

# THE LAW AND ECONOMICS OF GOOD FAITH IN THE CIVIL LAW OF CONTRACT

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prepared for the 2003 Conference of the *European Association of Law and Economics*, at Nancy, France, 18-20 September 2003

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## ABSTRACT

Good faith plays a central role in most legal systems, yet appears to be an intractable concept. This article proposes to analyse it economically as the absence of opportunism in circumstances which lend themselves to it. One of the

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<sup>1\*</sup> Our thanks to the *Fonds Georg Stellari* for financial support in preparing this article. We are grateful to Emmanuel Darankoum and Nicolette Kost-de Sèvres for fruitful collaboration in the research leading up to the present paper, and to Stéphane Beaulac, Elise Charpentier, Catherine Delforge, Vincent Gautrais, David Gruning, Brigitte Lefebvre, Guy Lefebvre, Didier Lluelles, Michel Morin, Adrian Popovici, Stéphane Rousseau and Catherine Valcke for helpful comments on earlier versions; to Boudewijn Bouckaert, as commentator, and to participants at the Nancy 2003 Conference of the European Association of Law and Economics, for critical discussion of the paper.

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objectives underlying the law of contract on an economic view is to curtail opportunism. In spelling out what this means, the paper proposes a three-step test: bad faith is present where a substantial informational or other asymmetry exists between the parties, which one of them turns into an undue advantage, considered against the gains both parties could normally expect to realise through the contract, and where loss to the disadvantaged party is so serious as to provoke recourse to expensive self-protection, which significantly raises transactions costs in the market. The three-step test is then used to analyse a set of recent decisions in international commercial transactions and three concepts derived from good faith: fraud, warranty for latent defects and lesion.

## INTRODUCTION

Good faith is a key principle in modern legal systems, in common law as well as in civil law.<sup>4</sup> It played a major role in late Roman law and in pre-codification French law.<sup>5</sup> Within the modern civil law family, it still plays an important role in modern French law<sup>6</sup> and a central role in modern German civil law ('*Treu und Glauben*').<sup>7</sup> In Dutch law, the recodification towards the end of the twentieth century recognised as fundamental principles of civil law the subjective notion of good faith as justifiable ignorance in the law of property, and the objective notion of good faith as loyalty in contractual dealings, for which the new term 'reasonableness and equity' (*redelijkheid en billijkheid*) was introduced<sup>8</sup>

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<sup>4</sup> Litvinoff, (1997), for a wider survey and a study of attempts to capture the essence of the concept. The reference to the Netherlands Civil Code at nt 53 is inaccurate, since the preliminary title, of which art. 6 was to be part, has been abandoned. See *New Netherlands Civil Code - Patrimonial Law / Le nouveau Code civil néerlandais - Le droit patrimonial* (trilingual edition) (translated by P.P.C. Haanappel and E. Mackaay) Kluwer, Deventer, The Netherlands and Boston, MA 1990; *Netherlands Business Legislation*, translated by Peter Haanappel, Ejan Mackaay, Hans Warendorf and Richard Thomas, The Hague, Kluwer Law International, 1999.

<sup>5</sup> Charpentier (1996).

<sup>6</sup> Arts 1134 and 1135 French Civil Code, in particular.

<sup>7</sup> Art. 242 BGB.

<sup>8</sup> The New Netherlands Civil Code is being adopted and put in force in stages. See *New Netherlands Civil Code - Patrimonial Law / Le nouveau Code civil néerlandais - Le droit patrimonial* (trilingual edition) (translated by P.P.C. Haanappel and E. Mackaay) Kluwer, Deventer, Netherlands and Boston, Mass., 1990; *New Netherlands Civil Code - Patrimonial Law / Le nouveau Code civil néerlandais - Book 8 - Traffic Means and Transport/ Livre huitième - Du transport et des moyens de transport* (trilingual edition) (translated by P.P.C. Haanappel and E. Mackaay), The Hague, Kluwer Law International, 1995; *Netherlands Business Legislation*, translated by Peter Haanappel, Ejan Mackaay, Hans Warendorf and Richard Thomas, The Hague, Kluwer Law International, 1999.

Articles 2, 248 and 258 of Book 6 (*Obligations*) contain the key provisions:

### Article 6:2

1. A creditor and debtor must, as between themselves, act in accordance with the requirements of reasonableness and equity.
2. A rule binding upon them by virtue of law, usage or a juridical act does not apply to the extent that, in the given circumstances, this would be unacceptable according to criteria of reasonableness and equity..

### Article 6:248

1. A contract has not only the juridical effects agreed to by the parties, but also those which, according to the nature of the contract, result from the law, usage or the requirements of reasonableness and equity.
2. A rule binding upon the parties as a result of the contract does not apply to the extent that, in the given circumstances, this would be unacceptable according to criteria of reasonableness and equity.

The Quebec Civil Code of 1994 has given good faith a substantially larger place than it had under the old Code of 1866. In all, 86 articles in the new code use the term good faith.<sup>9</sup> The Unidroit *Principles of International Commercial Contracts* of 1994 provide in art. 1.7 that each contracting party must act 'in accordance with good faith and fair dealing in international trade'.<sup>10</sup> A broad survey by Litvinoff of a range of national legal systems shows how widely the notion of good faith is used.<sup>11</sup>

There is agreement amongst scholars that the law of contracts must ensure that contractual arrangements generally conform to the requirements of good faith. But opinions diverge on how this should be accomplished. For some, good faith must be articulated as a general rule or an abstract principle; for others, good faith is better pursued, without necessarily using the term, through a myriad of particular institutions designed to ensure its presence in specific cases; the concept itself would merely serve as a moral standard. Civil law systems tend towards the former position, common law towards the latter. The division is, however, rather fuzzy. In the common law world, whilst English law remains

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Article 6:258

1. Upon the demand of one of the parties, the judge may modify the effects of a contract, or he may set it aside in whole or in part on the basis of unforeseen circumstances which are of such a nature that the cocontracting party, according to criteria of reasonableness and equity, may not expect that the contract be maintained in an unmodified form. The modification or the setting aside of the contract may be given retroactive force.
2. The modification or the setting aside of the contract is not pronounced to the extent that the person invoking the circumstances should be accountable for them according to the nature of the contract or common opinion.
3. For the purposes of this article, a person to whom a contractual right or obligation has been transferred, is assimilated to a contracting party.

<sup>9</sup> Key provisions are 6 and 7, at the beginning of the Code, and 1375, in the law of obligations.

6. Every person is bound to exercise his civil rights in good faith.

7. No right may be exercised with the intent of injuring another or in an excessive and unreasonable manner which is contrary to the requirements of good faith.

1375. The parties shall conduct themselves in good faith both at the time the obligation is created and at the time it is performed or extinguished.

The text of the Civil Code of Quebec (CCQ) may be found and searched at <http://www.canlii.org/qc/sta/csqc/20030530/c.c.q./>.

<sup>10</sup> Art 1.7

(1) Each party must act in accordance with good faith and fair dealing in international trade.

(2) The parties may not exclude or limit this duty.

English text at <http://www.jus.uio.no/lm/unidroit.contract.principles.1994/doc.html>; French at <http://www.unidroit.org/french/principles/contents.htm>. For a comparison between Unidroit principles and the Quebec Code, see Cr peau and Charpentier, (1998).

<sup>11</sup> Litvinoff, (1997).

opposed to explicit recognition,<sup>12</sup> American law has expressly adopted good faith in the Uniform Commercial Code and in the Restatement of Contracts, 2<sup>nd</sup>.<sup>13</sup> Both documents have inspired various state legislatures to adopt good faith in their statutes. Amongst civil law systems, good faith plays a key role in systems based on the German model, a somewhat lesser role in those following the French tradition.

It is our thesis that there is a common foundation – a common core, a deep structure – underlying the various uses of good faith in contract and that it can be traced with the tools of the economic analysis of law. Moreover, we expect the elements composing this common foundation to find expression in decisions which invoke good faith, or at least in the best motivated amongst them, without the deciding authority necessarily articulating them. This proposition is testable. We test them on a small set of decisions dealing with international commercial transactions. Furthermore, legal scholarship has established that even in civil law systems, good faith requirements have crystallised into a number of more specific institutions, such as fraud and mistake as defects of consent, latent defects in sale, duties of loyalty and co-operation in the law of mandate (agency).<sup>14</sup> If this is true, it should be possible to trace the elements composing the common foundation of good faith in the cases and the scholarship which have worked out these concepts into more specific rules for these derivative concepts. This proposition as well lends itself to testing.

In what follows we deal only with contractual good faith, leaving aside good faith in property law, where it applies, for instance, to the purchaser of stolen goods and to the possessor non-owner of goods who acquires ownership through prescription.<sup>15</sup> Good faith refers here to justifiable ignorance of facts or legal status. This notion, too, lends itself to an economic analysis, in which one compares the precautions that could have been taken to ascertain the accurate state of affairs to the risk and cost of acting on an erroneous assessment.<sup>16</sup>

The structure of the article is as follows. We first look briefly at what insights can be drawn from traditional legal scholarship on good faith, then set forth an economic conception of it. In the second part, proceed to test it on a set of

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<sup>12</sup> For example, Waddams (1991), at 256 ; O'Connor (1990), at 48 ; Teubner (1998); in support of good faith, see Stapleton (1999); Collins (1999).

<sup>13</sup> See Farnsworth, (1994) at 52.

<sup>14</sup> For instance Cordeiro (1996), at 240 ; Schoordijk (2003), at 42 (translation) : 'Good faith constitutes both in Germany and in the Netherlands the driving force behind the creation of new law ..'.

<sup>15</sup> Examples in the Quebec Civil Code: 932, 958 (possessor in good faith entitled to reimbursement of expenses made to property being reclaimed by its owner; has a retention right for the reimbursement); 1559 (payment in good faith to the apparent creditor is valid); 1714 (reimbursement of price to purchaser in good faith of a stolen object); 2163 (principal bound towards third persons who relied in good faith on the appearance of a mandate). Several articles propose an analysis of rules regarding the protection of the good faith purchaser of stolen goods: Weinberg, (1980); Levmore, (1987).

<sup>16</sup> See Mackaay (2001), at 31.

decisions in international sales and against more specific legal concepts derived from good faith.

## I. THEORY

### 1. A brief survey of legal scholarship

Whatever the precise role assigned to good faith, it is important to be clear about what the term means. In a survey of scholarly writing on the subject, good faith emerges as a fuzzy concept.<sup>17</sup> As for English law, in the conclusion of a recent study, for instance, good faith is characterised as ‘a fundamental principle derived from the rule *pacta sunt servanda*, and other legal rules, distinctively and directly related to honesty, fairness and reasonableness, the application of which is determined at a particular time by the standards of honesty, fairness and reasonableness prevailing in the community which are considered appropriate for formulation in new or revised legal rules.’<sup>18</sup> You recognise bad faith, or the absence of good faith, when you see it, but would be hard pressed to spell out criteria for its application.

Civilian scholarship is not much more helpful when it comes to characterising the concept. It tends to see good faith as a general principle of civil law. By general principle, it means ‘a general rule whose contents are fuzzy and whose role it is to federate a number of other rules’, which are its concrete applications.<sup>19</sup> It is not difficult to discern a host of applications of good faith which the courts would have to develop further: the duty to negotiate in good faith, the duty of trust and secrecy in contractual negotiations, the obligation of loyalty in the performance of a contract, the duty to inform before and during the life of the contract; the duty to cooperate with one’s contracting partner to allow the satisfactory performance of the contract.<sup>20</sup>

In Quebec law, to take this system as an example, the new Code provides for a central role of good faith by three general provisions mentioned above.<sup>21</sup> Several important Supreme Court decisions on sharp dealings by banks underscore this role.<sup>22</sup> Numerous applications of good faith may be found in the particular provisions of the Code: a duty to co-operate is a defining characteristic of partnership (art. 2186 CCQ); a duty for employees and agents to act faithfully

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<sup>17</sup> Litvinoff (1997), at 1663 ff. Hesselink (1998), at 288-89, summarises his survey as follows: “Good faith is said to be a norm, a (very important) principle, a rule, a maxim, a duty, a rule or standard for conduct, a source of unwritten law, a general clause. To an English lawyer – often accused by his continental European colleagues of making inconsistent use of terminology – this may seem rather confusing.”

<sup>18</sup> O'Connor (1990), at 102.

<sup>19</sup> Jaluzot (2001), at 187, n<sup>o</sup> 687.

<sup>20</sup> For a more detailed list: Whittaker/Zimmerman (2000), at 676.

<sup>21</sup> Arts 6, 7, 1375. See also Jobin (2000).

<sup>22</sup> *Banque nationale du Canada c. Soucisse*, [1981] 2 S.C.R. 339; *Houle c. Banque nationale du Canada*, [1990] 3 S.C.R. 122; *Banque de Montréal c. Bail Ltée*, [1992] 2 S.C.R. 554. These decisions may be found at <http://www.lexum.umontreal.ca/csc-scc/en/index.html>.

and honestly (art. 2088, 2138, 1309, 2238 CCQ); a duty of the agent to cooperate with the principal in the pursuit of the purpose of the mandate (art. 2149 CCQ) and to avoid a conflict with the interests of the principal (art. 2138 CCQ); in matters of fraud, silence may be equated with lies (art. 1401, par. 1 CCQ).

But what to make of the concept of good faith itself? One may grant to Ripert the thesis that good faith tend to moralise civil law,<sup>23</sup> but this scarcely suffices to operationalise the concept. Focusing more particularly on international transactions, Marquis summarises his survey of scholarship on good faith in these terms:

« Les idées mises de l'avant dans la recherche du sens de la bonne foi prennent à peu près l'allure des exemples suivants, qui concernent l'article 7 de la *Convention des Nations Unies sur les contrats de vente internationale de marchandises*. Pour un, V. Heuzé comprend la bonne foi "comme une invitation à introduire une certaine souplesse dans l'application des règles conventionnelles, un peu à la manière de ce qu'autorise, en droit français, la théorie de l'abus de droit". B. Audit voit dans la bonne foi un principe particulièrement pertinent dans le cas de déséquilibre contractuel. M.J. Bonell favorise une interprétation dite large de la bonne foi, élaborée "in the light of the special conditions and requirements of international trade". De leur côté, F. Enderlain et D. Maskow réservent un rôle restreint à la bonne foi. Selon ces derniers, "*observance of the principle of good faith means to display such conduct as is normal among businessmen*". Ils ajoutent que "no exaggerated demands can be made, and observance of good faith does in no way necessarily include the establishment of material justice between the contracting parties". Enfin, G. Flécheux affirme, dans une étude sur les obligations de l'acheteur, qu' "il restera toujours l'obligation de bonne foi", laissant par là sous-entendre qu'il ne s'agit pas là d'un principe marginal. »<sup>24</sup>

Popovici, in a recent piece, characterises bad faith dealing essentially as a *faute*.<sup>25</sup> For the lawyer-economist, it suggests the application of the Hand-test for negligence, comparing cost of prudence with cost of mishaps, discounted for the likelihood of their occurrence. This leads, however, to a dead end, since bad faith actions are designed to provide an advantage for the perpetrator at the expense of a contract partner.

To further specify the concept, legal scholarship uses terms such as 'fairness, fair conduct, reasonable standards of fair dealing, decency, reasonableness, decent behavior, a common ethical sense, a spirit of solidarity,

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<sup>23</sup> Ripert (1949), at 291; Whittaker/Zimmerman (2000), at 677.

<sup>24</sup> Marquis (1996).

<sup>25</sup> Popovici (2002), at 103.

community standards of fairness' and 'honesty in fact'<sup>26</sup> and their French equivalents: '*loyauté*<sup>27</sup>, '*honnêteté*', '*intégrité*'<sup>28</sup>, '*fidélité*', '*droiture*', '*véracité*'<sup>29</sup>, '*comportement loyal*', '*souci de coopération*', '*absence de mauvaise volonté*', '*absence d'intention malveillante*'<sup>30</sup>; the absence of good faith signals 'unconscionable'<sup>31</sup> behaviour, which in French is characterised as '*blâmable*', '*choquant*', '*déraisonnable*'.<sup>32</sup> In pre-revolutionary French law, good faith was considered to require 'that consent is valid, that parties abstain from trickery, violence, any dishonesty or fraud; but also that it was plausible and reasonable; and finally that the contract not be contrary to divine law, to good morals, nor to the 'common weal' (*profit commun*)'<sup>33</sup>

What constitutes fair dealing may be determined, in particular circumstances, by applicable by commercial or other practices or usages. The new Netherlands Civil Code expressly provides, in art. 3:12, that '[i]n determining what reasonableness and equity require, reference must be made to generally accepted principles of law, to current juridical views in the Netherlands, and to the particular societal and private interests involved.'<sup>34</sup> Lefebvre concludes her thesis by stating that good faith should be analysed by more objective criteria, not related solely to the individual, but which also take societal values into account.'<sup>35</sup>

Jaluzot, in her doctoral thesis, sees in long-term or *relational*<sup>36</sup> contracts a field where good faith would be eminently applicable: contracts in the civil code are essentially construed on the model of instantly concluded deals, where the initial consent has to carry the entire operation throughout its duration. In a relationship destined to last over time, circumstances may develop such as to require adjustments along the way; what is needed here is a tool capable of accomplishing this whilst leaving the original consent standing. 'Parties should be bound by the trust they have created, not only by what they explicitly undertook, but also by their attitude during the life of the contract. This allows parties to be held liable on the basis of what has happened during the contract

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<sup>26</sup> Keily (1999), at 17-18.

<sup>27</sup> Charpentier (1996), at 305.

<sup>28</sup> Pineau *et al.* (2001), at 35.

<sup>29</sup> Rolland (1996), at 381.

<sup>30</sup> Cornu (2000), V<sup>o</sup> Bonne foi.

<sup>31</sup> *Id.*, à la p. 17.

<sup>32</sup> *Id.*, à la p. 44.

<sup>33</sup> Ourliac/de Malafosse (1969), at 83, n<sup>o</sup> 67, quoted by Charpentier (1996), at 316.

<sup>34</sup> *New Netherlands Civil Code - Patrimonial Law / Le nouveau Code civil néerlandais - Le droit patrimonial* (trilingual edition) (translated by P.P.C. Haanappel and E. Mackaay) Kluwer, Deventer, The Netherlands and Boston, MA 1990.

<sup>35</sup> Lefebvre (1998), at 258.

<sup>36</sup> On this term see for instance Macneil (1974); Macneil, (1985); Schanze (1993); Goldberg (1998).



and not only at the time it was entered into.’<sup>37</sup> As regards the contents of good faith, Jaluzot concludes that in current usage, ‘in fact, good faith has no objectively determinable content; it can be used to justify any rule in the law of contracts and indeed outside of it.’<sup>38</sup>

All these formulae, intuitively plausible though one may find them, merely translate one general term into other general terms. A formula closer to translation into operational tests is given by Pineau *et al.*: ‘one should not profit from the inexperience or vulnerability of other persons to impose on them draconian terms, to squeeze out advantages which do not correspond to what one gives them.’<sup>39</sup> But even this does not allow us to set out clear criteria for applying the concept of good faith.

Economic analysis of law has been used as a tool for conceptual analysis (legal scholarship) as much as for policy analysis. Can it help us shed light of the concept of good faith?

## **2. An economic view of good faith**

Good faith appears in some law-and-economics scholarship, but only incidentally. Posner states, for instance, that ‘[g]ood-faith performance—which means in this context not trying to take advantage of the vulnerabilities created by the sequential character of contractual performance – is an implied term of every contract. No one would voluntarily place himself at the mercy of the other party, so it is reasonable to assume that if the parties had thought about the possibility of bad faith they would have forbidden it expressly.’<sup>40</sup> But the analysis is not pushed any farther. Major law-and-economics textbooks in the civil law tradition do not deal with the concept of good faith explicitly.<sup>41</sup>

To move ahead, it is useful to recall the purposes or missions which the economic analysis of law detects underlying the law of contracts. There are two. One is to reduce the various forms of transaction costs, the other to avoid opportunism.<sup>42</sup> Transactions costs are reduced by a variety of rules: by providing efficient rules where parties have not explicitly contracted – this may reduce mistakes and litigation; by obliging one party to provide information to the other in order for the latter to contract with sufficient knowledge of what is at stake; by allocating the risk for unforeseen circumstances to the party most cheaply able to assume them; by imposing various arrangements to create documents which may later be used as evidence should litigation arise. All these costs are

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<sup>37</sup> Jaluzot (1991), at 534 (translation).

<sup>38</sup> *Id.*, 539.

<sup>39</sup> Pineau *et al.* (2001), at 44.

<sup>40</sup> Posner (2003), at 95 (§ 4.1).

<sup>41</sup> For instance Schäfer/Ott (2000); Ogus/Faure (2002); Holzhauser/Teijl (1995); van Velthoven/van Wijck (2001); Chiancone/Porrini (1997). Even the very extensive encyclopaedia on law and economics prepared at the University of Ghent does not deal with it: Bouckaert/De Geest (eds) (2000).

<sup>42</sup> For instance Posner (2003), at 98 (§ 4.1).

technical and may change as a result, amongst other factors, of technological innovations.

Opportunism or strategic behaviour poses difficulties of a different order. It is the type of behaviour designated by French expressions such as *surprendre la bonne foi de quelqu'un* or *abuser de la bonne foi de quelqu'un*, for which there does not appear to be a direct English equivalent. A valid contract must ensure an expected gain to both parties. One party acts opportunistically in changing, often sneakily, the course of the contract so as to capture for himself, at the expense of the other, an advantage not assigned to him by agreement upon entering into the contract.

In the economic literature one finds discussed various typical forms of opportunism. *Free riding* – where a result can be brought about only by the contribution of all but where it is not feasible to supervise everyone, the free rider abstains from contributing, yet shares in the spoils – is one form.<sup>43</sup> *Shirking* in a labour relationship, whereby the employee gives the employer a lesser performance than promised, is another.<sup>44</sup> Supervision difficulties are also at the root of the *agency problems* – where one must pursue one's own plans by relying on someone else's good offices, whom one cannot fully supervise, the other person may pursue his or her own interests at one's expense;<sup>45</sup> difficulties of supervision also underlie *moral hazard* in insurance contracts – where the insured, once the insurance contract is written, behaves less carefully than promised or demonstrated when the premium was set.<sup>46</sup> A different form of opportunism occurs in *hold out* behaviour – where a collective project will go forward only with everyone's consent, the hold-out suspends his consent in the hope of securing more than his proportional share of the spoils.<sup>47</sup> The opportunism stems here not from an information (supervision) problem, but from the monopoly power conferred by the veto.

Though opportunism is frequently mentioned in the economic literature, it is not easy to find a general definition of it.<sup>48</sup> This is probably due to the fact that in the neoclassic model transactions are supposed to be performed flawlessly. On that view, only at the bargaining stage, but not during the performance, would there be room for strategic behaviour.<sup>49</sup> By contrast, for the institutionalists in economics opportunistic behaviour is a central concept at all stages of the contract. Olivier Williamson, who has done much to bring it in vogue, defines it as *self-interest seeking with guile*.<sup>50</sup> He opposes opportunism to trust and

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<sup>43</sup> See for instance Mackaay (2000), at 93

<sup>44</sup> Buechtemann/Walwei 1999, at 172.

<sup>45</sup> Id., at 95-96.

<sup>46</sup> Id., at 96.

<sup>47</sup> Id., at 94.

<sup>48</sup> Cohen (1992), at 954.

<sup>49</sup> Parisi 1999, at 31 (n. 13); see also Cooter (1982) at 16-24.

<sup>50</sup> Williamson (1975), at 26. This formula is repeated in later work such as Williamson (1985) and Williamson (1996).

associates it with selective or misleading disclosure of information and with *self-disbelieved promises* regarding one's future conduct. Lebreton, in a thesis dealing with opportunism in distribution contracts, adds that 'opportunistic conduct manifests itself in incomplete or deceptive disclosure of information, in efforts to mislead, to distort, to disguise, to put off or to create confusion in commercial dealings; it shows an evident lack of openness, honesty, loyalty.'<sup>51</sup> Opportunism arises where 'a performing party behaves contrary to the other party's understanding of their contract, but not necessarily contrary to the agreement's explicit terms, leading to a transfer of wealth from the other party to the performer.'<sup>52</sup> George Cohen defines opportunistic behaviour in general as 'any contractual conduct by one party contrary to the other party's reasonable expectations based on the parties' agreement, contractual norms, or conventional morality.'<sup>53</sup> Williamson explains that such behaviour is impossible where one's contracting partner has numerous persons to contract with or can easily switch suppliers. It is precisely small-numbers situations or those where one must deal with a particular person that open the door to opportunism.

Opportunism can take an infinity of forms. Its variants are coextensive with opportunities for making profit and (not) sharing it. Each new development in communication technology – the latest being the internet – brings its lot of new openings for opportunism. Responses to it develop apace. To accommodate such an open-ended arsenal of responses to opportunism, law needs a flexible concept, which is nonetheless compatible with the rule of law. It is our thesis that good faith is the exact opposite of opportunism.<sup>54</sup> To act in good faith is to abstain from opportunistic acts in circumstances which lend themselves to them. Opportunism is characterised in law as bad faith, or at least the absence of good faith.<sup>55</sup>

We must now look more closely at the specific characteristics of opportunistic behaviour, which law latches onto to punish bad faith. There are three elements: the relationship must in some sense be asymmetrical (1); one party must take advantage of the asymmetry to the detriment of the other (2) and to a significant degree, that is in excess of a certain threshold of tolerance (3).

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<sup>51</sup> Lebreton (2002), at 4-5 (translation) « [d]e façon générale, ces comportements [opportunistes] se matérialisent par la divulgation d'informations incomplètes ou dénaturées, par des efforts calculés pour fourvoyer, dénaturer, déguiser, déconcerter ou semer la confusion lors de transactions commerciales ; ils recèlent un manque évident de franchise, d'honnêteté, de loyauté. ».

<sup>52</sup> Muris (1981), at 521. Burton (2000) sees the problem of bad faith as the attempt to recapture opportunities missed during the negotiation leading to the initial contract, but as Muris argues, this test seems difficult to operationalise. In the older legal scholarship, Summers (1968) is a key piece for American law.

<sup>53</sup> Cohen (1992), at 957.

<sup>54</sup> See also Jamet-Legas (2002), Pt II, sct. I, c. I.

<sup>55</sup> « The opportunity for bad faith and the duty of good faith go together. There is no need to impose a legal duty of good faith where there is no opportunity for bad faith. » Bagchi (2003) at 1886.

### a. Asymmetry

An exchange is worthwhile precisely because of differences in the parties' assets, talents or valuation. These differences are not themselves a cause for concern. What we wish to focus on are differences in the information parties hold going into the contract or again factual or legal situations which make one party dependent upon the other – a form of monopoly in time or place.<sup>56</sup>

The information gap may come about in a number of ways. To give some examples: one party may be an expert at something, the other not; one controls some outward appearance on which the other must rely; one may be a large operator with significant scale economies in acquiring or processing information (for instance, testing complex objects), whereas the other acts as a consumer or in another small-player capacity; one party may act under serious constraints due to 'bounded rationality'<sup>57</sup> which are said to distort one's judgement in such matters as complex information or small probabilities. The gap may also stem from one party's difficulty to supervise performance by the other.

A monopoly in time or place arises where one party must necessarily deal with the other, whereas the latter has discretionary power as against the former and is not under a symmetrical dependency. Where the performance of the two parties under contract is not simultaneous or is spread out in time, the party who has performed first is at the mercy of the other, who still has to perform. A different dependency occurs in the case of what Williamson terms *asset specificity*<sup>58</sup>, where one party has undertaken specific investments (or developed specific skills) which can be used only in the contract with the other and which become a total loss if the contract is cancelled or not entered into.

Parties have generally incompletely specified their contract. That is they have not spelt out rules for dealing with unlikely contingencies, on the assumption that the risk they run this way is less onerous than that of dealing with them in the contract (including the risk that one's contracting partner might get 'cold feet' during the protracted negotiations). If one of the contingencies does occur, good faith would require that parties seek a solution in general conformity with the balance the original contract struck between them. But one of the parties may then attempt to turn the 'gap' to his or her advantage, by profiting from the other party's inattention or by playing hold-out.

A different asymmetry again arises where one party cannot, at affordable cost considering what is at stake, enforce his rights, whereas the other, being a repeat player who is a party to numerous similar contracts, can spread the cost (of creating a reputation for toughness) over all of these.

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<sup>56</sup> Art. 3 of the Council Directive 93/13/EEC of 5 April 1993 on Unfair terms in consumer contracts (OJ L 95, 21.4.1993, p. 29) speaks of a 'significant imbalance'. Art 3.11 of the *Unidroit Principles of International Commercial Contracts* (1994) uses the term 'gross disparity'.

<sup>57</sup> Mackaay (2000), at 38 ff. For a first systematic view of what it may entail for law, see Sunstein (2000); criticised by Posner (2001), ch. 8.

<sup>58</sup> Williamson (1985), at 52.

## b. Undue advantage

The asymmetry is not in itself a cause for concern. One deals with specialists precisely because of their expertise; the asymmetry is the reason for the contract. Moreover, parties entering into a contract under such circumstances are aware of the asymmetry and can structure the contract to provide suitable protection. For instance, where problems of agency may arise with company directors, one can structure the remuneration package so as to align the director's interest with that of the company by making the director part-owner of the company by means of share options. Again, the director who hides the true situation of the company when contracting liabilities will be sanctioned upon a (hostile) take-over and restructuring or by bankruptcy of the company.<sup>59</sup> Before entering into an agreement with a contractor one knows only slightly, it is wise counsel to check solvency, references and earlier dealings; in the course of the construction, one pays as work progresses and retains a portion of the total price until the work is fully completed. Trust between the parties, reputation and other tying factors may also adequately cover the asymmetry.

The problem arises when a party attempts to get a significantly larger piece of the joint gains of the contract than was envisaged under the initial agreement or corresponds to normal expectations of the parties. There is then an *undue advantage*.<sup>60</sup>

## c. Threshold

Persons knowingly engaging in an asymmetrical relationship which leaves them open to being exploited will take measures to protect themselves. These measures are costly and will prevent some other contracts that look otherwise promising from being concluded. The cost of protecting oneself includes foregoing some gains from trade.

For buyers and sellers alike, it would therefore seem worthwhile to explore whether one could improve the trade-off, by lowering the level of self-protection in exchange for an undertaking by all to abstain from gross forms of opportunism, backed by a public enforcement mechanism – a social compact. The – tacit – compact would formalise a certain level of trust amongst citizens. It would facilitate contracting, all the while leaving everyone in charge of guarding against the more obvious forms of opportunism, to prevent a moral hazard problem.

Two analogies present themselves here. The first is with an arms-reduction treaty between nations. By signing such a treaty, nations abandon a certain level of armament – *ex ante* precautionary measures, economists would say, against surprise attack by others – and replace it with less costly inspection procedures,

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<sup>59</sup> Gomez (1996), at 134, presents a table of forms of opportunism in company management and the various responses found to counter them.

<sup>60</sup> Art. 3.10 of the Unidroit *Principles of International Commercial Contracts* (1994) speaks of an 'excessive advantage'. Quoted in Lluellas/Moore 1998, no 907, p. 514.

leaving open the option, in case of trickery, to rearm – *ex post* protection.<sup>61</sup> Private law offers the second analogy, the protection of private property: owners restrict self-protective measures in favour of a broad-scale protection of public order against direct trespass of their property; they continue nonetheless to ensure themselves part of the protection of their property, by installing fences, doors with locks, supervision of the boundaries of the property, and so on. Public order protection may be thought to prevent a lapse into more widespread and costlier forms of protection by owners themselves<sup>62</sup>.

In the field that concerns us here, a compact of this sort promises gains in that contracts can be entered into more easily (with fewer preliminaries and precautions). But it makes citizens all the more vulnerable to the occasional crook who ignores it. What would happen if such abuse is left unpunished? The victim would compare cost of ‘accidents’ such as this with the cost of precautions that would prevent them but also cut short otherwise worthwhile transactions. The ‘accident’ cost is composed of the loss suffered as result of being exploited (as compared to a fair gain which was expected) multiplied by the likelihood of being victimised (again). What changes here is the perceived value of this likelihood. Cognitive psychology predicts that individuals are not good at handling small probabilities and base their assessment on readily recallable instances (*availability heuristic*).<sup>63</sup> This would suggest that ugly incidents are likely to provoke a ‘turn over’ of the victim into an over-protective mode. Moreover, since other individuals use similar simplifying heuristics in judging whether to protect themselves, information provided by victims is likely to sway them as well, provoking a veritable cascade.<sup>64</sup> In a slightly different context, this has been referred to as a snowballing effect: leave the first violation unpunished and soon people will believe that there is no norm, that anything goes.<sup>65</sup> The cascade can be very damaging since it undermines trust in the market and trust, as has been frequently observed, takes a long time to establish, but can be destroyed in no time at all.<sup>66</sup> In the opposite sense, court decisions visibly sanctioning opportunistic acts may lower the perceived likelihood of being victimised.

These considerations suggest a third test for judging whether particular acts should be sanctioned as bad faith. It would be to ask whether the disadvantage imposed upon the victim exceeds a threshold which is likely to push the victim into costly self-protection, and worse, to provoke a cascade of such reactions amongst others. What are the normal expectations of gain in a particular contract

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<sup>61</sup> The success of such treaties has been called into question: Stein (1990), at 130-135; Downs *et al.* (1986), at 118-146.

<sup>62</sup> Haddock (2003), at 186; McChesney (2003), at 231 f., 235.

<sup>63</sup> Tversky/Kahneman (1982).

<sup>64</sup> Kuran/Sunstein (1999), (2000).

<sup>65</sup> Schelling (1978), ch. 3 (using the example of waste bins in Washington DC warning that every paper pollutes; the first paper left on the pavement soon leads to the perception that it is all right to do so, which quickly turns public spaces into waste bins).

<sup>66</sup> Nooteboom (2002); Gambetta (1988); Heath (2001) 75.

should be and what puffing the victims should guard against themselves – hence the division of roles between public order and private protection – can be read in customs and practices as well as public documents. The third test is therefore a threshold of seriousness which must be attained before the law should intervene.<sup>67</sup>

The three factors together determine whether good faith is present in a given situation or not. We should expect them to be applied, even implicitly, in decisions relying on the concept of good faith, and in the test determining applicability of concepts derived from good faith. To these we must now turn.

## II. TESTS

### **1. Good faith in case law dealing with international transactions**

To see whether these predictions hold in decisions relying on good faith, we have examined a series of arbitration and judicial decisions dealing with international transactions. The idea behind this choice is that the decision-makers, not being bound by national legal systems and the standing legal literature explaining the concepts in those systems, would apply the notion of good faith in an unobstructed manner. Moreover, as in international transactions the contracting parties are based in different legal systems, it would be difficult for the decision-makers, barring explicit choice by the parties, to rely on one system's reading of good faith rather than another; they would be more likely to seek common sense and good faith foundations for their decisions. The Unidroit principles, adopted in 1994, direct them to do just that.<sup>68</sup>

To choose our corpus of decisions, we have examined a series of paper and electronic publications, where arbitration as well as judicial decisions are published.<sup>69</sup> In these sources, all decisions in which the decision-maker expressly relied on good faith and cited the Vienna Convention or Unidroit principles in his reasons for judgement were included. In all, this gave us 36 decisions, 19 by courts, 17 by arbitrators, over the period of 1990 to 2002. Some decisions were not available in languages which we read; we then relied on English or French summaries.

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<sup>67</sup> Lluelles/Moore (1998) allude to the idea of such a threshold in no 907, at 513.

<sup>68</sup> Unidroit *Principles of International Commercial Contracts* (1994).

<sup>69</sup> The list of sources examined is: *Revue d'arbitrage* (1995-2002) ; UNILEX database of decisions dealing either with the Vienna International Sale of Goods Convention (1980) or the Unidroit principles of 1994, available at <http://www.unilex.info>; *Revue de droit uniforme*, 2000 (case law pertaining to the International Sales Convention) ; the Pace University database in international law, available at: <http://www.cisg.law.pace.edu/>. We also used a compilation of decisions compiled by Liette Lamonde for Professor Guy Lefebvre (University of Montreal) in 1997, and dealing with the interpretation of article 7 of Vienna International Sale of Goods Convention (1980).

On the whole, the arbitration decisions are less informative than the judicial decisions; in some cases they merely state that the result conforms to good faith without giving detailed reasons.

In some instances, the decision states that there is no evidence of bad faith. Where a painting is sold which, according to information available to both parties and without further warranties on the subject, is attributed to a well known painter and, several sales later and after a new expert opinion, it is considered to be the work of lesser painter, the ultimate purchaser cannot sue the initial vendor.<sup>70</sup> In our terms, there is no asymmetry.

*Asymmetric information.* Several judicial decisions deal with well-known fraudulent manoeuvres: turning back the mile counter in cars;<sup>71</sup> providing security which turns out to be inexistent;<sup>72</sup> or giving out false letters of credit for the last of three transactions;<sup>73</sup> We are faced here with a problem of asymmetrical information that one party seeks to exploit at the expense of the other. The decisions do not deal explicitly with the threshold of seriousness; but in each case, the fraud is important and bears on the essence of the operation. Other cases of information asymmetry are one where apparent authority to deal stemmed from the use of stationery of the person represented,<sup>74</sup> and another where an exclusion of liability clause was part of the standard contract of one party, but not of the particular document handed to the other party and which had not otherwise been brought to the latter's attention.<sup>75</sup> The result at which the court arrives in the first case corresponds to a rule codified in Quebec's Civil Code as article 2163 as part of the law of mandate.<sup>76</sup>

*Asymmetry in time.* A series of decisions concern asymmetries in time: once delivery has been made, a non-conformity must be signalled in a brief period, since delaying it created increasing problems for the vendor.<sup>77</sup> By delaying, the purchaser can then put pressure on the vendor, which he may seek to turn to his advantage one way or another. To determine what constitutes a

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<sup>70</sup> *Kunsthhaus Math. Lempertz OHG v. Wilhelmina van der Geld*, Arrondissementsrechtbank Arnhem, Unilex, 17 July 1997.

<sup>71</sup> Oberlandesgericht Köln, Unilex, n° 22 U 4/96, 21 May 1996.

<sup>72</sup> Oberlandesgericht Frankfurt am Main, Unilex, vb/94124, 17 November 1995

<sup>73</sup> *Dulces Luisi, S.A. de C.V. v. Seoul International Co.Ltd, Seoulia Confectionery Co., Compromex*, Comision para la Proteccion del Comercio Exterior de Mexico, Unilex, n° m/115/87, 30 November 1998 (arbitration decision).

<sup>74</sup> Handelsgericht des Kantons Aargau, Unilex, n° OR 98.00010, 11 June 1999.

<sup>75</sup> Bundesgerichtshof, Unilex, n° VIII ZR 60/01, 31 November 2001.

<sup>76</sup> CCQ 2163. A person who has allowed it to be believed that a person was his mandatary is liable, as if he were his mandatary, to the third person who has contracted in good faith with the latter, unless, in circumstances in which the error was foreseeable, he has taken appropriate measures to prevent it.

<sup>77</sup> *CME Cooperative Maritime Etaploise S.A.C.V. v. Bos-Fishproducts Urk BV.*, Arrondissementsrechtbank Zwolle, UNILEX, n° HA ZA 95-640, 5 March 1997; Oberlandesgericht, UNILEX, n° 1U167/95, 28 February 1997 ; Handelsgericht Zürich, Unilex, n° HG 930634, 30 November 1998.



reasonable delay, which varies from one trade to the next, one may turn to customs and practices. In several decisions there is implicit consideration of a threshold of seriousness. A purchaser who has been given two extensions to pay and take delivery, and still has not performed, cannot reproach bad faith to the vendor who cancels the contract: the vendor is considered in good faith – he has not taken undue advantage of a discretionary power conferred on him by the contract; implicitly the purchaser is treated as acting in bad faith.<sup>78</sup>

*Asymmetries due to position.* In our corpus, two decisions deal with exclusive distribution contracts in which the grantor, having signed the first, exclusive, contract, subsequently grants a non-exclusive distribution licence for the same territory to a third person.<sup>79</sup> The relationship obliges parties to deal with each other exclusively (bilateral monopoly) and the grantor seeks to turn this to his advantage, to the detriment of the distributor, by granting a second licence.

*False reassurances and unfulfilled undertakings to correct.* Finally, there is a range of cases in which circumstances develop in a manner not anticipated in the contract and which one party seeks to turn to his advantage. Consider for instance situations where one party asks the other for clarifications and the other then gives reassurances which turn out to be false<sup>80</sup> or undertakes to make amends, but does not follow through.<sup>81</sup> The latter party takes advantage of an asymmetry he created himself precisely on the occasion when the other took precautions to prevent it. These situations are similar to those where someone seeks to exercise a (discretionary) right whilst his earlier behaviour indicated that he would not do so. A person who grants an extension for delivery cannot immediately turn round and sue for late delivery. Such behaviour goes against the principle of *clean hands*.<sup>82</sup>

On the whole, our study of the 36 cases dealing with international transactions leads to two conclusions. One is that the reasons for judgement given in the decisions deal with the first two of our three tests, but rarely with the third one, to wit that the acts by which one party seeks to take advantage of the other must reach a certain level of seriousness for there to be bad faith. Yet the third test is essential if recourse to good faith is to remain a means of last resort, as it should, given the broad discretion it confers upon the court.

The second conclusion is that, contrary to our expectations, the absence of well worked out criteria for interpreting good faith in international dealings, by

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<sup>78</sup> *Bielloni Castello S.p.A. v. EGO S.A.*, Corte di Appello di Milano, 11 December 1998.

<sup>79</sup> *W. v. R.*, ICC Court of Arbitration, Paris, Unilex, n° 8611/HV/JK, 23 January 1997 ; ICC International Court of Arbitration, Unilex, n° 9875, March 2000.

<sup>80</sup> Oberlandesgericht Köln, Unilex, n° 27 U 58/95, 8 January 1997 ; Internationales Schiedsgericht der Bundeskammer der gewerblichen Wirtschaft, Unilex, n° SCH-4318, 15 June 1994.

<sup>81</sup> Oberlandesgericht Köln, Unilex, n° 27 U 58/95, 8 January 1997.

<sup>82</sup> *CME Cooperative Maritime Etaploise S.A.C.V. v. Bos-Fishproducts Urk BV.*, Arrondissementsrechtbank Zwolle, UNILEX, n° HA ZA 95-640, 5 March 1997 ; *R. Motor s.n.c. v. M. Auto Vertriebs GmbH*, Unilex, n° 7 U 1720/94, 8 February 1995.

contrast to what is available within national legal systems is a source of hesitation for the decision makers. Hence it would seem worthwhile to pursue these investigations within national legal systems. We now look at some concepts considered to be derivatives of good faith within national systems.

## **2. Analysis of three concepts derived from good faith**

If good faith has been the mould used to fashion a series of more specific concepts,<sup>83</sup> which have subsequently started to lead a life of their own, we may expect that in the criteria for the application of these concepts as synthesised by the legal literature and the cases, we should find back the three general characteristics of good faith which postulated earlier in this paper. The number of derivative concepts is considerable. Whittaker and Zimmerman provide the following list for civilian systems:

'They include, as regards the civilian jurisdictions, and apart from special legislation: *culpa in contrahendo*; *obligations d'information*; *laesio enormis*; the abuse of rights; personal bar; interpretation of the parties' intentions (whether standard or 'supplementary'); the doctrine of 'lawful contact'; laches; unconscionability; *Verwirkung*; *purgatio morae* and *purgatio poenae*; doctrines of change of circumstances or 'erroneous presuppositions'; the notion of a 'burden' (*Obliegenheit*); *force majeure*; *exceptio doli*; mutual mistake; liability for latent defects; the legal consequences associated with the maxims *nemo auditor turpitudinem suam allegans* and *dolo agit qui petit quod statim redditurus est*; and *venire contra factum proprium*.<sup>84</sup>

For common law jurisdictions, they add:

'The range of doctrines (...), again apart from special legislation, is hardly less varied, reference being made to: the law of implied terms; the doctrine of estoppel (including proprietary estoppel); part performance of a contract in equity; the de minimis rule; qualifications of legal rights by reference to the notion of reasonableness; relief against forfeiture in equity; the maxim according to which 'no man can take advantage of his own wrong': the notion of breach of confidence; the doctrine of fundamental mistake; the law relating to repudiation; and (occasionally) even a rule that a contractual power may only be exercised in good faith.<sup>85</sup>

In what follows we examine three derivative concepts in more detail, to wit fraud as a defect of consent, the warranty against latent defects and lesion.

### **a. Fraud as a defect of consent**

Fraud, or *dol* in French, is used for acts aimed at misleading someone into contracting while mistaken about the import of the contract.<sup>86</sup> The concept includes the idea of tricks, deception, scheming and other fraudulent or disloyal

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<sup>83</sup> Cordeiro (1996), at 223, 234 et 240.

<sup>84</sup> Whittaker/Zimmerman (2000), at 676; also Zimmerman 2001, 172.

<sup>85</sup> Ibid.

<sup>86</sup> Karim (2002) at 187; Flour/Aubert/Savaux (2002) at 149.

tactics with a view to misleadingly securing consent of the other party. Various commentators have observed that the concept is a specification of the good faith norm and of the duty to inform, which it presupposes.<sup>87</sup>

*i. Asymmetry*

At the core of the concept of fraud is the intention to deceive, that is to withhold from the other party information relevant for its consent. It may be accomplished by positive acts, such as lies or a fraudulent scheme, but also by omission, silence or failure to correct mistaken views. It is intimately interwoven with the duty to inform, which is recognised in various areas of the law of contract.

Positive acts and omissions form a continuum of conduct which limits information available to one contracting party so as to procure to the other an advantage in excess of what would be normally foreseeable. We are clearly facing an informational asymmetry here.

In assessing whether fraud has been committed, it is generally accepted that one has to take into account the identity and character of each of the parties, considering their authority, their expertise, their age and their level of education.<sup>88</sup>

*ii. Undue advantage*

The criterion used in civil law systems is that the victim of the fraud would not have contracted or have contracted at more advantageous conditions. The victim is considered to be placed at an unforeseen disadvantage by comparison to the gains the parties could normally expect to draw from a similar contract. This appears to correspond to our criterion.

*iii. Threshold*

To be actionable, the fraud must be decisive; this is the case where the victim would not have contracted or have contracted at more advantageous terms. This test does double duty: it determines whether the perpetrator of the fraud has put the victim at a disadvantage and whether the disadvantage is important enough to have made a difference in the victim's behaviour. If victims are forced to live with a contract they would not have signed had they been properly informed, they will in the future change their behaviour so as to be on guard for such schemes (*self-protection*). This raises the cost of doing business, but for minor attempts at deception, self-protection is probably cheaper than public protection through the courts; for significant ones, the reverse holds. The idea of a threshold separates the two sectors.

Civilian systems capture some of this difference in the distinction between *bonus dolus* – *malus dolus*. Puffing in a effort to sell one's goods belongs to the

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<sup>87</sup> Karim (2002) at 187; Delebecque (1999) at 58.

<sup>88</sup> Terré et al. (1999) at 215; Karim (2000) at 192; Pineau et al. (2001) at 181.

first variety.<sup>89</sup> Parties are supposed to be able to cope with this by themselves. This guards against an all too simplistic or naïve confidence and encourages all contracting parties to undertake the most elementary checking themselves.<sup>90</sup>

The distinction between what is fraud and what is acceptable exaggeration corresponds to the duty to inform incumbent on the better informed party and the duty to inquire and otherwise inform oneself for the potential victim. The boundary is considered to be set by the behaviour of a normally diligent<sup>91</sup> buyer. This criterion may be related to usage and practices prevailing within the relevant community.<sup>92</sup> One may surmise that experience, reflected in custom and practices, has led to the best division of tasks between self-protection and protection by the law.

### **b. Warranty for latent defects in sale**

The liability for latent defects seeks to ensure useful possession of the object sold to the buyer. Wherever the object has defects making it unfit for the purpose for which it is normally used and those defects cannot be detected by ordinary means at the time of purchase, the vendor or manufacturer is liable. The warranty does not cover apparent defects, i.e. those detectable by ordinary means, which in current Quebec law means inspection by a 'prudent and diligent' purchaser, without resorting to an expert.<sup>93</sup>

Two different logics are at work in this concept. Where the vendor or manufacturer is aware of the defect but does not – adequately – inform the purchaser of it, we are faced with a problem of opportunism, hence of bad faith, which is topic of this paper. In the opposite case, one may wonder whether the vendor or manufacturer could have detected and corrected the defect at a cost below the discounted loss the defect causes to the purchaser, in which case ordinary negligence logic – barring contractual stipulations to the contrary – commands that he should be liable for it. The vendor or manufacturer is the

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<sup>89</sup> Pineau et al. (2001), at 179-180, write: '[N]'est "répréhensible" que le mensonge qui présente une certaine gravité et non point le "menu mensonge", pain quotidien des contractants! [...] Le "pieux mensonge", les exagérations généralement admises dans les affaires lorsqu'il s'agit de vanter sa marchandise, ne constituent pas un dol'.

<sup>90</sup> Terré et al. (1999) at 215, write that parties should 'ne pas faire montre d'une trop grande naïveté à l'égard des affirmations de son partenaire et à procéder à un minimum de vérifications'.

<sup>91</sup> Art. 1725 (and others) CCQ use the term 'prudent and diligent buyer'. (1725. The seller of an immovable is warrantor towards the buyer for any violation of restrictions of public law affecting the property which are exceptions to the ordinary law of ownership).

<sup>92</sup> Pineau et al. (2001), at 180; Delebecque (1999) at 59.

<sup>93</sup> 1726, par. 2 CCQ (The seller is bound to warrant the buyer that the property and its accessories are, at the time of the sale, free of latent defects which render it unfit for the use for which it was intended or which so diminish its usefulness that the buyer would not have bought it or paid so high a price if he had been aware of them.

The seller is not bound, however, to warrant against any latent defect known to the buyer or any apparent defect; an apparent defect is a defect that can be perceived by a prudent and diligent buyer without any need of expert assistance.)

'cheapest cost avoider'.<sup>94</sup> The cost of the liability, and hence of the preventive measures the manufacturer puts in place, is passed on to the consumer as a higher price for a better quality product. If the defect cannot be so detected and corrected, and hence is economically 'unpreventable', the vendor or manufacturer acts as a loss spreader – an insurer by another name – for all clients, who pay for this 'insurance' in the purchase price of the object. The manufacturer then still has an incentive to engage in research which in the future will improve the quality of the product and hence reduce the cost of the implicit 'insurance premium'.

The warranty goes back to Roman law.<sup>95</sup> This explains perhaps why amongst its sanctions one does not find the option to repair or correct the defect. In Roman times, Zimmermann surmises, defective objects such as animals or slaves could scarcely be repaired.<sup>96</sup> Modern case law and scholarship has added the requirement that vendor must be allowed to attempt a repair before facing the resolution of the sale, with full restitution of the price, or a reduction in price. A second peculiarity of warranty for latent defects in civil law systems is that liability for damage arises only where the vendor or manufacturer had actual or presumed knowledge of the defect. Actual knowledge without disclosure of the relevant information amounts to fraud, which is our topic here. For presumed knowledge, even though the civil law equates it to a form of *dol*, the explanation must be different and lie in the second or third of the three logics (cheapest cost avoider, cheaper insurer, incentives for research) mentioned earlier. In the case of manufacturers, actual knowledge may be difficult to prove. By means of various presumptions, of knowledge<sup>97</sup> but also of defectiveness in case of premature deterioration<sup>98</sup>, the Code helps buyers to prove their case, a form of reduction of transactions costs.<sup>99</sup>

Even where the vendor had no actual knowledge of the defect, he still faces the prospect of having to take back the product and restore the purchase price to the buyer. The explanation must be that the vendor now has an incentive to

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<sup>94</sup> The term was proposed by Calabresi (1970) at 139, 150, 244.

<sup>95</sup> Zimmermann (2001), at 122.

<sup>96</sup> Ibid.

<sup>97</sup> In Quebec law, 1728 and 1730 CCQ. (1728. If the seller was aware or could not have been unaware of the latent defect, he is bound not only to restore the price, but to pay all damages suffered by the buyer. 1730. The manufacturer, any person who distributes the property under his name or as his own, and any supplier of the property, in particular the wholesaler and the importer, are also bound to warrant the buyer in the same manner as the seller.)

<sup>98</sup> In Quebec law, 1729 CCQ. (A defect is presumed to have existed at the time of a sale by a professional seller if the property malfunctions or deteriorates prematurely in comparison with identical items of property or items of the same type; such a presumption is not made, however, where the defect is due to improper use of the property by the buyer.)

<sup>99</sup> Proving one's case against a mass manufacturer is no trivial matter as is readily seen in, for instance, the suit against Ford regarding the defective design of the Pinto. See *Grimshaw v. Ford Motor Co.*, 119 Cal. App. 3rd 757, at 800; 174 Cal. Repr. 348 (1981); comment by Schwartz (1991) and Page (2002) at 810 f.

discover latent defects in objects he uses and is better placed to discover them than is the prospective purchaser.

*i. Asymmetry*

What interests us here are cases of actual knowledge of a defect without disclosure of the relevant information to the purchaser. This amounts to an asymmetry of information. Only *latent* defects are actionable, not apparent ones. This is immediately explicable from an economic point of view since what the purchaser is properly appraised of can scarcely be used for opportunistic moves. There is no asymmetry here.

By extension, the obligation to warrant holds for the manufacturer of mass-produced objects, who is well placed to know the chance of defects, at least in a statistical sense, by conducting the appropriate quality control tests. There is an asymmetry here with respect to the purchaser of individual objects of the mass-produced series. Between two professionals, both operating as large-scale purchasers and sellers, the asymmetry does not arise: the professional purchaser is more easily aware of and better able to cope with individual defects than is the consumer-purchaser. The law recognises this by attaching a lower level of liability to such relationships.

*ii. Undue advantage*

This factor is assessed by giving the buyer three options: leave the sale undisturbed (presumably no disadvantage to the buyer); *quanti minoris* (reduction of price, i.e. a judicially assessed compensation for the disadvantage); nullity of the sale, each party recovering what it had tendered (this restores subjective value to each, except for the time spent in locating a good purchase).

The warranty becomes actionable where either the object sold is unfit for its normal purpose or is unsuitable for a specially agreed (different) purpose. This limitation reigns in a moral hazard (opportunism, hence bad faith) problem with buyers being too freely able to return what they bought or to return the object after misusing it.<sup>100</sup> Sellers may of course contractually grant such return privileges for a limited time, thereby allowing purchasers to judge whether the purchase is fair. Where the option is not exercised, the purchaser presumably sees no undue advantage.

*iii. Threshold*

Case law has determined that latent defects must be of a certain seriousness to be actionable. What this amounts to is somewhat fuzzy, but the test which for instance the Quebec Civil Code proposes, in art. 1726, reminds us of one we already encountered with respect to fraud: 'The seller is bound to warrant the buyer that the property and its accessories are, at the time of the sale, free of latent defects which render it unfit for the use for which it was

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<sup>100</sup> In Quebec law, 1729, second sentence CCQ.

intended or *which so diminish its usefulness that the buyer would not have bought it or paid so high a price if he had been aware of them.*<sup>101</sup>

Only *latent* defects are actionable, not apparent ones. One might think of defects on a sliding scale of seriousness: to one side the apparent deficiencies; as one moves along the scale, the less obvious ones until at the other end of the scale one reaches defects that are totally hidden and will only be discovered after a lot of experience. The latent character of the defect acts as a further element of the threshold.

### c. Lesion

In civilian systems, the concept of lesion or *lesio enormis* is perhaps bad faith in its least adulterated form. Civilian scholarship defines it as ‘a loss a contracting party suffers as a result of the lack of equivalence between the advantage acquired and what is given up in return for it’;<sup>102</sup> or again as ‘a disequilibrium at the time of entering into the contract between the prestations reciprocally agreed to’.<sup>103</sup> In all civilian systems, lesion can only be invoked exceptionally. In Quebec law, for instance, it is applicable as regards minors and adults under a protective regime<sup>104</sup>, in consumer contracts<sup>105</sup> and in a few particular sets of circumstances.<sup>106</sup>

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<sup>101</sup> 1726 CCQ, italics added. The formula for fraud, in art. 1401, par. 1, is : Error on the part of one party induced by fraud committed by the other party or with his knowledge vitiates consent whenever, but for that error, the party would not have contracted, or would have contracted on different terms.

<sup>102</sup> Flour et al. (2002) at 168-169 (préjudice que subit une partie contractante à raison d’un défaut d’équivalence entre l’avantage qu’elle obtient et le sacrifice qu’elle consent).

<sup>103</sup> Pineau et al. (2001) at 208 (un état de déséquilibre existant au moment de la conclusion du contrat entre les prestations réciproquement stipulées).

<sup>104</sup> Art. 1405 CCQ. (Except in the cases expressly provided by law, lesion vitiates consent only in respect of minors and persons of full age under protective supervision.)

<sup>105</sup> In Quebec law, art. 8 and 9 of the *Consumer Protection Act*, Revised Statutes of Quebec, ch. P 40.1.

Art. 8. The consumer may demand the nullity of a contract or a reduction in his obligations thereunder where the disproportion between the respective obligations of the parties is so great as to amount to exploitation of the consumer or where the obligation of the consumer is excessive, harsh or unconscionable.

Art. 9. Where the court must determine whether a consumer consented to a contract, it shall consider the condition of the parties, the circumstances in which the contract was entered into and the benefits arising from the contract for the consumer.

<sup>106</sup> Artt. 424, 472, 1609, 2332 CCQ. (424. Renunciation by one of the spouses, by notarial act, of partition of the family patrimony may be annulled by reason of lesion or any other cause of nullity of contracts.

472. Acceptance and renunciation are irrevocable. Renunciation may be annulled, however, by reason of lesion or any other cause of nullity of contracts.

1609. An acquittance, transaction or statement obtained from the creditor in connection with bodily or moral injury he has sustained, obtained by the debtor, an insurer or their representatives within thirty days of the act which caused the injury, is without effect if it is damaging to the creditor.

*i. Asymmetry*

The cases where lesion can be invoked have a point in common, to wit that one party may be considered to be in a weak bargaining position in relation to the other. The asymmetry may pertain to information, to expertise or to the scale at which he or she operates (economic power), as in consumer-merchant dealings, the consumer being a 'small-scale' operator in such dealings.<sup>107</sup>

The asymmetry may stem from one party's presumed inability to appraise the full consequences of his or her decisions, due to inexperience (minors) or limited mental capacity (adults in a protective regime). The few special cases where the Quebec Code admits lesion similarly denote a presumed vulnerability of one of the parties: stress of divorce (424 and 472 CCQ) or physical injury (1609 CCQ). The case of an excessively onerous loan (2332 CCQ) stands somewhat apart but also refers to situations where the debtor presumably contracted under stress without fully realising that he was being taken advantage off. Of course, making such loans avoidable will make it harder for poor debtors to find loans.

*ii. Undue advantage*

The very definition of lesion stresses this factor, as in article 1406 of the Quebec Code, for instance,

Lesion results from the exploitation of one of the parties by the other, which creates a serious disproportion between the prestations of the parties; the fact that there is a serious disproportion creates a presumption of exploitation.

How to distinguish a respectable but hefty profit for one party from one that is gained at the expense of the other party whose vulnerability is exploited? Values of what one gains from a contract are essentially subjective. Parties engage in a exchange precisely because they do not value the exchanged objects or services and sums of money in the same way. It is touchy for a court to second-guess the persons directly concerned on the 'equivalence' of the prestations, hence to assess the fairness of the deal. It is equally tricky to detect abuse in the behaviour of commercial operators seeking a profit.

Quite sensibly, the Code accommodates these concerns by making transactions avoidable for lesion at the pleasure of the disadvantaged party, but with the option of maintaining it with a reduction in the price. The discretion offered here to the presumably disadvantaged party opens the door to opportunism on his or her part. To counter this risk, the Quebec Civil Code

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2332. In the case of a loan of a sum of money, the court may pronounce the nullity of the contract, order the reduction of the obligations arising from the contract or revise the terms and conditions of the performance of the obligations to the extent that it finds that, having regard to the risk and to all the circumstances, one of the parties has suffered lesion.)

<sup>107</sup> As Pineau et al. (2001) at 218 put it : 'situation de faiblesse, d'inexpérience ou de gêne de l'autre'.



provides that the court may maintain the contract in spite of the demand for its nullity, where the other offers an equitable corrective.<sup>108</sup>

All in all, our second test appears to be clearly present amongst the conditions for the applicability of the concept of lesion.

### *iii. Threshold*

In the provisions dealing with lesion in Quebec law, the idea of a threshold is close to the surface. Article 1406 of the Quebec Civil Code refers to a 'serious disproportion' and article 8 of the *Consumer Protection Act* to [a disproportion] so great as to amount to exploitation of the consumer'.

In French law, specific numbers are sometimes spelt out for the disproportion to be actionable, for instance, in flat-fee contracts for copyright exploitation<sup>109</sup> and in the sale of immovable property.<sup>110</sup> But the application of these provisions is cumbersome, to put it mildly. The Code itself provides, for immovable property, that the disadvantage has to be for seven twelfths of the value and that the value is to be assessed by three independent experts appointed by the court, or by agreement between the parties.

All in all, the provisions defining lesion appear to contain elements referring to our three tests: an asymmetry which one party turns to its (undue) advantage at the expense of the other, with sufficient seriousness to imperil the normal functioning of markets with the implicit division of self-protection and public protection that it presupposes. At the same time, they show the practical difficulty of specifying a threshold for judicial intervention sufficiently restrictive to maintain the stability of contract, which is also an essential condition for properly functioning markets.

## CONCLUSION

Good faith is an old and yet intractable notion, in civil law as well as in common law jurisdictions and in international commercial law. In civil law systems its role has been strengthened in recent codifications. It remains, however, an ill-understood concept. To clarify it, legal scholarship draws on intuition and uses terms such honesty and loyalty, which are more or less synonymous and equally open-ended.

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<sup>108</sup> Art. 1407 and 1408 CCQ. (1407. A person whose consent is vitiated has the right to apply for annulment of the contract; in the case of error occasioned by fraud, of fear or of lesion, he may, in addition to annulment, also claim damages or, where he prefers that the contract be maintained, apply for a reduction of his obligation equivalent to the damages he would be justified in claiming. 1408. In the case of a demand for the annulment of a contract on the ground of lesion, the court may maintain the contract where the defendant offers a reduction of his claim or an equitable pecuniary supplement.).

<sup>109</sup> Art. L. 131-5, Code la propriété intellectuelle (lesion for 7/12 of the value). See Lucas/Lucas (2001), no 539, at 435 f.

<sup>110</sup> Art. 1674 of the French Civil Code (lesion for 7/12 of the value). See Carbonnier (1996) no 78, at 146.

Good faith appears to be an open-ended concept or principle rather than a specific rule. It has been the mould in which have been fashioned a range of more specific concepts that have started to lead a life of their own in case law and legal scholarship. At first blush, good faith seems bound to continue its role as an open-ended instrument of last resort and allowing considerable discretion to the courts, to sanction highly undesirable acts for which no more specific rules are available.

This article has explored what the economic analysis of law has to offer by way of clarification of the concept of good faith. In an economic analysis, the law of contracts appears to have two broad functions: to reduce transactions costs and to curtail opportunism. Good faith, or rather its absence, is linked to the second function. Good faith is the exact opposite of opportunism.

While the term opportunism appears regularly in economic discourse, it is as hard to find a good definition of it there as it is to find one of good faith in the legal literature. Both appear to be used in a fuzzy manner to refer to behaviour contrary to the cooperative solution in bilateral and multilateral relationships. The most appropriate formula to describe it in our view has been put forth by George Cohen. It is worth repeating it here: 'any contractual conduct by one party contrary to the other party's reasonable expectations based on the parties' agreement, contractual norms, or conventional morality.'<sup>111</sup>

To operationalise the concept, we have proposed a three-step test, which are themselves relatively open-ended: an asymmetry between the parties; which one of them seeks to exploit to the detriment of the other in order to draw an undue advantage from it; the exploitation being sufficiently serious that, in the absence of a sanction, the victim and others like him or her are likely substantially to increase measures of self-protection before entering into a contract in the future, thereby reducing the overall level of contracting.

If this is accurate, one should be able to trace, even implicitly, the three factors in reasons for judgement in decisions relying on good faith and in concepts considered to be emanations of good faith. We looked at a set of decisions in international commercial law and at the concepts of fraud (*dol*) in contract, warranty against latent defects and lesion by way of an informal test. The general conclusion is that the first two concepts are usually easy to trace, the third one with more difficulty. It would be useful to repeat the test on a more diversified corpus.

At a normative level, if our three factors are accepted as appropriately characterising good faith, one would have to look for them amongst the facts giving rise to legal disputes. It is for the legal community to decide whether that clarifies the concept of good faith.

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