

Reasonableness, good faith and ‘the spirit of the agreement’ in commercial contracts (Westfields Homes Ltd v Keay Homes (Windrush))

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Commercial analysis: Where a development agreement requires ‘both parties [to act]...in good faith’, ‘reasonably’ and ‘in the spirit of the agreement’, how does the court give content to those obligations? Does one party’s refusal to permit the registration of a charge, needed to secure refinancing, amount to a breach? The court held that where the contract prescribed no basis for determining ‘the spirit of the agreement’, it would be interpreted as a reference to the parties’ shared aims in entering into the agreement, ascertained as part of the usual process of construction. As to the requirement to act reasonably, the court distinguished between situations where the contract left that to be determined objectively by the court, and those where it was left to one of the parties. The latter might be qualified by an implied Braganza duty to exercise the decision without being arbitrary, capricious or irrational. Written by Seb Oram, barrister at 3PB Barristers.

Westfields Homes Ltd and another v Keay Homes (Windrush) Ltd [\[2020\] EWHC 3368 \(Ch\)](#)

What are the practical implications of this case?

The decision is an application of established principles, in a familiar commercial context. Two aspects of it are noteworthy.

The first is the reminder that obligations to act in good faith and in the spirit of the agreement, take their meaning from the remaining express terms of the contract. As Lady Justice Arden observed in *Re Coroin Ltd (No 2)* [\[2013\] EWCA Civ 781](#), [\[2013\] 2 BCLC 583](#) (at [50]–[53]), they cannot expand a party’s obligations because, unless the contract provides express guidance, there is no benchmark against which the court could enforce the obligation. The effect of such a clause is to require performance in accordance with the shared aims of the parties in entering into the agreement; it is ‘merely a mirror image of the process of interpreting the agreement or implying terms into it’. An obligation to perform in good faith does, however, require the parties to observe reasonable commercial standards of fair dealing (see paras [28]–[32] of the decision).

Consistently with that approach, such a clause does not require a party to subordinate its own commercial interests but, rather, to recognise the legitimate rights of both parties that the contract expressly confers (*Gold Group Properties Ltd v BDW Trading Ltd* [\[2010\] EWHC 1632 \(TCC\)](#), at [88]–[91]).

Secondly, the court recognised an important difference between a mere obligation to act reasonably (ie imposing an objective standard that would be evaluated by the court), and one to act in a manner that one of the parties considered to be reasonable. The latter requires a subjective evaluation that the court will not second guess; but if the exercise of that discretion might adversely affect the interests of the other party, the court will readily imply a qualification that it must be exercised honestly, rationally and for the purpose for which it was conferred (*Braganza v BP Shipping Ltd* [\[2015\] UKSC 17](#); [\[2015\] 1 WLR 1661](#)).

Those drafting contracts need to ensure that the express, primary obligations adequately describe the required performance and protections. Residual ‘good faith’ and ‘spirit’ clauses will rarely expand upon those: they impose secondary obligations of commercial probity; and prevent attempts at cynical, literalist interpretations.

What was the background?

The defendant (Keay) had assigned to the claimant developer (Westfields), the benefit of an option to purchase certain land in the Cotswolds. The option was exercised, and the land purchased by Westfields on 11 July 2014. It intended to develop the land in two phases.

Under the terms of various agreements, including 'the Supplemental Agreement', Keay would be entitled to 20% of the net proceeds of any further sale by Westfields. The Supplemental Agreement granted Keay three protections to secure that interest:

- a charge over the property
- the right to enter a notice against the title for any period while that charge was not in place (ie before the charge took effect, and if it was temporarily removed for financing purposes), and
- a right to enter a restriction against the title to the property, preventing dispositions without its consent

The development was only possible with external funding. Funding for phase 1 was provided by an entity called Ratesetter, whose loan was secured by a further charge against the property. By a deed of priority Ratesetter's charge was conferred initial priority up to a specified, variable limit and Keay's charge would be redeemed in advance of any further sums beyond that.

Westfields now wanted to start phase 2 of the development and, for that purpose, wished to refinance the Ratesetter loan (by redeeming its charge and obtaining further financing for phase 2) with United Trust Bank ('UTB'). Central to the dispute were various provisions of the Supplemental Agreement intended to make sure that the protections given to Keay could not disrupt the development.

The issue for the court was whether those provisions required Keay:

- to execute a revised deed of priority to enable the financing of Phase 2, and/or
- to give consent to the registration of a charge in favour of UTB

By clause 6 of the Supplemental Agreement, Keay agreed, as regards any restriction, 'to give consent to registration of a first legal charge in favour of a main funder for the development of the Property by [Westfields]...'. By clause 5, it agreed 'to temporarily remove any...notice to enable registration of a first legal charge in favour of a main funder for the development...'. Each of those obligations was subject to the critical proviso that 'such finance secured by the first legal charge is in accordance with the spirit of this agreement both parties acting reasonably and in good faith to each other'. Keay also agreed to 'give consents in respect of Notices and the above restriction to enable sales of completed properties provided the terms of this agreement have been complied with'; and 'to enter into such deeds of priority as it considers reasonable in order to enable [the claimants] to finance the development'.

What did the court decide?

Keay essentially gave three reasons for refusing its consent. First, that the proposed deed of priority was unreasonable because it allowed all of the funding provided by UTB to attain priority over Keay's profit share (ie Keay would lose the benefit of a priority cap). The UTB proposal was consequently neither in accordance with the spirit of the Supplemental Agreement, nor reasonable. Secondly, Westfields had not provided sufficient financial information to permit Keay to form a considered view about the proposal. Thirdly, Westfields was proposing to act contrary to the spirit of the agreement by refinancing and commencing phase 2, before the phase 1 works had been completed and contractually audited.

Each of those arguments failed because the contract imposed no obligation on Westfields to act as Keay contended. Although the initial Ratesetter charge had included a priority cap, which would be lost under the UTB proposal, Westfields was not contractually obliged to ensure such a cap. Moreover, the loss of the cap would make no difference to Keay's commercial rights under the contract, because it was only ever entitled to payment out of the net proceeds of the development, ie after all costs of financing had been met. Keay was entitled to security, but was not entitled 'to frustrate the development by withholding consent to proposed financing or refinancing unless the proposed financing is not in accordance with the spirit of the agreement, is unreasonable or in bad faith' (at [36]).

The deputy master also noted the difficulty that Keay would have in proving a breach of bad faith in a Part 8 claim without cross-examination. Although establishing breach of a good faith clause did not require proof of dishonesty, it is difficult to see how such an allegation could be made out without proving bad faith (at [31]–[32], [43]).

Case details

- Court: Chancery Division
- Judge: Deputy Master Hansen
- Date of judgment: 11 December 2020

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