

## Observation of Good Faith Principle in Contract Negotiations A Comparative Study with Emphasis on International Instruments

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### ABSTRACT

*Good Faith is one of the important principles in contract law. This principle is inherited from Roman law and it has been mostly developed in civil law system. Observation of Good faith and Fair dealing in French and German law and many other countries is considered as legal obligation. Good faith, also, is of special stand In Chinese law of contract. Since Good faith is considered as important and valuable, it has been recognized in Common Law System and adopted in English and American law. Islamic law also contains numerous examples of obligations that are based on Good Faith principle. Nowadays, good faith principle has been incorporated in important international instruments such as CISG, UPICC, PECL, and DCFR and its scope has been developed. If good faith principle was being considered in fulfilling of contracts, today it also is considered as important in pre-contractual and conclusion stages of contracts. The aforementioned documents contain regulations for observing good faith in preliminary negotiations, conclusion of contract, fulfilling of contract and the interpretation thereto. The present Article is attempted to show that Good faith is important in all stages including preliminary negotiation and it should be incorporated in domestic legislations. Remedy for breach of this duty in the pre-contractual sphere should be limited only to compensation for damages.*

**Keywords:** *Good Faith, Contract Negotiations, legal Systems, International Instruments*

### 1. INTRODUCTION

Classic contracts have simple formation procedure and they are completed by an offer and acceptance merely. If negotiation is required, it will be done in a short time period subsequent to the formation of the contract e.g., transactions that are concluded in supermarkets and stores daily. But in modern contracts, contract formation procedure is complicated and requires negotiations. In the procedure of these contracts, counter offers are corresponded until the parties reach to a mutual agreement.

According to the freedom of negotiation principle, either party may leave the negotiations prior to the formation of contract and either party shall bear its own special costs and the risks may arise from its acts (Weitzenbock, 2004). The rule is considered in international documents such as the Art. 3:301 of the Second book of the Draft Common frame of Reference, Article 2:301 of the Principles of European Contract Law and Article 2.1.15 of the Unidroit Principles of International Commercial Contracts. These instruments emphasize the aforementioned principle.

However, parties' freedom to negotiate and make decision on the conditions of negotiation is not unlimited and may not contradict with good faith principle and fair dealing (Art. 2.1.15 Unidroit Principles 2010, Comment 2), because the freedom of action that is the basic idea for freedom of negotiation may be misused.

If one party reasonably relies on the formation of the contract in the future, (e.g. incurring expenses for preparing for fulfillment of future contract obligations) sudden and unfair interruption in pre-contractual negotiations by other party may be deemed as breach of good faith principle (Weitzenbock, 2004). Is there any responsibility for interruption of negotiations or generally for breach of good faith principle during negotiation? If the answer is positive, what is its basis and remedy? These are the questions that this article intends to consider.

The responsibility arising from preliminary contractual negotiations is, for the first time in 1861, raised in the thesis of German Lawyer, Rudolf von Jhering (Legrandjr, 1991). In 1907 a French lawyer, Raymond Saleilles, developed Jhering opinion and claimed that parties to negotiation shall behave in good faith and they may not waive the negotiations obstinately and leave the aggrieved party uncompensated. Consequently, the opinion emerged in German law and developed and interpreted in France (Novoa, 2005). Nowadays, pre-contractual liability is developed in domestic law and it is also recognized in international documents. In this article nature,

basis of the pre-contractual liability and different types of duty to good faith negotiation has been studied. It is notable under Art. 42 and 43 of China Contract Law, the pre-contractual liability is recognized under good faith and fair dealing principle.

## 2. NATURE OF PRE-CONTRACTUAL LIABILITY

Pre-contractual liability has been mentioned in three situations in the article 2.1.15 of the Unidroit Principles, article 2:301 Principles of European Contract Law and article 3:301 of the Second Chapter of DCFR. The first case is where one party starts negotiation aiming failure to reach an agreement with the other party. The second case is where one party starts negotiation having good faith but waives it with bad faith. The third case is where one party starts negotiation without real intention for conclusion of contract but continues negotiations (Fages, 2008; Lando & Beale, 2000)

There is no rule concerning pre-contractual liability in United Nations Convention on Contracts for the International Sale of Goods (1980). Some authors believe that, the Convention's regulations are not provided for pre-contractual liability and since pre-contractual liability is not an issue that is considered by the Convention, the second part of article 7 of the CISG is not applicable for its subjects.

Nevertheless pre-contractual liability is considered in all of three international documents (UPICC, PECL and DCFR). But the question is that what is the nature of pre-contractual liability in international documents? To find the answer, we should resort to the Rome II Regulation concerning non-contractual obligations (Regulation (EC) No 864/2007 of the European Parliament and of the Council of 11 July 2007 on the law applicable to non-contractual obligations-Rome II). Article 12 (1) of the convention describes pre-contractual liability as a non-contractual obligation arising out of dealings prior to the conclusion of a contract (Fauvarque-Cosson & Mazeaud, 2008). In a case, (C334/00[2002], Cited in: <http://www.unilex.info/case.cfm?id=813>) European Court of Justice held that because bona fide behavior duty during negotiation and duty for unjustifiable interruption of negotiations are not relying on parties agreement but applied by law, the Brussels Convention for determining the competent court considers the damages claim for breach of pre-contractual duties such as bona fide negotiation as a tort claim, rather than contractual (Cartwright, 2006). In Article 2:301 of Principles of European Contract Law (Lando & Beale, 2000) and also Article 3:301 of the Second book of Draft Common Frame of Reference (DCFR), the liability arising from preliminary negotiations is considered on the basis of misrepresentation and the aggrieved party shall have the right to claim the incurred damage on non-contractual basis. But if the negotiating party promises to the other party, contractual liability will be considered (Bar et al., 2009).

Under Unidroit Principles (Comment 2), the liability arising from preliminary negotiations is implicitly considered non-contractual. It is also noted that only if the parties agree on bona fide negotiation duty explicitly, the liability will have contractual nature (Art. 2.1.15 Unidroit Principles 2010, Comment 2).

## 3. THE BASIS OF PRE-CONTRACTUAL LIABILITY

Numerous bases have been suggested for justification of pre-contractual liability. Good faith principle is its main basis. But other bases are also considered that will be examined briefly.

### 3.1. Good Faith Principle

One of the main bases for pre-contractual liability is bona fide principle in Roman law. Nowadays, the scope of this principle not only consists of performance of contract but also will be applied in pre-contractual stage.

Saëilles, the French lawyer, suggested that bona fide principle and fair behavior is to be applied in pre-contractual stage and on liability arising from breach of the principle.

According to this principle, the parties shall have fair behavior and they shall not terminate negotiations without a justified cause. So, the basis for the pre-contractual liability is that by commencement of preliminary negotiations, special relationship is established between the negotiation parties which is called relation of trust and requires reciprocal fairness by either party (Kucher, 2004). In Common Law, the general obligation for good faith behavior and fair dealing in pre-contractual stage is not accepted (Lando, 2004).

The reason is that the freedom of negotiation principle as a basis for pre-contractual relationship in Common Law is based on the presumption that until the contract has not been concluded by acceptance of offer, the contractual liability no longer exists. Prior to acceptance, offeror is free to waive the impending transaction by withdrawing his/her offer (Tene, 2006). For example in a case (Walford v Miles [1992] 2 AC 128) House of Lords held that either party is free to enter or withdraw from negotiations (MacQueen & Zimmermann, 2011).

By the view, Common Law does not describe negotiations as a “protected legal relationship”, so, commentators claim that there is no good faith negotiation principle in English law (Fairgrieve, 2010) and even the parties' express agreement for bona fide negotiation is not binding (Bar et al., 2009).

Bona fide behavior in pre-contractual stage has also been considered in international documents and they oblige the parties to be bound to and therefore breach of such duty entails liability. According to the second part of Article 3:301 of the Second book of DCFR, Article 1:102 Principles of European Contract Law and Article 1.7 Unidroit Principles of Commercial International Contacts, the parties to negotiations are bound to good faith negotiates and fair dealing. Any exclusion or limitation to the obligation is not possible by agreement and this is a mandatory rule.

Art. II. – 3:301 of DCFR states: “A person who is engaged in negotiations has a duty to negotiate in accordance with good faith and fair dealing and not to break off negotiations contrary to good faith and fair dealing. This duty may not be excluded or limited by contract” (Ibid).

Article 2.1.15 UPICC has expressed: “However, a party who negotiates or breaks off negotiations in bad faith is liable for the losses caused to the other party”. This statement clearly indicates to good faith principle as a major basis for pre-contractual liability.

### **3.2. Fault**

If one of the parties breaches truthfulness and bona fide duty in negotiations in pre-contractual stage, this is considered as a fault (Fauvarque-Cosson & Mazeaud, 2008). In French law, one of the bases for pre-contractual liability is misuse of right, and this is because there is fault in enjoyment of freedom in negotiation and its interruption (Cadet et Tourneau, 2008). The first chamber of French Supreme Court believes that if negotiation interrupted without bad faith, there is no fault, even though the aggrieved party may claim damages by invoking to other bases (Chauvel, 2007). Article 16 of Chancery Project (French Ministry of Justice Proposal for reforming the law of contracts), also considers entering or continuing negotiation without genuine intention for formation of contract as fault.

Fault must be clear and affirmative in pre-contractual liability. This is because if one is known responsible for interruption of negotiations conveniently, it will lead to serious harm to individual autonomy and commerce flourish. In other words, pre-contractual fault must be clear and affirmative and the act has to be considered as false, and it is not necessary to be willful. So, waiver from negotiations does not create liability in itself and there must be an illegal element such as false information, lack of intention for agreement or continuance of negotiation where there is no chance for conclusion of contract (Novoa, 2005).

### **3.3. Unjust Enrichment Theory**

Unjust enrichment theory is one of the bases for pre-contractual liability. It may happen that one negotiates with counter party without genuine intention or is intended to achieve the commercial data and secrets of the party for taking some interest without any consideration in return for. So, unjust enrichment may be considered as one of bases for pre-contractual liability.

If negotiator behaves unfairly and achieve some interests by the expense of the other party as a result of such blameworthy behavior, then the liability will be justified by this theory (Kucher, 2004). The main basis for pre-contractual liability in restitution of the achieved interests in negotiation course is the unjust enrichment theory.

The negotiating party may not dedicate such interests through unjust exemption of liability. In such a case pre-contractual negotiation requires that ideas to be disclosed or services fulfilled in negotiation (Novoa, 2005).

### **3.4. Misrepresentation Theory**

Misrepresentation is always taking place prior to the formation of contract and consequently, its original position is in preliminary negotiations. Misrepresentation is considered as a basis of the pre-contractual liability in common law but its applicability and favorability is less than unjust enrichment theory. According to this rule, one who misrepresents fraudulently and has intention of the conclusion of the contract, may not relieve from liability (Ibid).

Under US law (See: Restatement 2d Torts Â§ 525, Illustration 1), one who transacts relying on other party misrepresentation and incurs damage may claim damages (Thai, 2004). For example where the seller of a second hand car reverses the speedometer and the buyer buys relying on the speedometer, there is

misrepresentation in pre-contractual stage. Breach of a duty to inform in pre-contractual negotiations as one of the bases for liability in French law, defined as misrepresentation (Chauvel, 2006).

In international documents (DCFR & PECL) misrepresentation is also considered as one of the justifying bases for liability arising from misrepresentation in negotiations (Bar et al., 2009).

Deceit of negotiating party is one of the causes which results liability. Deceit may take place as a false statement (express or implied) or as failure to provide of necessary information. Article 3.2.5 Unidroit principles is expressed that A party may avoid the contract when it has been led to conclude the contract by the other party's fraudulent representation, including language or practices, or fraudulent non-disclosure of circumstances which, according to reasonable commercial standards of fair dealing, the latter party should have disclosed (see Art. 3.2.5 Unidroit Principles 2010, Comment 2).

### **3.5. Promissory Estoppel or Specific Promise Theory**

One of the other bases for pre-contractual liability in Common Law is Promissory Estoppel or Specific Promise, that one party promises the other in preliminary negotiation stage (Novoa, 2005).

According to this Doctrine, where one party in pre-contractual stage promises the other party and the latter relies on that promise and incurs damage, pre-contractual liability is applied (Goderre, 1997).

Reliance is the basis of this Doctrine (Chung, 2008). The term "*promissory estoppel*" appears to have been invented by *Williston* in his 1920 contracts treatise. He presumed that for fulfillment of charitable promises, reliance on the promise is considered as Substitution for Consideration (Ibid). According to section 90 of Restatement (Second) of Contracts, *promissory estoppel* is a promise that the promisor expects the promisee to be induced for specific act or omission relying on it. In such a case if it be possible to avoid unfairness by fulfillment of promise, the promise is binding (Steinberg, 1975).

## **4. TYPES OF DUTY TO GOOD FAITH**

Bona fide principle keeps special place in contracts, nowadays. The scope of the principle is not limited to contract fulfillment stage and it is also considered in different stages such as conclusion and interpretation phase. In preliminary negotiation also, good faith applies so efficiently and the duty may be arise from statute or contract (Novoa, 2005). Good Faith duty in pre-contractual stage imposes various duties on negotiating parties that may be classified as follows:

### **4.1. Obligation to Non-Disclosure Of Information**

The obligation requires keeping silence about information, documents and circumstances related to the other party character and asset. It is notable that the obligation exists where the information is exchanged in the normal course of negotiation (Ibid).

Obligation for keeping secrets is considered in articles 2:302 Principles of European Contract Law, 2.1.16 Unidroit Principles and the first part of article 3:302 of the Second book of DCFR.

The first paragraph of Article II. – 3:302 DCFR is expressed: "If confidential information is given by one party in the course of negotiations, the other party is under a duty not to disclose that information or use it for that party's own purposes whether or not a contract is subsequently concluded. The second part of the article defines confidential information criteria as follow: In this Article, "confidential information" means information which, either from its nature or the circumstances in which it was obtained, the party receiving the information knows or could reasonably be expected to know is confidential to the other party (Bar et al., 2009).

### **4.2. Obligation of Custody and Conservation**

This obligation obliges the parties to custody all the objects they take from each other in the course of negotiation (Novoa, 2005).

### **4.3. Obligation of Seriousness**

It means that each party is bound to talk with the other party in the beginning of negotiation having genuine intention for conclusion of contract and once he finds out that he does not have desire to finalize the contract, he has to leave the negotiations seriously (Ibid).

For example, A learns of B's intention to sell its restaurant. A, who has no intention whatsoever of buying the restaurant, nevertheless enters into lengthy negotiations with B for the sole purpose of preventing B from selling the restaurant to C, a competitor of A's. A, who breaks off negotiations when C has bought another restaurant, is liable to B, who ultimately succeeds in selling the restaurant at a lower price than that offered by C, for the difference in price (Art. 2.1.15 Unidroit Principles 2010, Illustrations 1).

#### 4.4. Obligation to Inform

There are two factors for duty to inform, first personality of parties and second nature of contract (Novoa, 2005). In French law duty to inform is provided under the conditions that are defined in article 1110 of Catala Project (Proposals for Reform of the Law of Obligations and The Law of Prescription). The article provides that if one of the parties knows or ought to have known information which he knows is of decisive importance for the other, he has an obligation to inform him of it. However, this obligation to inform exists only in favour of a person who was not in a position to inform himself, or who could legitimately have relied on the other contracting party, by reason (in particular) of the nature of the contract or the relative positions of the parties (Cartwright et al., 2009). Article 3:101 of the Second book of DCFR provides a pre-contractual duty to inform the other party that there is duty for disclosure of the expected information to the counter party, prior to conclusion of contract for delivery of service and goods (Fages, 2008).

Duty to inform is stipulated in Article 4:107 Principles of European Contract Law and if false statement of one contracting party, whether by word or conduct, or fraudulent non-disclosure of any information that according to good faith or fair conduct should have been disclosed, leads to conclusion of contract, the other party may terminate the contract and the party receiving false information, may claim damages if he has been relied on the information (Lando & Beale, 2000).

#### 4.5. Prohibition to Deceive

It means that one party shall not deceive other party concerning issues and facts that are of essential importance for conclusion of contract or acceptance of special conditions (Novoa, 2005).

### CONCLUSION

Although under freedom of negotiation principle, each party may leave the negotiations prior to the formation of contract, but this freedom is not unlimited and both parties must be negotiate based on good faith. Today bad faith in stage of negotiations may raise liability for compensation of damages. The nature of liability under Rome II Regulation is a non-contractual responsibility. There are different basis for Pre-Contractual Liability. The most important basis is good faith principle, but fault, unjust enrichment, misrepresentation, Promissory Estoppel are considered as other bases. Types of duty to good faith negotiation are classified in some categories. Obligation to non-disclosure of information, obligation of custody and conservation, obligation of seriousness, obligation to inform and prohibition to deceive are the main titles of above mentioned duty.

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