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Is a Relational Contract a Legal Concept?

Hugh Collins*

Abstract: The idea of a relational contract has been discussed in sociology, economics and law. The concept has recently been adopted in a trilogy of decisions in the High Court in the United Kingdom. The paper addresses two questions. What does the idea of a relational contract mean? If the notion of relational contract applies to a contract, does it have particular legal implications for the transaction, such as an expansion of mandatory or supplementary duties of disclosure and obligations to perform in good faith? The paper proposes a concept of relational contracts that emphasises the economic significance of indeterminate implicit obligations and which supports the development of a contextual approach to interpretation and the insertion of implied obligations of co-operation and mutual trust and confidence.

Key words: relational contract; co-operation; mutual trust and confidence; good faith; implicit obligations.

1. A Legal Concept of a Relational Contract

In the common law world, legal scholars and judges occasionally invoke the idea of a 'relational contract'. The term 'relational contract' has been applied frequently to the contract of employment.¹ Lord Steyn accepted this description when he said: 'it is no longer right to equate a contract of employment with commercial contracts. One possible way of describing a contract of employment in modern terms is as a relational contract'.² The idea of a relational contract has also been used in scholarly literature in connection with certain kinds of commercial agreements such as franchises, distributorships, and other kinds of long-term business relationships.³

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¹ RC Bird, 'Employment as a Relational Contract' (2005) 8 *U.Pa Journal of Labor and Employment Law* 148; M Boyle, 'The Relational Principle of Trust and Confidence' (2007) 27 *OJLS* 633; Mark Freedland, *The Personal Contract of Employment* (OUP 2003) 88; Douglas Brodie, 'How Relational is the Employment Contract?' (2011) 40 *ILJ* 232; J Levin, 2002. "Multilateral Contracting and the Employment Relationship." (2002) 117 *Quarterly Journal of Economics* 1075.

² *Johnson v Unisys Ltd* [2001] ICR 480, [16] (HL); approved in *Braganza v BP Shipping Ltd* [2015] SCUK 17, [2015] ICR 449, [54] Lords Hodge and Kerr.

³ Eg Victor Goldberg, 'Relational Exchange: Economics and Complex Contracts' (1980) 23 *American Behavioural Scientist* 337; Charles J Goetz and Robert E Scott, 'Principles of Relational Contracts' (1981) 69 *Va L Rev* 1089; Richard E Speidel, 'The Characteristics and Challenges of Relational Contracts' (2000) 94(3) *Nw U Law Rev* 823; L Mulcahy and C Andrews, 'Baird Textile Holdings v Marks & Spencer plc' in R Hunter, C McGlynn and E Rackley (eds), *Feminist Judgments: From Theory to Practice* (Hart Publishing 2010) 93; Catherine Mitchell, *Contract Law and Contract Practice – Bridging the Gap between Legal Reasoning and Commercial Expectation* (Hart Publishing 2013) Chapter 6; David Campbell, 'Good Faith and the Ubiquity of the 'Relational' Contract' (2014) 77 *MLR* 460.

Judicial references to relational contract in connection with commercial transactions have, however, been sparser in the common law world.⁴ Recently, in three cases concerning commercial contracts, the English High Court has adopted the label of ‘relational contract’ in its reasoning. The types of commercial contracts concerned a distributorship for a product,⁵ a joint venture to exploit the digital form of educational materials,⁶ and a long-term service contract made by a private business to provide a county police authority with a car disposal and destruction service.⁷ What significance should be attached to this recent development in the judicial use of the phrase ‘relational contract’?

It is possible that this usage of the label of relational contract is a passing fad that will soon be forgotten. Even if it persists, it may turn out that the label has little practical significance. But what importance might it have? What would be the consequence of recognising the idea of a relational contract as a legal concept? It might become a tight legal category of nominate contracts, like a sale of goods or a contract of employment, to which automatic legal consequences will be attached whenever the category is applicable to a particular transaction. In the case of the sale of goods, for instance, it is a legal concept because it offers a description of a determinate class of transactions,⁸ and applies particular and specialised legal rules to those transactions within that class such as implied terms regarding title and quality of the goods.⁹ But the label of a relational contract might merely supply a looser concept that steers legal reasoning in particular directions, such as encouraging a more contextual approach to interpretation or a greater disposition to accept the existence of obligations to perform in good faith, without actually mandating any particular rules that should be applicable to the contract. In this looser form of legal concept, it may be hard to identify whether the label of relational contract directs legal reasoning or merely summarises a result.

No doubt there are good reasons to be sceptical about the prospects for the creation of a new legal concept. Leaving aside the tendency of lawyers the world over to prefer to recycle old concepts rather than to invent new ones to deal with novel social and economic phenomena, there are some more immediate difficulties that this proposed new legal concept needs to address. The two most obvious problems are the lack of a clear definition or paradigm of a relational contract and considerable uncertainty about what legal consequences might flow from the application of the classification to a particular contract. With respect to the descriptive paradigm of a relational contract,

⁴ Scattered examples include: *Dymocks Franchise Systems (NSW) Pty Ltd v Bilgola Enterprises Ltd* (1999) 8 TCLR 612, 652-653 [236] Hammond J (retail business format franchise; New Zealand High Court applying the law of New South Wales) affirmed on other grounds in *Dymocks Franchise Systems (NSW) Pty Ltd v Todd* [2002] UKPC 50, [2002] 2 All ER (Comm) 849; *Flyn and anor v Breccia & anor* [2015] IEHC 547 (High Court Eire) (agreement between shareholders for acquisition of shares in a business); *Bobux Marketing Ltd v Raynor Marketing Ltd* [2001] NZCA 348; [2002] 1 NZLR 506, [42]-[45] (Thomas J dissenting) (distribution agreement); *GEC Marconi Systems Pty Limited v BHP Information Technology Pty Limited* [2003] FCA 50 [351] Finn J (software development).

⁵ *Yam Seng Pte Ltd v International Trade Corporation Ltd* [2013] EWHC 111, [2013] All ER (Comm) 1321 (QB).

⁶ *Bristol Groundschool Ltd v Intelligent Data Capture Ltd & Ors* [2014] EWHC 2145 (Ch).

⁷ *D&G Cars Ltd v Essex Police Authority* [2015] EWHC 226 (QB).

⁸ Sale of Goods Act 1979, s2 (1) A contract of sale of goods is a contract by which the seller transfers or agrees to transfer the property in goods to the buyer for a money consideration, called the price.

⁹ Sale of Goods Act 1979, ss.12-15.

though there is widespread agreement that it involves a long-term business relationship, it is unclear for instance whether such a relationship requires a long-term contract that binds the parties together over a substantial period of time. There is also scepticism about whether it makes sense to speak of a class of relational contracts as opposed to recognising that ‘relationality’ or perhaps more precisely ‘trust’ is a feature of all contracts, though this dimension may vary between types of transactions in its extent and significance.¹⁰ Assuming that a paradigm of a relational contract can be devised, many questions persist regarding the possible legal effects of the application of that classification, including the question whether there is or should be any legal effect at all. In particular, the frequent suggestion that relational contracts require the imposition of an implied legal duty of fair dealing and performance in good faith is likely to provoke controversy.

Before tackling those questions directly, it is helpful to examine briefly the three recent cases in the English High Court where the phrase ‘relational contract’ has apparently been used as a legal concept. Having considered that trilogy, we can then explore further these issues concerning the paradigm of relational contract and the legal consequences attached to the paradigm, before reaching a conclusion as to whether relational contract is now a legal concept. That exploration will draw heavily on research in sociology and economics, where the concept of a relational contract has been widely employed.

2. The Trilogy of Relational Contracts

*Yam Seng Pte Ltd v International Trade Corporation Ltd*¹¹

The *Yam Seng* case concerned a contract for the distribution of bottles of fragrances and other toiletries primarily through duty free shops in airports in South East Asia. The brand of the fragrances was ‘Manchester United’ and the packaging used the insignia of the soccer team. Given the worldwide popularity of the brand name, presumably it was expected that consumers would purchase the products as a way of identifying with their heroes. (I can imagine the advertising catch-phrase: ‘I go all swooney when you smell like Wayne Rooney’; or perhaps ‘Man U smell good’). The contract between the two businessmen, trading as small companies, was brief and relatively informal, but it described how the defendant had a worldwide license to manufacture and sell fragrances under the Manchester United brand name and that the claimant would have exclusive rights to market the fragrances in particular locations including some duty-free shops in airports in south east Asia. As well as complaining about misrepresentations made by the defendant prior to entry into the contract, the claimant argued that the defendant had committed a breach of contract when it permitted sales of the branded fragrances in ordinary shopping outlets in Singapore at

¹⁰ David Campbell, ‘*Arcos v Ronaasen as a Relational Contract*’ in David Campbell, Linda Mulcahy and Sally Wheeler (eds), *Changing Concepts of Contract* (Palgrave Macmillan 2013) 138; David Campbell, ‘The Relational Constitution of the Discrete Contract’ in David Campbell and Peter Vincent-Jones (eds), *Contract and Economic Organisation: Socio-legal Initiatives* (Dartmouth 1996); Hugh Collins, *Regulating Contracts* (OUP, 1999) 141.

¹¹ *Yam Seng* (n 5).

prices as much as 20% below those specified for sales in the duty free airport outlets where the claimant was marketing the products.

Leggatt J found that although the defendant had not deliberately permitted this undercutting of the prices charged in the duty free shops by other distributors, he had failed to cooperate either by stopping the undercutting or by alerting the claimant to his inability to prevent it. This failure undermined the business model of this particular distributorship under which the claimant would be able to market the goods in duty-free outlets at slightly discounted prices and it also put him in breach of contract with the duty-free retailers. Although the case was decided in favour of the claimant on the ground of misrepresentation, Leggatt J also held that there was a repudiatory breach of contract based on breach of an implied term requiring honest conduct, because 'the nature of the dishonesty, on a matter of commercial importance..., was ... such as to strike at the heart of the trust which is vital to any long term commercial relationship, particularly one which is dependent as this relationship was on the mutual trust of two individuals.'¹² The reasoning in this case seems to proceed from a finding that the distribution agreement was a relational contract, to the insertion of implied term requiring good faith in the sense of honest disclosure of material information needed for the success of the commercial enterprise by maintaining trust.

Leggatt J described a relational contract as 'a longer term relationship between the parties to which they make a substantial commitment'.¹³ In addition, Leggatt J pointed to an implicit understanding of the parties founded on a perception of what is necessary to give business efficacy to their transaction that they will communicate, co-operate, not act in a way to destroy mutual trust and confidence, and be loyal. The particular implied legal obligation that Leggatt J envisaged as arising from this relational contract seems to have been a duty to disclose information that was vital to the success of the business operation, breach of which harmed the interests of the claimant without any compensating advantage to the defendant, since he did not benefit from the higher retail sales price in the high street, and so the defendant's conduct failed to defend this distributorship against its competitors. In other words, there had been a clear breach of an implied term requiring loyalty to the purpose of the contract and co-operation through being honest and keeping the other party properly informed.

¹² Ibid [171].

¹³ Ibid [171]. 'In some contractual contexts the relevant background expectations may extend further to an expectation that the parties will share information relevant to the performance of the contract such that a deliberate omission to disclose such information may amount to bad faith. English law has traditionally drawn a sharp distinction between certain relationships - such as partnership, trusteeship and other fiduciary relationships - on the one hand, in which the parties owe onerous obligations of disclosure to each other, and other contractual relationships in which no duty of disclosure is supposed to operate. Arguably at least, that dichotomy is too simplistic. While it seems unlikely that any duty to disclose information in performance of the contract would be implied where the contract involves a simple exchange, many contracts do not fit this model and involve a longer term relationship between the parties which they make a substantial commitment. Such "relational" contracts, as they are sometimes called, may require a high degree of communication, cooperation and predictable performance based on mutual trust and confidence and involve expectations of loyalty which are not legislated for in the express terms of the contract but are implicit in the parties' understanding and necessary to give business efficacy to the arrangements. Examples of such relational contracts might include some joint venture agreements, franchise agreements and long term distributorship agreements.'

*Bristol Groundschool Ltd v Intelligent Data Capture Ltd & Ors*¹⁴

The phrase ‘relational contract’ was next applied in *Bristol Groundschool* to a contract that may best be described as a kind of joint venture. The claimant had developed a business of writing and publishing training manuals for pilots. To create and exploit a digital version of the product, the claimant entered into a contract with the defendant, who turned the manuals into digital form with some added functionality. The parties published the digital manuals jointly and agreed to share the costs of production equally. The defendant received a royalty fee of £200 on every copy sold. As the relationship slowly soured, in anticipation of termination of the joint venture, the claimant secretly accessed the defendant’s database via a VPN network link, which had been provided for other purposes, in order to download digital materials. A year later, after the relationship became extremely acrimonious, the joint venture fell apart and the claimant used the downloaded files to link up with another supplier to continue the digital side of the business.

One issue before the court was whether the secret download via the VPN was a breach of contract. There was no express term that covered this question. Richard Spearman QC, acting as a judge in the Chancery Division, cited the decision and description of relational contract in *Yam Seng* with approval, and concluded that this joint venture was also a relational contract. It fell within the description of a relational contract because the joint venture was a long-term relationship, to which the parties had both made financial commitments, and in the evidence of the parties during the trial it was acknowledged that they needed to act towards each other in a trustworthy and honest way. The judge held that, as the contract was a relational contract, there was an implied term requiring good faith in performance. In this context, the requirement of good faith was greater than honesty. The relevant test was that of conduct that would be regarded as "commercially unacceptable" by reasonable and honest people in the particular context involved,¹⁵ a standard that the defendant had breached.

*D&G Cars Ltd v Essex Police Authority*¹⁶

The third recent decision in which the label of ‘relational contract’ was attached to a commercial contract was *D&G Cars Ltd v Essex Police Authority*. This contract was a five year franchise or exclusive license under which the police authority granted a private contractor the right to dispose of cars in accordance with the police authority’s instructions. These cars might have been stolen, involved in an accident, owned by someone without insurance, used in evidence in a case, or in some other way come into the possession of the police. Instead of crushing one car completely, as instructed by the police authority, the contractor used the vehicle as a ‘ringer’ to demonstrate to staff how the chassis and parts of vehicles could be exchanged without detection, and then an apparently almost new car could be created out of older parts. As a result of a

¹⁴ *Bristol Groundschool* (n 6).

¹⁵ *Ibid* [196], citing *Royal Brunei Airlines Sdn v Tan* [1995] 2 AC 378; *Yam Seng* n 5 [144]; *Mid Essex Hospital Services NHS Trust v Compass Group UK and Ireland Ltd (t/a Medirest)* [2013] EWCA Civ 200 [150] (Beatson LJ).

¹⁶ *D & G Cars* (n 7).

tip-off, it was discovered that the car that had been sent to be crushed was a different one, albeit with the correct transferred registration and chassis numbers, and that the claimant was using the condemned car for its own business. On discovering this disobedience or carelessness in carrying out instructions, the police authority removed the franchise and excluded the contractor from bidding for a new one. The claimant argued that this termination was a fundamental breach of contract and sought damages of about £1 million, whereas the defendant insisted that it had merely accepted the claimant's repudiatory breach of contract.

Dove J described this contract as 'a relational contract *par excellence*'.¹⁷ It was a long-term contract and relationship; the court stressed the need for the contractor to act with integrity and honesty in carrying out the instructions of the police authority, which itself was acting on behalf of the public in dealing with these cars. In addition, the cars were never the property of the contractor, but were owned by the registered owner or had been confiscated by a legal process, so the contractor had to take care of the cars, especially if it was required eventually to return a vehicle to its owner. In this case the implied term was described not as one of good faith but rather as a term that the parties would act with honesty and integrity in operating the contract.¹⁸ Dove J. explained his use of different language as setting a standard that was not merely about dishonest behaviour but concerned conduct that was inconsistent with the maintenance of the long-term relationship.¹⁹ It is noticeable that some of the language used to describe the implied term in this case invoked the implied term found in contracts of employment, namely the obligation on employers (and employees), not to act, without good reason, in a manner likely to destroy mutual trust and confidence between the parties.²⁰ The court concluded on the facts that there had been a serious breach of the express term in relation to following the disposal instructions of the defendant and a breach of the implied term of honesty and integrity, even if it were the case that the conduct of the contractor had not been deliberately dishonest and fraudulent.²¹

The Emerging Legal Concept of a Relational Contract

This trilogy of cases supports the claim that the idea of a relational contract is being used as a legal concept in the sense that the judges have in mind a descriptive paradigm of a relational contract and, having identified the existence of a relational contract, they are prepared for that reason to imply contractual obligations such as duties of fair dealing, good faith, and mutual trust and confidence. But much remains

¹⁷ Ibid [176]

¹⁸ Ibid [176]

¹⁹ Ibid [175] 'By the use of the term 'integrity', rather as Leggatt J uses the term 'good faith', the intention is to capture the requirements of fair dealing and transparency which are no doubt required (and would, to the parties, go without saying) in a contract which creates a long-standing relationship between the parties lasting some years and which has the qualities and features to which I shall turn shortly. There may well be acts which breach the requirement of undertaking the contract with integrity which it would be difficult to characterise definitively as dishonest. Such acts would compromise the mutual trust and confidence between the parties in this long-term relationship without necessarily amounting to the telling of lies, stealing or other definitive examples of dishonest behaviour. They would amount to behaviour which the parties would, had they been asked, have identified as obvious acts which were inconsistent with the maintenance of their intended long-term relationship of fair and open dealing and therefore would amount to a breach of their contract.'

²⁰ *Malik v Bank of Credit and Commerce International SA* [1997] ICR 606, [1998] AC 20 (HL).

²¹ *D & G Cars n 7* [203]-[205].

to be clarified. A relational contract is still an incipient legal concept, for which the details need to be fleshed out rather more.

What are the elements of the descriptive paradigm of a relational contract that are being used in these cases? Drawing together the threads of the definition used in these cases, we can observe that emphasis is placed on the following four features of the transaction which draw it into the paradigm of a relational contract.

- (1) A longer-term business relationship;
- (2) Investment of substantial resources by both parties;
- (3) Implicit expectations of cooperation and loyalty that shape performance obligations in order to give business efficacy to the project;
- (4) Implicit expectations of mutual trust and confidence going beyond the avoidance of dishonesty.

These elements in the paradigm provide a useful start, though they require further refinement and elaboration before they can provide us with a workable paradigm of a relational contract.

With respect to the legal rules that arise from the application of the concept of a relational contract, in these cases the legal consequence has been the development of an implied term, breach of which is treated as a repudiatory breach of contract. The terms implied into these relational contracts concerning good faith, fair dealing, and mutual trust and confidence are certainly not regarded by the High Court as the same as fiduciary duties, but nor are they merely a rudimentary requirement of honest conduct, such a duty to refrain from fraud, which in any event is likely to be applied as a bare minimum standard to every contract.²² The precise content of the duties inserted by implied terms into relational contracts will evidently depend on the context and purpose of the transaction, the express undertakings made by the parties, and the acknowledged implicit expectations of the parties. But two elements of these implicit obligations stand out: expectations of cooperation and loyalty in order to give business efficacy to this kind of transaction, and the avoidance of actions likely to destroy mutual trust and confidence between the parties. Although Leggatt J described these implied terms as terms implied in fact or *ad hoc* terms suitable for a particular contract, this characterisation may turn out to be inaccurate. If it becomes the practice of the courts to insert such terms routinely into contracts that have been labelled as relational contracts, it seems that the terms would be more properly classified ones that are implied by law into all contracts of this type.²³

3. Lessons from Social Sciences?

Although more instruction can be derived from these cases, at this point it is helpful to consider the insights of the scholarly literature regarding relational contracts in the

²² *HIH Casualty v Chase Manhattan Bank* [2003] 2 Lloyd's Rep 61 (HL); *Bhasin v Hyrnew* 2014 SCC 71, [2015] 4 LRC 85 (SC Canada).

²³ For the contrast between terms implied in fact and terms implied by law and how these classifications can be manipulated see: Elizabeth Peden, 'Policy Concerns behind Implications in Law' (2001) LQR 459; Hugh Collins, 'Implied Terms: The Foundation in Good Faith and Fair Dealing' (2014) 67 CLP 297, 301-309.

social sciences. Unlike legal scholars, sociologists and economists tend not to be much interested in the normative implications of their analyses or what legal rules should apply to a particular case. But their interest in the empirical practices of transactions has the potential to offer insights regarding the special characteristics of relational contracts beyond those mentioned in the above trilogy of cases. These insights should assist in constructing a legal paradigm for relational contracts and may offer indirect guidance on the issue of the appropriate legal and regulatory framework to govern relational contracts. In pursuit of that purpose, we will consider briefly three strands in that literature: the sociology of embedded exchange; the economics of self-enforcing contracts or relational contracts; and the institutional economics theory of quasi-integration.

The Sociology of Embedded Exchange

The work of Ian Macneil launched the concept of a relational contract.²⁴ Although he was a professor of law, his perspective on contracts was thoroughly sociological. Macneil's views evolved during the course of his career,²⁵ but a consistent central proposition of his work maintains that any proper understanding of contracts as a social phenomenon needs to appreciate that they are embedded in social structures and norms.²⁶ Macneil contrasted this contextual approach towards understanding contracts with the approach of classical contract law, which was said to look merely at the express contractual agreement, what the parties said or wrote, and not at the full context of their exchange relationship. He labelled a thoroughly contextual approach that took into account all the implicit normative understandings between the parties the 'relational contract' approach. He further insisted that for the purpose of understanding contracts, both sociologically and in law, there were some kinds of deeply embedded contracts, somewhat confusingly described as 'relational contracts', as opposed to discrete contracts, for which it was essential to investigate the whole context and the implicit norms extremely thoroughly in order to understand properly all the normative dimensions of the transaction.²⁷ In contrast, such an extensive contextual exercise was mostly unnecessary for a complete understanding of simple discrete transactions such as the purchase of a newspaper at a kiosk.²⁸ Those points created the impression that in Macneil's view there exists an identifiable category of contracts that could be described as relational contracts, in which the appropriate legal method, unlike the normal method applicable for discrete contracts, should involve extensive examination of the implicit expectations of the parties. But eventually, in

²⁴ Ian R Macneil, 'Contracts: Adjustment of Long-term Economic Relations Under Classical, Neoclassical and Relational Contract Law' (1978) 72 Nw U Law Rev 854.

²⁵ The variations are expertly charted in David Campbell, 'Ian Macneil and the Relational Theory of Contract' in David Campbell (ed) *The Relational Theory of Contract: Selected Works of Ian Macneil* (Sweet & Maxwell 2001) 3.

²⁶ Ian R Macneil, *The New Social Contract* (Yale U P 1980); similar views can be found earlier in sociological studies of contracts: S Macaulay, 'Non-Contractual Relations in Business' (1963) 28 *American Sociological Review* 45; M Granovetter, 'Economic Action and Social Structure: The Problem of Embeddedness' (1985) 91 *American Journal of Sociology* 481.

²⁷ Ian R MacNeil, 'Relational Contract Theory: Challenges and Queries' (2000) 94 Nw U Law Rev 877, 881; Ian Macneil, quoted in Campbell (ed) *The Relational Theory of Contract*, above n 25, 368.

²⁸ Ian R Macneil, 'Relational Contract: What We Do and Do Not Know' (1985) *Wisc Law Rev* 483.

response to criticism,²⁹ it became apparent that such a sharp conceptual distinction was not what Macneil intended to say: he argued that the context of an exchange matters for an understanding of all contracts, because they are normally embedded in prior social relations. His claim was rather that the focus of traditional contract law on the original express agreement between the parties might function reasonably successfully when applied to relatively short-term, discrete transactions, but in more complex, long-term, transactions that require co-operation and perhaps flexibility, to understand the expectations of the parties and how the transaction was supposed to function, the focus must be much broader and embrace the entire relationship between the parties as it has developed.³⁰

Although Macneil does not ultimately support the claim that there is a class of contracts that can properly be described as relational, he does suggest that at one end of a spectrum of types of contractual relationships, the relational end, the classical approach to the analysis of contracts will prove defective, because it fails to examine the unexpressed expectations of the parties and their implicit undertakings. Macneil frequently offers the example of a contract of employment as one that usually lies at the relational end, because both employer and employee will have expectations that go beyond the formal exchange of work for wages, such as the expectation that the employee will work hard and be loyal to the interests of the employer. Those expectations will usually be protected by terms implied by law in the contract of employment.³¹ It seems that Macneil would favour interpretative techniques or implied terms that protected implicit expectations of this kind in other types of commercial transactions at the relational end of the spectrum. Macneil does not automatically classify long-term contracts as relational contracts, though the two categories overlap and are frequently confused.³² It is certainly more likely in long-term contracts such as employment and business franchises that the formal agreement will prove incomplete in its planning for future contingencies and that it will be appropriate for a court to flesh out the agreement by reference to implicit understandings and expectations. Ultimately, however, Macneil fails to provide a description or paradigm of relational contracts: the category consists rather of those kinds of transactions where it is appropriate to embark upon a deeper investigation of the context in order to ascertain properly the implicit obligations and understandings that inform the contractual undertakings.

Relational Contracts in Economic Theory

The idea of relational contracts also appears in economic analysis of transactions. 'The literature on relational contracts is concerned with the impact of the ongoing nature of the relationship on trade between the parties, on their payoffs, on the nature of any legally enforceable contract used to supplement the relational contract, and on

²⁹ Eg David Campbell, 'The Relational Constitution of the Discrete Contract' in D Campbell and P Vincent-Jones (eds), *Contract and Economic Organisation: Socio-Legal Initiatives* (Dartmouth 1996) 40.

³⁰ Macneil (n 24) 890.

³¹ *British Telecommunications plc v Ticehurst* [1992] ICR 383 (CA).

³² Eg Lord Steyn *Total Gas Marketing Ltd v. ARCO British Ltd and Others* [1998] UKHL 22, [1998] 2 Lloyd's Rep 209; Ewan McKendrick, 'The Regulation of Long Term Contracts in English law', in J Beatson and D Friedman (eds) *Good Faith and Fault in Contract Law* (OUP 1995) 305.

the design of organizations.’³³ The core insight of this analysis is that some transactions will be ‘self-enforcing’ in the sense that the pay-offs for both parties will usually be greater if the contract or business relationship is continued rather than discontinued, so they probably will perform their contracts as best they can and maintain their business relationship.³⁴

An example of this type of relational contract might be a ‘requirements contract’, under which a supplier agrees to meet all the customer’s needs for a product or service over a period of time if and when the purchaser chooses to place an order. Under the common law, owing to the absence of consideration in the form of a promise to buy something, such a requirements contract is unlikely to be legally enforceable. Even so, most suppliers regard requirements contracts as extremely beneficial,³⁵ because in practice the agreement is likely to channel a lot of business between the firms, not because there is anything that is legally binding in the long-term relationship, but because of the long-term economic incentives for both parties in nurturing and staying loyal to the business relationship. It is the long-term economic interest of both parties in sharing the surplus arising from the relationship that binds the parties together and provides the crucial incentive to perform satisfactorily.

A similar analysis can be applied to casual workers, including those working under ‘zero hours contracts’, where strictly speaking there may not be a binding umbrella or long-term contract between the parties at all owing to the lack of consideration.³⁶ In practice, despite the absence of legal sanctions, the casual worker is likely to enjoy stable employment because both parties have incentives to continue the relation: the employer wants to keep a regular pool of staff on which to draw and the worker needs a regular income each week. This kind of legally unenforceable relational contract that is nevertheless a crucial and almost permanent business relationship was also at the heart of the dispute between a preferred supplier and a retail chain in *Baird Textile Holdings v Marks & Spencer plc*,³⁷ a case to which we will return in a moment.

The importance of the pay-offs from long-term business relationships as a self-enforcing mechanism may also explain why, in the event of defective or tardy delivery of goods, businesses typically prefer to grant a discount on future orders from the injured party rather than offer immediate compensation.³⁸ This behaviour fits into a more general observed pattern of the avoidance of litigation whenever a long-term business relation needs to be preserved,³⁹ because the long-term pay-offs from future

³³ James M. Malcomson, ‘Relational Incentive Contracts’ in Robert Gibbons and John Roberts (eds), *The Handbook of Organizational Economics* (Princeton UP 2012) 1014, 1015; J Levin, ‘Relational Incentive Contracts’ (2003) 93 *American Economic Review* 835.

³⁴ L G Telser, ‘A Theory of Self-enforcing Agreements’ (1980) 53 *Journal of Business* 27.

³⁵ Stuart Macaulay, ‘Non-Contractual Relations in Business’ (1963) 28 *American Sociological Review* 45.

³⁶ *Carmichael v National Power plc* [1999] ICR 1226 (HL).

³⁷ [2001] EWCA Civ 274.

³⁸ Levin, n 33, 836; H Beale and T Dugdale, ‘Contracts between Businessmen: Planning and the Use of Contractual Remedies’ (1975) 2 *British Journal of Law and Society* 45, 59; Comment, ‘The Statute of Frauds and the Business Community: A Re-Appraisal in Light of Prevailing Practices’ (1957) 66 *Yale LJ* 1038, 1061.

³⁹ Stuart Macaulay, ‘An Empirical View of Contract’ (1985) *Wisconsin Law Review* 465; Collins, *Regulating Contracts*, above n 10, 323-330.

business deals are greater than any short-term gain from an insistence on contractual rights.

The economic model of relational incentive contracts stresses the special importance of these contracts as a business framework in those instances where it may not be possible to measure and verify accurately whether the performance of the parties reaches the expected standards under the contract. If the contract requires 'best efforts', 'good faith', or 'innovation' in performance, or confers a discretionary power to address future contingencies or reward good performance, it is not easy for the parties or a court to assess whether the expected standard has been met or the power exercised appropriately. Where there are long-term pay-offs from meeting expectations as far as possible, either in the form of anticipated future business deals or perhaps receipt of a discretionary bonus payment, this relational incentive quality of the agreement is likely to avoid the need to litigate.⁴⁰

Where a legal dispute does arise, this economic theory might be interpreted as suggesting that a court should strive to ensure that the pay-offs are preserved in order to serve the goal of the reduction of litigation and the maintenance of the expected benefits from continuation of the business relationship. A court might seek to imply terms that will sustain a relational contract even when the long-term pay-offs are relatively small and may not invariably be enough to provide a sufficient incentive to perform according to expectations. For instance, a legal analysis might need to interpret the obligations of the parties under a binding contract in such a way that the legal duties do not permit one party to frustrate that logic of long-term pay-offs. That analysis applies neatly to *Yam Seng*: by permitting stores in ordinary shopping malls to sell the product for less than the price in the duty free outlets, the action was bound to frustrate the commercial operation of the distributorship in duty-free shops before long by disrupting the pay-offs for the distributor. In cases where the performance expectation has probably been satisfied but the other party has declined to reward it by conferral of a discretionary bonus, it would be appropriate for a court to intervene, as they do, to prevent such an irrational exercise of a discretionary power.⁴¹

A more puzzling situation for legal regulation concerns those long-term business relationships, such as a preferred supplier under a requirements arrangement, where there is arguably no binding long-term contract at all. Economic relational contract theory tells us that these arrangements are self-enforcing because of the pay-offs arising from the business relationship in the long run. But litigation will occur

⁴⁰ W. Bentley MacLeod and James M. Malcomson. 'Motivation and Markets' (1998) 88(3) *American Economic Review* 388; cf Susan Helper and Rebecca Henderson, 'Management Practices, Relational Contracts, and the Decline of General Motors' (2014) 28 *Journal of Economic Perspectives* 49, 55: relational contracts defined as: 'agreements based on subjective measures of performance that could neither be fully specified in advance nor verified after the fact and were thus enforced by the shadow of the future'.

⁴¹ *Eg Equitable Life Assurance Co. Ltd v Hyman* [2002] 1 AC 408 (HL); *Abu Dhabi National Tanker Co v Product Star Shipping Ltd (The "Product Star")* (No 2) [1993] 1 Lloyd's LR 397 (CA); *Horkulak v Cantor Fitzgerald International* [2004] EWCA Civ 1287, [2005] ICR 402 (CA); *Socimer International Bank Ltd v Standard Bank London Ltd* [2008] EWCA Civ 116, [2008] 1 Lloyd's LR 558; cf Hugh Collins, 'Discretionary Powers in Contracts' in David Campbell, Hugh Collins, John Wightman (eds), *Implicit Dimensions of Contract: Discrete, Relational and Network Contracts* (Hart Publishing 2003) 219.

presumably, as in *Baird Textile Holdings v Marks & Spencer plc*,⁴² when one party decides that the pay-offs arising from continuation of the business relationship are insufficient in comparison with alternative market opportunities and so walks away from the relationship. Economic relational contract theory explains why it is perfectly sensible not to bother with a binding long-term contract when the pay-offs from the relationship are high, so it makes commercial sense to reach the legal conclusion that Marks & Spencer plc were not legally bound to a long-term contract. On the other hand, it might be argued that Baird Textile was under a misapprehension, fostered by the conduct of Marks & Spencer, that those pay-offs that sustained this long-term business relationship were still in place, and so Marks & Spencer, if aware of this misapprehension, should perhaps have been under a duty to inform Baird Textile of the change of circumstances and their imminent exit from the supplier relationship. A failure to do so at the earliest opportunity might justify a legal claim for compensation for wasted expenditure or missed opportunities to avoid loss that occurred whilst labouring under this misapprehension.⁴³ Alternatively, this economic perspective might be used to justify an award of compensation to mimic what the parties already believed was present in their transaction,⁴⁴ namely economic incentives to continue the relationship such as the profits that would have been made by the sale of products made by Baird Textile in the next season in the retail outlets of Marks and Spencer. In this context, the economic theory of relational contracts provides no ground for doubting that there was no long-term binding contract between the parties, as the English Court of Appeal decided, but does raise questions about whether the law, in providing support for relational transactions of this type, should not require disclosure as soon as possible of the vital information that the pay-offs that sustain the long-term business relationship are no longer believed to be present.

Institutional Economics and Quasi-Integration

Institutional economics argues that relational contracts provide a particular institutional structure for the organisation of production and the division of labour, which occupies a middle ground between markets and organisations (or firms).⁴⁵ In markets, contracts for goods and services are made between parties with somewhat antagonistic interests in the sense that although both expect to be better off as a result of the exchange, their pay-offs from a particular transaction will depend to a considerable extent on reducing the benefit to the other party by for example paying a lower price for the goods and services provided by the other party. Within organisations, however, though there is a network of contracts that bind the parties together, such as contracts of employment, share ownership, and directorships, some of these contracts are supplemented by a mechanism that requires co-operation from everyone to maximise the profits of the organisation itself, the profits then being distributed according to the remuneration formula set by the contracts.⁴⁶ In the case of

⁴² [2001] EWCA Civ 274.

⁴³ This seems to have been the gist of the claim for breach of an implied duty of good faith in *Bhasin v Hymew* (n 22).

⁴⁴ D Charney, 'Nonlegal Sanctions in Commercial Relationships' (1990) 104 Harv Law Rev 373; Collins, *Regulating Contracts*, (n 10) 120.

⁴⁵ R H Coase, 'The Nature of the Firm' (1937) 4 *Economica* N.S. 386; Oliver E Williamson, *The Economic Institutions of Capitalism: Firms, Markets and Relational Contracting* (Free Press, 1985).

⁴⁶ 'The parties are not aiming at utility-maximization directly through performance of specified obligations; rather, they are aiming at utility-maximization indirectly through long-term co-operative

employees, for instance, though their remuneration is in part determined by antagonistic bargaining with the employer about the amount of wages, the opportunity for the worker to earn higher pay is determined also in part in the long run by the efficiency and profitability of the organisation as a whole, which in turn may depend to some extent on the contribution and effort of the worker. The law reflects the economic logic of the organisation by imposing duties of loyalty on its productive members: the directors of a company owe fiduciary duties, employees and managers duties of loyalty and good faith. The crucial variable that determines the incidence of legal obligations of loyalty and co-operation is the point at which the contract falls on the spectrum between market and organisation. International commodity sales are at the extreme market end of the spectrum and so give rise to no duties of loyalty and co-operation other than those explicitly agreed; business partnerships lie at the other organisational end and require a close approximation to fiduciary duties.

Institutional economics is mostly focussed on the reasons for selecting a market or organisational framework. Considerable emphasis is placed on the point that the costs of writing contracts or the inability to write complete contracts that deal adequately with every future contingency drive parties towards an institutional or organisational framework. Given those problems, however, the parties may not need to or wish to integrate fully within a single organisation, but may prefer and be able to construct an intermediate position that might be described as a relational contract. Goetz and Scott suggest how that problem of writing contracts to deal with contingencies explains the incidence of relational contracts,

‘A contract is relational to the extent that the parties are incapable of reducing important terms of the arrangement to well-defined obligations. Such definitive obligations may be impractical because of inability to identify uncertain future conditions or because of inability to characterize complex adaptations adequately even when the contingencies themselves can be identified in advance.’⁴⁷

This description of a relational contract emphasises two problems. The first concerns the task of addressing all future contingencies, which is a standard problem for any long-term transaction. What makes relational contracts special is the second problem, which is the inability to plan completely through the express terms of the contract how to manage and adapt to even clearly foreseeable contingencies. This second problem concerns the recognition that in an on-going relationship, co-operative changes will be required, though it is hard to say anything more specific than that.

As a possible solution to both problems, the contract might confer power on one party to determine all the necessary interstitial adjustments, as in the case of the employer’s power to direct labour and the employee’s duty to comply with those instructions. Where such a dictatorial power or vertical integration is unacceptable, the parties to a contract must accept some kind of duty of co-operation or flexibility in order to secure the adaptations to the contract that are necessary for the success of the enterprise. Such a contract that requires co-operation and loyalty as an implicit obligation might be labelled as a hybrid or an instance of quasi-integration, for it borrows some elements of an integrated organisation in the form of obligations of loyalty and co-

behaviour manifested in trust and not in reliance on obligations specified in advance.’ David Campbell and Don Harris, ‘Flexibility in Long-term Contractual Relationships: the Role of Co-operation’ (1993) 20 JLS 166, 167.

⁴⁷ Goetz and Scott (n 3) 1091.

operation, whilst preserving most other features of standard market transactions.⁴⁸ In business format franchise agreements such as fast food restaurants, for instance, the franchisor and franchisee remain separate business entities, but they co-operate for the purpose of marketing a product or service. Both parties have an interest in maximising retail sales, for which purpose they will need to co-operate intensively, yet both parties have an interest in maximising their own returns on their investment by securing a greater share of the profits in the franchise agreement. The underlying economic logic in these quasi-integration arrangements is driven both by the market and the organisation: parties must both compete and co-operate.⁴⁹

In *Yam Seng v International Trade Corporation*,⁵⁰ Leggatt J identified franchises, joint ventures, and distributorships as examples of contracts where greater duties of co-operation and good faith arise. Commercial agents should be added to the list.⁵¹ From the perspective of institutional economics, the reason why these contracts require as normal incidents greater duties of loyalty and co-operation is not because they are long-term and not because the parties may have invested substantially in the project, though both of these features are likely to be present, but because the contract establishes a quasi-integrated system of relations of production with intensified contradictory pressures simultaneously both to co-operate and to compete in order to overcome problems of adaptation to foreseen and unforeseen contingencies. The economic logic of the relational contract is that both parties will be better off if they co-operate to maximise the size of the pie, such as sales in a franchise or distribution network, but simultaneously they still need to compete to obtain a greater slice of the profits arising from their labours. Each party needs to be co-operative and loyal to the general aim of the networked business enterprise, whilst ensuring that it obtains a fair share of the rewards. These expectations of loyalty and co-operation within relational contracts must fall short of those applicable to organisations, however, for both parties remain residual profit-takers with antagonistic interests. Loyalty is owed, not to each other, but rather to the relational contract itself as the embodiment of an independent business operation.⁵²

⁴⁸ Other labels for these instances of quasi-integration include ‘symbiotic contracts’: E Schanze, ‘Symbiotic Contracts: Exploring Long-Term Agency Structures Between Contract and Corporation’ in C Joerges (ed), *Franchising and the Law: Theoretical and Comparative Approaches in Europe and the United States* (Nomos 1991) 67; and ‘networks’: W W Powell, ‘Neither Market nor Hierarchy: Network Forms of Organisation’ (1990) 12 *Research in Organisational Behaviour* 295; G Thompson, J Frances, R Levacic, J Mitchell, *Markets, Hierarchies & Networks: The Coordination of Social Life* (Sage 1991); A Grandori and G Soda, ‘Inter-firm Networks: Antecedents, Mechanisms and Forms’ (1995) 16(2) *Organization Studies* 183; Richard M Buxbaum, ‘Is “Network” a Legal Concept?’ (1993) 149 *Journal of Institutional and Theoretical Economics* 698; M Amstutz and G Teubner (eds), *Networks: Legal Issues of Multilateral Co-operation* (Hart Publishing 2009); Gunther Teubner, *Networks as Connected Contracts* (ed Hugh Collins, Hart Publishing 2011).

⁴⁹ Hugh Collins, ‘Introduction’, to Teubner, *Networks as Connected Contracts* (n 48) 21-25; Gunther Teubner, ‘*Coincidentia Oppositorum*: Hybrid Networks Beyond Contract and Organisation’ in Amstutz and Teubner (n 48) 3.

⁵⁰ *Yam Seng* n 5.

⁵¹ Legislation provides the core implied term in this case, though framed as a remedy on termination: European Directive 86/653 of 18 December 1986 on the coordination of the laws of the Member States relating to self-employed commercial agents [1986] OJ L 382/17; implemented in the UK by Commercial Agents (Council Directive) Regulations 1993, SI 3053 1993.

⁵² Teubner, *Networks as Connected Contracts* (n 48) Chapter 4, III; cf R Bohner, ‘Asset-sharing in Franchise Networks: The Obligation to Pass On Network Benefits’ in Amstutz and Teubner (n 48) 153.

This concept of a relational contract arguably fits the transactions in the trilogy of cases. The distribution agreement in *Yam Seng*⁵³ made no attempt to specify all the details of the performance required from both parties, so they would have to adjust the relationship according to the circumstances pertaining in the different retail locations. As well as the problem of greater discounts in ordinary shopping malls than those available at the airports, the supplier also discovered to its surprise that it required a special license to sell the fragrances in China and that it, as the manufacturer rather than the distributor, would have to acquire that license at considerable cost, an unexpressed obligation that it failed to fulfil. Similarly, the joint venture in the *Bristol Groundschool*⁵⁴ case could not specify exactly what was required to turn the product into digital form successfully, though clearly the parties would have to co-operate and disclose relevant information. In *D&G Cars v Essex Police*,⁵⁵ in some respects there is almost vertical integration arising from the contractor's strict obligation to comply with the instructions of the police authority, breach of which even on a single occasion might destroy the mutual trust and confidence that was necessary for that relationship to continue. At the same time, however, the contractor earned its remuneration by disposing of the cars at a profit or by making insurance claims, so that it was acting primarily on its own account.

4. The Paradigm of a Relational Contract

These examinations of the trilogy of cases in the English High Court and social science theories of relational contracts may enable us now to give greater precision to a legal concept of a relational contract and its likely legal consequences. To mine this social science material is complex both because it does not address normative questions about the appropriate kind of legal regulation and because different branches of the social sciences produce different paradigms of relational contracts or at least descriptions with very different emphases. Even so, there seems to me to be sufficient overlap to create a productive synthesis.

Indeterminate performance obligations

Many descriptions of the concept of a relational contract commence with a statement that they are long-term contracts. A reference to a long-term business relationship is central to the consideration of long-term pay-offs in the economic model and seems to figure strongly in the other analyses. For Macneil, the need in relational contracts to examine the context of a contract and how its performance obligations evolved is only likely to arise in the context of a long-term contract. Similarly, many of the co-ordination problems that relational contracts as a form of quasi-integration are designed to address arise from the inability to specify in advance contract terms that deal with unforeseen contingencies or contingencies that will require adaptation. The contracts involved in the trilogy of cases where the concept of relational contracts was employed by the High Court were all expected to last over many years.

However, in the social science literature a long-term contract is neither necessary nor sufficient for the presence of a relational contract. The necessary long-term business relationship could be constructed from an unenforceable business relationship such as

⁵³ *Yam Seng* n 5.

⁵⁴ *Bristol Groundschool* n 6.

⁵⁵ *D & G Cars* n 7.

a requirements agreement or an umbrella agreement for casual work, or it could comprise a succession of almost identical short-term contracts such as repeated orders for goods of a particular type from a specified seller. Conversely, it is quite possible that a long-term supply contract could have hardly any relational qualities, but be regarded instead as creating at arms length limited and determinate obligations between the producer and the customer.⁵⁶ Similarly, a syndicated loan agreement with a term of 20 years or a mobile phone service contract for three years could have none of the features of a relational contract.

What does seem to be important in the social science description of relational contracts is that the terms of the contract use indeterminate descriptions of the expected performance obligations, in part because contingencies cannot always be foreseen, but more importantly because the precise needs for co-operation cannot be described clearly in advance, but will necessarily emerge during performance of the contract. The presence of vague terms in a contract does not, of course, make it a necessarily a relational contract: it could be simply a poorly drafted one. But indeterminacy with respect to performance obligations is a necessary feature of relational contracts. This indeterminacy may be discovered in vague terms, general expressions of intention, gaps regarding important matters, statements of the kind that the parties will use best endeavours to achieve a goal or deal with contingencies, and explicit references to good faith in performance.

This important distinction between determinate and indeterminate long-term contracts lay at the heart of the decision of the Court of Appeal in *Mid Essex Hospital Services NHS Trust v Compass Group UK and Ireland Ltd (t/a Medirest)*.⁵⁷ In this contract for the provision by a private contractor of cleaning services to a public hospital, the express terms of the long-term contract specified detailed regulation of the contractor's duties and how defects in performance should be treated through a penalty points system, though the contract did require good faith from one of the parties in respect of some aspects of performance. The Court of Appeal rejected any suggestion of a general duty to perform the contract in good faith. The court held that the contract provide a complete and measurable set of requirements for performance by the contractor, so that additional obligations of co-operation and good faith were unnecessary for business efficacy except where the parties had expressly provided for them. This rejection the application of the concept of a relational contract or the legal standards associated with that concept seems to have been appropriate, for the contract, though involving some integration into the functioning of the hospital, was not an instance of quasi-integration that depended upon duties of co-operation and loyalty, but remained an arms length market contract. There was no lack of specificity in the terms of the contract in dealing with contingencies, so the court could eventually without much difficulty secure to each party their determinate entitlements under the contract. So this contract could not be classified as a relational contract from the perspective of the social science literature, and that view was followed implicitly by the Court of Appeal. Whether or not it makes sense to try to deliver public services through discrete contracts is, of course, another question.⁵⁸ In

⁵⁶ Eg *Hamsard 3147 Ltd (t/a Mini Mode Childrenswear) & Anor v Boots UK Ltd* [2013] EWHC 3251 (Pat).

⁵⁷ *Mid Essex Hospital Services* (n 15).

⁵⁸ Peter Vincent-Jones, 'The Limits of Contractual Order in Public Sector Transactions' (1994) 14 *Legal Studies* 364.

addition, the Court of Appeal appears to have attached no significance to the point that there had been a breakdown of mutual trust and confidence between the parties, a matter that was regarded as crucial in *D & G Cars* because it was a public service contract.

Commitment

Another factor often used to describe a relational contract is what Leggatt J referred to as a ‘substantial commitment’ by both parties to the contract. However, this feature does not figure significantly in the social science literature regarding the concept of relational contracts and may be misleading. It is true that some economic theories predict that at a certain point the level of investments sunk irretrievably into a project will become so great that the parties will prefer the security and control of a single corporate organisation,⁵⁹ but until that point is reached, the contractual framework of a joint venture or another type of relational contract should provide adequate protection for those investments.⁶⁰ At the core of the idea of quasi-integration is certainly an idea that both parties will have to make a contribution to the successful outcome and in that sense make a commitment. It also seems to be the case that usually, if the parties commit to this relationship, either expressly or by implication, they are not supposed to commit to a rival business relationship such a competing franchise. Yet the commitment may not have to be in the form of an investment that might be lost by premature termination of the contract, but may rather take the form of investments in skills and know-how. After a period of time in a successful relationship, it may become tempting to the parties to seek to improve their share of the rewards of their co-operation by threatening to exit from the business relationship. That kind of strategic behaviour does not appear to be unique to relational contracts and indeed may be rarer given the potential pay-offs for both parties from continuing the business relationship.

Although it may be correct that parties to relational contracts often make substantial commitments, that element does not seem to be an essential feature of these transactions. In the trilogy of cases, the entrepreneur in *Yam Seng* had spent time and effort establishing a distribution network at the airports, but had not made significant financial investments. There was a substantial investment by the defendant IT company in the development of a software programme in *Bristol Groundschool* and once the joint venture was established successfully, there was certainly a risk of strategic behaviour, which may have been the reason why the defendant surreptitiously seized the software platform as a kind of anticipatory retaliation. That kind of risk of behaviour that destroys mutual trust and confidence can be addressed by vertical integration,⁶¹ though at the cost of losing the incentive structures of a market transaction. *D&G Cars* seem not to have made significant new investments to take on the disposal work for the police. For these reasons, the proposed feature for relational contracts of a ‘substantial commitment’ may not be a useful descriptive

⁵⁹ Benjamin Klein, ‘Fisher–General Motors and the Nature of the Firm’ 2000 43 *Journal of Law and Economics* 105.

⁶⁰ Goetz and Scott (n 3) 1102 illustrate the kinds of protections available by reference to restrictive covenants not to compete and guarantees to buy back investments in plant and machinery. This problem of strategic behaviour is addressed in the EU by Directive on commercial agents (n 51).

⁶¹ George Baker, Robert Gibbons and Kevin J Murphy, ‘Relational Contracts and the Theory of the Firm’ (2002) *Quarterly Journal of Economics* 39.

criterion, since it probably applies more broadly to long-term contracts, though in so far as it indicates a commitment to the success of the business relationship itself, it is likely to be a feature of relational contracts.

Indeterminacy and Expectations

That last remark brings us to the most puzzling aspect of constructing a paradigm for a relational contract, which concerns the dimension of psychological attitude or expectations. A hall-mark of relational contracts is that the parties do not regard their written contract as a more or less complete statement of their rights and obligation, but expect that these obligations will evolve and be refined as the project develops. These expectations, though implicit, are nevertheless essential for business efficacy and the success of the project in the long run. Indeed, as Macaulay suggested, the parties may regard these commercial expectations as the central governing norms of their business relationship and will conform to those standards even when the written contractual obligations appear to point in a different direction.⁶² Where Macneil seems to have gone wrong in his analysis of relational contracts is that he argued that the source of legal rules to govern relational contracts should be general norms of reciprocal exchange behaviour.⁶³ Whilst it may be true that implicit obligations in relational contracts may include generally shared values such as honesty and reciprocity, that is not a special feature of relational contracts. The distinctive expectations or implicit obligations of relational contracts will arise from the crevices and dynamics of a particular contractual relationship, and, as Leggatt J suggests in *Yam Seng*,⁶⁴ will typically be justified in accordance with the ‘business necessity’ test used for the *ad hoc* insertion of terms implied in fact.⁶⁵ We should accept, therefore, that it will be a distinctive feature of the paradigm of a relational contract that these implicit undertakings or expectations will play a pivotal role in shaping the business relationship and guiding performance of the contract. While some implicit obligations will be present in all transactions, in relational contracts, where it is not possible to specify in verifiable detail in advance all aspects of performance during the productive activity, the parties will rely more heavily on these implicit expectations of cooperation, honesty, and loyalty to shape performance obligations.

To sum up this analysis of the paradigm of a relational contract for the purpose of developing a legal concept, we have identified three key aspects. First, there is a long term business relationship that will provide sufficient pay-offs to both parties to continue with the relationship even through periods of considerable adversity. Second, obtaining the benefits of the business relationship will require adaptation, cooperation, and evolution of performance obligations, so that indeterminate implicit obligations of this kind must be central to the deal. Third, these implicit indeterminate obligations must be understood as arising not from general moral standards or norms of reciprocity such as honesty, but will be tailored to achieve what is necessary to secure the success of the venture. Business necessity in this context requires the acceptance of obligations derived from the general concepts of cooperation and loyalty or commitment to the project.

⁶² S Macaulay, ‘The Real and the Paper Deal: Empirical Pictures of Relationships, Complexity and the Urge for Transparent Simple Rules’, in Campbell *et al.* (n 41) 51.

⁶³ Macneil, *New Social Contract* (n 26).

⁶⁴ *Yam Seng* n 5 [134]; cf Mitchell (n 3) Chapter 2.

⁶⁵ *The Moorcock* (1889) 14 PD 64 (CA); cf Collins (n 23) 304-6.

5. Legal Consequences of Relational Contracts

Assuming we have constructed from the legal and social science materials a workable paradigm for relational contracts, it remains to identify the key legal consequences that will flow from the application of the legal concept of a relational contract. The most important legal consequence is that the approach to the interpretation of relational contracts must be relatively contextual. Given that implicit obligations regarding co-operation and trustworthiness are central to the economic dynamic of these transactions, when a court encounters such a transaction it should be appropriate to examine the whole context with a view to identifying not only the explicit obligations in any written documents but also the implicit expectations that were formed at the commencement of the contract and during its performance. To ignore those implicit obligations that form the life-blood of relational contracts and to adopt a purely formal approach that only examines the written contract would not be even close to an interpretation of the intentions and expectations of the parties. Such an interpretation would not match up to a ‘business common sense’ interpretation of the contract.⁶⁶

Most lawyers accept today that it is necessary to have regard to the context of transaction in order to understand the meaning of the express terms.⁶⁷ But the proposal advanced here is to go further and search the context for additional obligations that the parties recognise implicitly in their dealings but have not included in their contract. This proposed method is much more controversial, because it weakens the privileged position of the written text of the contract under classical contract law and as a consequence may render litigation more protracted.⁶⁸ Advocates of traditional formalist interpretations of contracts argue that judges should stick to the written text of the contract, even in relational contracts, because courts lack the skills and information to go much beyond it, and that any such adventures will make the law less predictable and increase the costs of litigation.⁶⁹ Such fidelity to the written text will also encourage the parties to address foreseeable problems explicitly in their contracts, which will in turn reduce the need for litigation. In response to these points, we must remember firstly that a defining feature of relational contracts is the necessary indeterminacy of performance obligations, even for foreseeable risks, so that the option of more comprehensive explicit contracts is not available. Secondly, given that the long-term business relationship relies for its existence and success on the acceptance by the parties of indeterminate obligations of co-operation and trustworthiness, unless the law insists on incorporating these implicit expectations in any interpretation of the obligations arising from a contract, it will become a rogue’s charter by permitting opportunists and the unscrupulous to act in

⁶⁶ *Rainy Sky SA v Kookmin Bank* [2011] UKSC 50, [2011] 1 WLR 2900, [21] (Lord Clarke).

⁶⁷ Roger Brownsword, ‘After *Investors*: Interpretation, Expectation and the Implicit Dimension of the ‘New Contextualism’’ in Campbell *et al* (n 41) 103.

⁶⁸ For a survey and critique of this approach: Hugh Beale, ‘Relational Values in English Contract Law’ in Campbell *et al*, (2013) (n 10) 116.

⁶⁹ Robert E Scott, ‘The Case for Formalism in Relational Contract’ (2000) 94 Nw U Law Rev 847; Jonathon Morgan, ‘In Defence of *Baird Textiles*: A Sceptical View of Relational Contract Law’ in Campbell *et al* (2013) (n 10) 166.

ways that fall below the reasonable expectations of the parties and the normal standards of commercial propriety. Whilst it is important for a court to examine carefully the express terms of any relational contract, the process of construction should not halt there, for in relational contracts the written express terms should be regarded as the tip of an iceberg of implicit undertakings that may further evolve during the performance of the contract.

In trying to describe this contextual approach to the interpretation of relational contracts in another paper on contracts of employment,⁷⁰ my suggestion was that a court should view a relational contract such as a the contract of employment in three dimensions. The first dimension that court should consider is the express terms in written contract, to which could be added any interpretations or implied terms that can be regarded as necessary additional implications to make sense of the explicit terms. Then, secondly, the court should enquire whether there might be additional implicit obligations that arise from the employment relationship if it was expected to last for a period of time or indefinitely. This second enquiry tries to match the obligations of the contract with the long-term pay-offs that were anticipated from the long-term contract or relationship. That dimension of the employment relationship might be exemplified by deferred expectations of remuneration such as bonuses, a pension entitlement, or promotions. The third dimension concerns trust or the preservation of the relationship itself, or what is sometimes called in connection with employment the 'psychological contract'.⁷¹ An implied term of mutual trust and confidence or a duty to perform in good faith is the normal legal mechanism that tries to articulate in the contract of employment and other relational contracts expectations of fair and equitable treatment, respect for human rights and difference, and obligations of loyalty to the relationship on both sides.

Although it is a challenging process of legal reasoning for a court to take into account all three dimensions of the interpretation of contracts of employment at the same time, failure to do so is likely to produce a result that is perceived to be unjust to one of the parties because it deviates too much from their multi-dimensional expectations. Once that three dimensional approach to the interpretation of relational contracts is accepted, it suggests further that we should expect in relational contracts the development of implied or perhaps sometimes mandatory terms that try to articulate and defend the second and third dimensions of relational contracts that comprise implicit expectations about long-term pay-offs and trustworthy behaviour.

For the second dimension, the relevant implied obligations can be loosely gathered together under a heading of a duty of co-operation for the purpose of achieving the long-term goals of the business relationship. Each project or type of relational contract may require particular instances of this general implied obligation for the purpose of supporting the co-operative goal. In contracts of employment this duty to cooperate is described as an obligation 'to serve the employer faithfully with a view to

⁷⁰ Hugh Collins, 'The Contract of Employment in 3D' in Campbell *et al* (2013) n 10, 65.

⁷¹ D M Rousseau, 'Psychological and Implied Contracts in Organizations' (1989) 2 *Employee Responsibility and Rights Journal* 121; Katherine VW Stone, 'The New Psychological Contract: Implications for the Changing Workplace for Labor and Employment Law' (2001) 48 *UCLA Law Review* 519; J A-M Coyle-Shapiro et al (eds), *The Employment Relationship: Examining Psychological and Contextual Perspectives* (OUP 2004).

promoting those commercial interests for which he is employed.’⁷² In a distributorship such as the one involved in *Yam Seng*, in the view of the court, cooperation required honesty in communications, some disclosure of vital information, and a degree of loyalty to the project in the sense of avoiding actions that would defeat its business objectives. In a franchise operation, the duty of loyalty might comprise a duty not to undermine the business reputation of the franchise business or, as in *Shell UK Ltd v Lostock Garage Ltd*,⁷³ a duty not to favour in-house retail outlets and large franchisees with large rebates whilst refusing them to small independent franchisees with little bargaining power, thereby forcing them to run their businesses at a loss, though only Bridge LJ accepted the existence of an implied duty of loyalty in that case.

For the third dimension of interpretation of a relational contract, which tries to protect the trust on which the long-term relationship must be based, the appropriate implied term will include honesty in communications, but beyond that it is likely to include a duty of fair dealing and the avoidance of actions that are calculated to destroy mutual trust and confidence. As we have already noted, such obligations are not designed to impose moral standards on the parties to relational contracts. The aim is rather to provide support for what is a business necessity in these contracts, which is a measure of trust and fair dealing. In the employment context it is evident that once there has been a complete breakdown of mutual trust and confidence, there is no way back to an efficient and effective employment relationship. Where successful performance of a commercial contract requires intense cooperation to a degree analogous with employment within a business, it is understandable that once suspicions of dishonesty, cheating, and opportunism begin to poison a relationship, there may be no way of retrieving the situation and proceeding with the project together. Even a single act of misconduct that has no adverse financial or reputational consequences for the other party may be sufficient to destroy mutual trust and confidence and prevent any workable continuation of the relational contract. In both *Bristol Groundschool* and *D & G Cars*, once the trickery had been exposed, the other party was not prepared to continue the relationship even though the long-term pay-offs might have been unaffected. Sometimes this breach of trust may be described as an act of disloyalty, not really meaning disloyalty to the other party, but rather disloyalty to the project by conduct such as helping a competitor that is almost certainly bound to frustrate the objectives of the long-term business relationship.

5. Conclusion

Is the phrase ‘relational contract’ now a legal concept? Although it is at an incipient stage, the building blocks of a legal concept of a relational contract seem to be in place. I have proposed a paradigm description of the three principal features of a relational contract that include a long-term business relationship in which indeterminate implicit expectations and obligations are essential to its successful performance. With respect to the legal consequences that flow from the application of the concept, my analysis supports what was described at the outset as a loose legal

⁷² Buckley LJ, *Secretary of State for Employment v ASLEF (No 2)* [1972] ICR 19 (CA).

⁷³ [1976] 1 WLR 1187 (CA). For other examples of obligations of loyalty in networks: *Seven Eleven Corporation of SA (PTY)Ltd v Cancun Trading No 150 CC*, Case No 108/2004, 24 March 2005; *Dymocks* (n 4); *Bohner* (n 52).

concept that points towards an approach rather than dictates particular rules. Under this looser legal concept, for relational contracts courts should pursue a more contextual approach towards interpretation. This approach should in addition to taking full account of the express terms of the contract give equal weight to the dimensions of supporting the long-term pay-offs of the business relationship and preserving the necessary trust within the relationship. That task should usually be accomplished by implied terms that seek to articulate obligations of co-operation in support of the long-term pay-offs and obligations of mutual trust and confidence to preserve the necessary trust between the parties. Notice that these legal consequences do not include necessarily a requirement of good faith in performance, whether optional or mandatory, though certainly conduct that might be described as bad faith might be challenged as behaviour that undermines co-operation or is calculated to destroy mutual trust and confidence.