous update here.

Facts. The factual background is complex and is set out in considerable detail in the judgments of the High Court and Court of Appeal. In summary, the minority shareholders (the "Petitioners") including two individuals called Mr Faulkner and Dr Sachs alleged that they had been unfairly prejudiced by the majority shareholders (the "Investors" or the "Appellants"), on the basis that they were excluded from any continuing role in the management of Compound Photonics Group Limited (the "Company").

Dr Sachs was Chief Executive Officer of the Company and an employee of the Company's subsidiary, Compound Photonics UK Limited ("CPUK"). He had day-to-day control of the business of the two companies. Mr Faulkner was an independent financial adviser, who was the non-executive Chairman of the Company. In his role as financial adviser, Mr Faulkner had originally introduced the other Petitioners to CPUK as shareholders.

The Shareholders' Agreement contained a clause pursuant to which the shareholders undertook to each other and to the Company that they would at all times act "in good faith" to each other in relation to the matters contained in the Agreement.

The Investors became disappointed with the progress of a corporate project led by Dr Sachs and ultimately threatened to withdraw funding unless he resigned, which he did. Subsequently, Mr Faulkner was removed by shareholder vote.

High Court Decision. The High Court agreed with the Petitioners and found that they had been unfairly prejudiced. Although it was common ground that the Company was not a "quasi-partnership", the High Court accepted that, in excluding Dr Sachs and Mr Faulkner, the Investors had acted in breach of the terms of the Shareholders'

Agreement. The Court was of the view that the Shareholders' Agreement and the Company's Articles amounted to a "constitutional settlement" between the shareholders. Pursuant to that constitutional settlement, Dr Sachs and Mr Faulkner were entrenched in office as directors and any votes by the shareholders in favour of these directors' removal would be a breach of contract.

The High Court reached its finding further to its interpretation of the express "good faith" clause in the Shareholders' Agreement and looked beyond the four corners of the agreement to ascertain the meaning of the clause. In particular, the High Court adopted the formulation of HHJ Klein in *Unwin v Bond* [2020] EWHC 1768 (Comm) regarding the "minimum standards" of conduct required by a contractual good faith clause. In particular, the "minimum standards" required the shareholders to act "with fidelity to the bargain".

The Investors appealed arguing that the High Court interpreted the duty of good faith, as set out in the Shareholders' Agreement, too broadly. In particular, they submitted that the clause should not have been interpreted to mean that they had relinquished the right to remove the Petitioners or take control of the Company's management and that a duty of good faith could not be breached without a finding of dishonesty or bad faith. In this regard, they had genuinely and reasonably formed the view that it was necessary for Dr Sachs to cease to be involved in the management of the business for the good of the Company. They also denied any wrongdoing in respect of Mr Faulkner's removal as director.

Court of Appeal Decision. In a unanimous decision, the Court of Appeal overturned the High Court Decision pursuant to a detailed analysis of the existing case law on the meaning of the duty of good faith. The key findings were as follows:

- **Meaning of good faith clause**. The Court held that the meaning of a contractual clause encompassing a duty of good faith is contextual and it is inappropriate to apply concepts and ideas from cases in other areas of law or commerce. The High Court had incorrectly applied and endorsed *Unwin*, given that *Unwin* was a case in which the presiding judge had reached his conclusion by analysing other cases to deduce some "minimum standards". It was not a case that pertained to what a duty to deal "fairly and openly" required in the context of the statutory process for removal of a company director by its shareholders pursuant to s.168 of the Companies Act 2006 (the "Act"). Therefore, *Unwin* was not relevant on the facts of this case.

- **Fidelity to the bargain**. The Court reviewed the authorities that had been relied upon by the High Court in respect of fidelity to the bargain and the requirement for a contracting party to consider the other party's interests. The Court made the following findings:

- *Firstly*, it was inappropriate to rely on the general principles set out in the New South Wales case law[1] on the facts of this case. The concepts relating to good faith in the performance of contracts that had been adopted and developed in the New South Wales case law were general and had not been developed in the context of individually negotiated contracts. Therefore, these general principles do not automatically apply to a contractual clause requiring the parties to act in good faith.

  The Court of Appeal also noted that a different approach would be warranted for *implied* terms as opposed to *express* terms incorporated in the contract. In the latter case, the context given by the other terms of the contract should also be considered. The Court stated that: *"It is entirely understandable that if a term is implied as a matter of law, it should have a single, clearly understood meaning."* However, there is no *"sound juridical basis for saying that all of the same concepts should automatically be regarded as incorporated in a formulaic way whenever any contract governed by English law contains an express term requiring the parties to act in good faith."*

- *Secondly*, as to the requirement for a contracting party to consider the other contracting party's interests, this had been developed in cases where a business decision might deprive the other party of commercial benefit that it expected to enjoy under the contract. This requirement did not automatically apply in the context of voting by shareholders at general meetings of a limited company. In particular, in that context there is no requirement for shareholders to consult with each other or to take into account the interests of other shareholders when deciding how to vote. Nor is there a requirement for the shareholders voting in favour of a resolution to have regard to the particular interests of the minority, as opposed to the benefit of the company as a whole. The Court also noted that the *"structure of a limited company and the relationship and interests of its members form a very different backdrop to that of an ordinary commercial contract."*

- *Thirdly*, the Court stated that *"considerable caution must be exercised"* before interpreting a good faith clause as requiring fidelity to the bargain in the context of changes to the constitution of a company or a board of directors. This is due to the fact that the terms of the articles and the identity of a company's directors *"are not cast in stone when the company is incorporated, but can be amended and changed from time to time by specified majority votes of the shareholders."* There is therefore *"inherent flexibility to amend the statutory contract by a democratic shareholder process to respond to changing and unforeseen circumstances."* As a

[1] For example, *Overlook v Foxtel* [2002] NSWSC 17, *Burger King Corp v Hungry Jack's Ltd* [2001] NSWCA 187 and *Macquarie International Health Clinic v Sydney South West Area Health Service* [2010] NSWCA 268.

result, it would be wrong to presume that a good faith clause has been designed to prescribe how the parties should behave in unforeseen future circumstances or that such a clause should have the result of *"eliminating flexibility and entrenching the original structure so that changes cannot be made at all."*

- *Fourthly*, although judges have, from time to time, used the expression "*the spirit of the contract*" in the context of a good faith clause, this was not an *"open invitation"* to interpret the clause as imposing additional substantive obligations or restrictions outside the contract terms. A court needs to identify the shared aims of the parties as objectively ascertained from the express and implied terms of the contract.

- **S 168/the parties' bargain**. The Court of Appeal rejected as incorrect the High Court's finding that although the Investors had *"an unrestricted right as a matter of company law"* to remove the Petitioners as directors, that right was excluded *"as a matter of private contract"* in this case. The Court of Appeal held that *"it is clear from the wording of section 168 that the statutory right to remove a director is not given to the majority shareholders, and neither does it prevent them from alienating any such right. The right under section 168 is given to the company in general meeting, and it is the company that cannot by contract alienate such right by contract between it and the director."*

- **Bad faith and dishonesty**. The Court rejected the proposition that a breach of the duty to act in good faith was synonymous with a requirement of dishonesty. The clause prohibited conduct that reasonable and honest people would regard as commercially unacceptable without necessarily being dishonest.

- **Shareholders' Agreement/Company's constitution**. The Court considered that the High Court was not correct in accepting the argument that pursuant to section 17 of the Act (which defines references to a company's constitution), the constitution of the Company included the Shareholders' Agreement (including the good faith clause therein) for the purposes of section 171 of the Act (which requires directors to act in accordance with a company's constitution). The Court of Appeal also rejected the further argument made on appeal that by the indirect operation of section 257 of the Act (regarding resolutions or decisions by members), section 171 should place directors under a general obligation to exercise their powers in accordance with a shareholders' agreement. The Court considered that this would be an *"entirely new statutory obligation to place on directors, which is not mentioned in any of the materials attending the passing of the 2006 Act, and is a proposition for which [the Court was] shown no supporting academic or other commentary."*

- **Unfair prejudice**. The Court did not find any unfair prejudice in respect of the removal of either of the directors. As far as Dr Sachs was concerned, the Court found that the majority shareholders had rationally and genuinely believed that the decision was in the Company's interests. As to Mr Faulkner, there had never been an agreement for him to be entrenched in office. Nor had the management of the Company been conducted unfairly.

Commentary. The Court of Appeal has made it clear that a contextual approach is required when interpreting an express clause of good faith in a contract. In particular, while general principles apply in relation to an implied duty of good faith, it is inappropriate to rely on a formulaic interpretation of an express term of good faith, which has been negotiated and mutually agreed between the contractual parties.

The case also provides a useful reminder of the fact that shareholders must consider the benefit of the company, as a whole, as opposed to the interests of the minority shareholders, in particular, when casting their vote.

As far as directors' duties are concerned, the Court has confirmed that section 171 of the Act does not place directors under a general obligation to exercise their powers in accordance with a shareholders' agreement. Moreover, a shareholders' agreement is not part of a company's constitution.

Last but not least, petitioners or claimants do not have to go as far as proving dishonesty when arguing a breach of a contractual term of good faith. Such a duty may also have been breached where the behaviour at issue is commercially unacceptable (by reasonable standards) and yet not dishonest per se.

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