No duty to exercise option reasonably or in good faith in engine maintenance agreement (Cathay Pacific Airways Ltd v Lufthansa Technik AG)

21/07/2020

Commercial analysis: The High Court found that there was no duty of good faith or duty to act reasonably in respect of an option to withdraw engines from a maintenance agreement. The judgment provides a helpful discussion of the case law concerning the principles of contractual interpretation and implied terms (including on the basis of the Braganza v BP Shipping Ltd and Socimer International Bank v Standard Bank London line of cases and relational contracts). The judgment also serves as a reminder to practitioners that evidence of statements made in pre-contractual negotiations, including mutual understanding (subject to limited exceptions) are generally inadmissible to assist with the interpretation of a concluded contract. Written by Rebecca Farrell, counsel, at 3 Paper Buildings.

Cathay Pacific Airways Ltd v Lufthansa Technik AG [2020] EWHC 1789 (Ch)

What are the practical implications of this case?

For commercial entities who have received the benefit of legal advice prior to entering into a contract, this judgment highlights the difficulties a party may experience in seeking to subsequently persuade the court that a contextual approach should be favoured over a textual analysis of the disputed clause in question.

The case further serves as a reminder to practitioners regarding what evidence is admissible where a term is challenged on the basis of a purported shared mutual understanding (see paras [118]–[127]). The general rule (subject to limited exceptions) is that evidence of statements provided in pre-contractual negotiations is inadmissible for the purposes of interpreting the concluded contract. It follows that statements made by one party as to what it believed another to have understood are unlikely to be considered by the court in deciphering the meaning of a contractual provision.

This judgment also draws together and highlights to practitioners the evolving case law concerning implied terms, in particular those implied by virtue of *Braganza v BP Shipping Ltd* [2015] 4 All ER 639 and *Socimer International Bank v Standard Bank London* [2004] All ER (D) 68 (Jul) (*Braganza/Socimer*) and good faith implied terms associated with relational contracts. In so doing the judgment demonstrates the difficulties parties may experience in relying on the same in the context of commercial contracts.

What was the background?

The negotiations

In brief terms, Pratt & Whitney developed a range of turbofan jet engines for use on long haul aircraft such as the Boeing 747. Within this engine range there was the:

- PW4056-3 (the 4056 engines), and
- PW4062 (the 4062 engines)

Initially in 2005, Cathay Pacific considered acquiring a fleet of six second-hand Boeing 747-400 aircraft with twenty-six 4056 engines. In early 2006, Lufthansa was contacted to discern whether it would be interested in providing maintenance, repair and overhaul (MRO) services to Cathay Pacific for the 4056 engines. Negotiations accordingly commenced between the parties.

At a similar time, Cathay Pacific decided that it wished to purchase a further five new 747-400s to use as air cargo carriers (freighters). Twenty 4062 engines and two spares would be used to power the freighters. This subsequently became six aircraft and 27 engines. In May 2006, Lufthansa were invited to submit proposals to act as the MRO provider for the 4062 engines. This was to be a 'stand-alone' proposal for these engines.

Cathay Pacific sought a ten-year MRO contract for the 4056 and 4062 engines respectively.

A notable background fact understood by the parties was that some of the aircraft which the 4056 engines were installed on were subject to a lease which would expire during the ten-year term. The result being that the aircraft may be returned to the owners during the contractual period and the MRO services required may reduce.

Within the negotiations concerning the MRO contracts for the 4056 and 4062 engines, Cathay Pacific updated its requirements for both engines within written correspondence. It highlighted the fact that four of the aircraft's leases scheduled return dates fell within the ten-year period and it needed to have the option to retire the aircraft from the fleet on the dates specified.

The MRO Agreement for the 4056 engines was signed on 29 March 2007 (the 4056 contract). The agreement for the 4062 engines was signed on 9 May 2007 (the agreement).

The option

Clause 2.12 of the agreement provided:

> 'CX may at its option remove Engines from the Flight Hour Service programme prior to the completion of the Term. A financial reconciliation will be performed with respect to each engine removed from the Flight Hour Service programme in accordance with Schedule 13[…].'

Schedule 13 of the agreement provided a reconciliation calculation which was payable (by either Cathay Pacific or Lufthansa) if an engine was removed from the 'Flight Hours Service Programme'. There was a financial incentive for Cathay Pacific to remove them before the end of the ten-year term.

The agreement was subsequently amended in 2011 by the addition of an obligation on Cathay Pacific to use commercially reasonable endeavours in relation to the removal of specific engines and to allow Lufthansa a reasonable opportunity to present proposals to prevent such removal.

The dispute

In summary, the dispute began when Lufthansa became aware that Cathay Pacific were considering removing 4062 engines from the Flight Hours Services Programme and performing a financial reconciliation pursuant to clause 21.1 of the agreement.

Points to resolve

In this matter the court was required to determine whether Cathay Pacific was entitled to two sums from Lufthansa under the agreement—the Schedule 13 reconciliation and the Schedule 4 reconciliation.

The Schedule 13 reconciliation

The first payment was said to have arisen from Cathay Pacific's exercise of an option under the agreement. Lufthansa contended that no sum was due since the option was not validly exercised for three main reasons:

- on its proper construction, the option was not exercisable and did not give rise to the remuneration sought

- the option was subject to a *Braganza*/*Socimer* type limitation that it may not be exercised in an arbitrary and/or unreasonable manner and it was exercised in such a manner by Cathay Pacific
- the agreement was a relational contract and the option had not been exercised in a way that would be regarded as commercially acceptable by reasonable and honest people

Lufthansa also contended that Cathay Pacific had failed to allow it a reasonable opportunity to present commercial proposals to prevent the removal of the engines, in breach of the amended 2011 version of clause 2.12.

The Schedule 4 Reconciliation

There was also a dispute between the parties as to the correct sum due under Part 3 of Schedule 4 to the agreement.

What did the court decide?

The Schedule 13 reconciliation

The court considered 'from a purely textual point of view, Lufthansa's case is an ambitious attempt at linguistic manipulation'. In the court's judgment there was no ambiguity: the clause appeared to grant Cathay Pacific a unilateral option to withdraw engines from the Flight Hours Services programme at any time prior to the Term.

The court referred to the principles identified by the Chancellor in *Deutsche Trustee v Duchess and Others* [2019] EWHC 778 (Ch) at paras [29]–[30] which were subsequently approved by the Court of Appeal. The principles set out in *Deutsche Trustee* are derived from the well-known case law in this area concerning the proper approach the interpretation of contractual provisions, namely: *Arnold v Britton* [2015] UKSC 36, [2015] AC 1619, *Wood v Capita Insurance Services Ltd* [2017] UKSC 244, *Rainy Sky SA v Kookmin Bank* [2011] UKSC 50, [2011] 1 WLR 2900 and *Re Sigma Finance Corp* [2009] UKSC 2, [2010] 1 All ER 571.

The court was not persuaded that the option should only be available to Cathay Pacific if the removal of the engine is for an operational purpose and if the engine was to be removed from the fleet. The court emphasised that 'English law does not easily accept that people have made linguistic mistakes, especially in formal documents drawn up by sophisticated commercial parties with the assistance of commercial law firms on both sides'.

The court found that evidence as to the mutual understanding was not admissible (see paras [121]–[126]) and, in any event even if that was wrong, it was not persuaded by Lufthansa's argument that there was a shared mutual understanding that the clause would only be used for operational purposes or the contention that Cathay Pacific's interpretation led to a highly uncommercial result.

Implied terms

The court did not accept in the alternative that as a result of the implication of any term the option was fettered either on the basis of business efficacy, the *Braganza/Socimer* line of case law or because the contract was a relational contract which implied the parties ought to deal with each other in good faith.

In so doing the court considered *Braganza/Socimer* line of case law. The court considered the origins of the authorities here. Although the law in this area is still in development, the court accepted Chief Master Marsh's summary of the principles in *UBS AG v Rose Capital Ventures Ltd and others* [2018] EWHC 3137 (Ch).

The court also made reference to the recent decision of HHJ Pelling QC in *Taqa Bratani Ltd v Rockrose UKSC8 LLC* [2020] EWHC 58 (Comm). Paragraph [183] of the court's decision deals with the reasons why no *Braganza/Socimer* implied term ought to be implied as a fetter on the exercise of the option which in very brief terms are as follows:

- the option was closer in nature and type to clauses which have been held not subject to *Braganza/Socimer* type implied term
- the option was comparable to the partial termination clause dealt with in *Taqa Bratani Ltd v Rockrose*

References:

- *UBS AG v Rose Capital Ventures Ltd [2018] EWHC 3137 (Ch) at para [49]*
- the exercise of the option is not 'the type of decision where one party is given a role in the on-going performance of the contract such as where an assessment has to be made'
- a power to withdraw an object from a contract of service is a power included for the benefit of the terminator and where clearly drafted, generally ought to be given its intended effect
- given the parties were corporations assisted by lawyers, there appeared to be no reason why the court ought to alter the nature of the bargain struck
- the option here was comparable to the option in *Monk v Largo* [2016] EWHC 1837 (not reported by LexisNexis® UK) which was unsuitable for the implication of a *Braganza/Socimer* type implied term

Likewise the court did not accept that the agreement met the relevant test for a good faith term to be implied as a matter of law. Although the case law was in a 'state of development', the court identified the key principles (summarised in paragraph [218] of the judgment):

- a term of good faith may be implied in a relational contract as a matter of law under the principles set out by Lord Wilberforce in *Liverpool City Council v Irwin* [1976] AC 239 subject to any contrary express term for example, as in *Sheihk Tahnoon Bin Saeed Bin Shakhboot Al Nehayan v Kent* [2018] EWHC 333 (Comm)
- the test for incorporation as a matter of law is whether the contract is a long-term contract which requires the parties to collaborate in future in ways that respects the spirit and the objectives of their joint venture but which the parties have not specified or have been unable to specify in detail. The contract will also involve trust and confidence that each party will act with integrity and co-operatively
- a good faith term may be implied as a matter of fact in a relational contact but there is no special rule for incorporation in a relational contract. Each term must be considered against the usual test for implied terms
- the main test of whether a term of good faith is to be implied in a contract is whether a reasonable reader of it would consider the term to be so obvious as to go without saying or the term is necessary for business efficacy
- the overall character of the contract is an important consideration. In relation to this question the indicia in *Bates v Post Office* [2019] EWHC 606 (QB) at para [725] may be helpful
- the implication of a good faith term as a matter of fact is possible even in the case of long, complex and sophisticated contracts expressed in writing

The court found that the agreement did not meet the test for the implication by law of a good faith term as required by Sheikh Tahnoon. The only criteria it satisfied was that it was a long-term contract.

The judge also asked himself whether a reasonable person reading the agreement at the time it was made, with knowledge of the circumstances in which it was entered into (though not the negotiations of the parties or their drafts and preparatory documents) would consider that it was obvious that the parties had to act in good faith in all their dealings or whether such an obligation was necessary to give coherent effect or business efficacy to the agreement. The answer was 'no'.

Finally, the court did not accept that Cathay Pacific had failed to comply with clause 21.2 as amended (see paras [243]–[245]).

Schedule 4 reconciliation

The court dealt with what it considered to be the correct calculation of the schedule 4 Reconciliation at paras [251]–[258].

Case details

- Court: High Court of Justice, Business and Property Courts of England and Wales, Chancery Division
- Judge: John Kimbell QC (sitting as a deputy judge of the High Court)
- Date of judgment: 10 July 2020

Rebecca Farrell is a counsel at 3 Paper Buildings. If you have any questions about membership of LexisPSL's Case Analysis Expert Panels, please contact caseanalysis@lexisnexis.co.uk