

**THE ELEVENTH SULTAN AZLAN  
SHAH LECTURE 1996\***

**CONTRACT LAW: FULFILLING THE  
REASONABLE EXPECTATIONS OF  
HONEST MEN**

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It is a great honour for me to be invited by His Royal Highness to deliver the eleventh in a series of annual lectures which bear his prestigious name. I am the more honoured since His Royal Highness is both a distinguished jurist and an eminent former judge whose valuable contribution to the law is widely known beyond the frontiers of this country. At the same time it is a daunting experience for me to give this lecture in his presence. I only wish I could produce a lecture which is a worthy response to the gracious hospitality of his Royal Highness who invited my wife and myself to your wonderful and beautiful country.

A thread runs through our contract law that effect must be given to the reasonable expectations of honest men. Sometimes this is made explicit by judges; more often it is the implied basis of the court's decision. Tonight, I would like to examine what this means, and to relate it to some parts of English contract law. It is an important subject for the future of the English law of contract, which is part of our common heritage. It may be of interest in this commercially vibrant country.

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\* Text of the Eleventh Sultan Azlan Shah Law Lecture (organised by the Faculty of Law, University of Malaya and the British Council) delivered by the Rt Hon Lord Steyn, on 24 October 1996 in the presence of DYMM, Sultan Azlan Shah, the Sultan of Perak.

The modern view is that the reason for a rule is important. The rule ought to apply where reason requires it, and no further. But often the real purpose of a rule is debatable. The question can then only be solved by rational argument, and a judgment by an impartial judge. Once the purpose of a rule has been identified by effective and proper adjudication, it is an important and legitimate matter to enquire whether the particular rule fulfils that purpose. If it does not, it is defective. At the very least a judge, and particularly an appellate court, is entitled to re-examine the law to make doubly sure that the law indeed commands something that does not make sense. Usually, it will be found, on conscientious and rigorous re-examination, that the common law solution is one which is meaningful and in accord with common sense. Simple fairness ought to be the basis of every legal rule and, in a common law case, the presumption in favour of the fair solution is powerful. These considerations are the framework in which one must approach the proposition that in contract law effect must be given to the reasonable expectations of honest men.

That leads me to a preliminary distinction. It is a defensible position for a legal system to give predominance to the subjective intentions of the parties. Such a policy can claim to be committed to the ideal of perfect individualised justice. But that is not the English way. Our law is generally based on an objective theory of contract. This involves adopting an external standard given life by using the concept of the reasonable man. The commercial advantage of the English approach is that it promotes certainty and predictability in the resolution of contractual disputes. And, as a matter of principle, it is not unfair to impute to contracting parties the intention that in the event of a dispute a neutral judge should decide the case applying an objective standard of reasonableness. That is then the context in which in English law one should interpret the proposition that effect must be given to the reasonable expectations of honest men.

It is possible to refine the meaning of the proposition. Once one uses the external standard of reasonableness the reference to honest men adds little. Although the hypothetical reasonable man pursues his own commercial self-interest he is by definition not dishonest. The proposition can therefore be re-defined simply to say that the law must respect the reasonable expectations of the contracting parties. That brings me to consider what the reasonable expectations of the parties means. The expectations that will be protected are those that are, in an objective sense, common to both parties.<sup>1</sup> The law of contract is generally not concerned with the

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<sup>1</sup> Reiter and Swan, "Contracts and the Protection of Reasonable Expectations", in *Studies in Contract Law*, ed by Reiter and Swan, 1980, Toronto, 1-22, at 7.

subjective expectations of a party. The law does not protect unreasonable expectations. It protects only expectations which satisfy an objective criterion of reasonableness. Reasonableness is a familiar concept and no definition is necessary. But it is, of course, right to stress that reasonableness postulates community values. It refers not to the standards of Lord Eldon's day. It is concerned with contemporary standards not of moral philosophers, but of ordinary right thinking people. Sometimes those standards will receive their distinctive colour from the context of a consumer transaction, a business transaction or even a transnational financial transaction. And the usages and practices of dealings in those disparate fields will be prime evidence of what is reasonable.

It is now of some relevance to consider the status of our proposition. It is certainly not a rule of law. It is possible to argue that it is a general principle of law, such as, for example, the principle that no man may benefit from his own wrong. I prefer to regard it as the central objective of the law of contract. The function of the law of contract is to provide an effective and fair framework for contractual dealings. This function requires an adjudication based on the reasonable expectations of the parties. It is right to acknowledge, however, that the reasonable expectations of parties cannot always prevail. Sometimes they must yield to countervailing principles and policies. For example, other values enshrined in law and public policy may render the contract defeasible. Nevertheless, the aim of protecting reasonable expectations remains constant.<sup>2</sup>

It is now possible to examine how the English law of contract measures up to this policy. Inevitably, I will have to be selective. But I hope to look at topics that are of considerable practical importance. The first relates to the formation of contracts.

The classical doctrine is that a contract can only come into existence by the congruence of a matching offer and acceptance. As a general proposition this makes sense, but it does not solve all cases satisfactorily. Take, for example, the so-called battle of the forms cases notably in the field of negotiations for the conclusion of building and engineering contracts. Each party insists on contracting only on his own standard conditions. In the meantime the work starts. Payments are made. Often it is a fiction to identify an offer and acceptance. Yet reason tells us that neither party should be able to withdraw unilaterally from the transaction. The reasonable expectations of the parties, albeit that they are still in disagreement

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<sup>2</sup> Reiter and Swan, *op cit*, at 6.

about minor details of the transaction, often demand that the court must recognise that a contract has come into existence. The greater the evidence of reliance, and the further along the road towards implementation the transaction is, the greater the prospect that the court will find a contract made and do its best, in accordance with the reasonable expectations of the parties, to spell out the terms of the contract.<sup>3</sup>

That brings me to a serious blemish in the English law of contract. Some eighty years ago, in *Dunlop Pneumatic Tyre Co Ltd v Selfridge & Co Ltd*<sup>4</sup> the House of Lords held that English law does not recognise a contract for the benefit of a third party. Despite condemnation by many judges and academic writers, this rule lingers on. The rule was laid down as being a self evident proposition of logic. But the logic was flawed. It is indeed obvious that a bilateral contract cannot impose a burden on a stranger. But if for commercial or other good reasons two parties agree that one will confer a benefit on a third party, and the latter accepts the benefit, no legal logic demands that the stipulation be denied effect. Certainly, the doctrine of consideration poses no problem: ex hypothesi the stipulation for the benefit of a third party is part of an agreement involving an exchange of promises between the contracting parties. The ruling in *Dunlop Pneumatic* is inconsistent with the prime function of the law of contract which is to facilitate commercial dealings. It ignores the fact that parties in good faith rely on the agreement for the benefit of a third party. It fails to take into account that businessmen, for sensible reasons, sometimes wish to enter into such promises in favour of third parties.

Confidence in promises is the lifeblood of commerce; and there can be no confidence if parties are not obliged to perform the promises. The privity rule causes particular difficulties where the main contractors, sub-contractors and consultants are linked in a network of contracts. The privity rule also frequently prevents a party to a bilateral contract from taking out an insurance policy for the benefit of a third party. Where there is no statutory inroad on the privity rule such a stipulation is unenforceable. Take also the common example of a buyer of goods from a distributor. As part of the distributorship agreement between the manufacturer and distributor, a manufacturer's warranty is given for the benefit of the buyer. No consideration passes from the buyer to the manufacturer. The manufacturer's warranty is a classic contract for the benefit of a third party. It would be absurd to deny efficacy to it. It would be a serious defect in our contract law if businessmen were precluded by legal doctrine from confer-

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<sup>3</sup> *G Percy Trentham Ltd v Archital Luxfer Ltd* [1993] 1 Lloyd's Rep 25.

<sup>4</sup> [1915] AC 847. See also *Midland Scruttons Ltd v Silicones Ltd* [1962] AC 446 and *Kepong Prospecting Ltd v Schmidt* [1968] AC 810.

ring such benefits on third parties. Not surprisingly, judges display much ingenuity in inventing exceptions to the rule to avoid the inconvenience and unfairness of the rule. It is also noteworthy that a contract for the benefit of a third party is recognised in the legal systems of most European countries, as well as in much of the common law world, including the United States, New Zealand and parts of Australia. In an excellent report the English Law Commission has recommended that the rule be reversed by statute.<sup>5</sup> Given decades of procrastination one would hope that the proposed legislation will now be enacted speedily. It is to be noted, however, that the Bill provides that the legislation should not be construed as preventing judicial development of third party rights. That is important because the legislation may not be comprehensive. The Law Commission's proposals require identification of the third party by name, as a member of a class or as answering a particular description. It may not give a remedy in the manufacturers' warranty case. It may therefore still be desirable for the House of Lords to review *Dunlop Pneumatic* in a suitable case.

That brings me to the related topic of consideration. The classic model of English contract law is a bargain: and a bargain postulates an exchange. Consideration is therefore historically a fundamental doctrine of English law. Almost 90 pages are devoted to it in the ninth and latest edition of Professor Treitel's book on contract law.

At first glance it seems a highly technical doctrine. On the other hand, the question may be asked why the law should refuse to sanction a transaction for want of consideration where parties seriously intend to enter into legal relations and arrive at a concluded agreement. If the court refuses to enforce such a transaction for no reason other than that the parties neglected to provide for some minimal or derisory consideration, is it not arguably a decision contrary to good faith and the reasonable expectations of the parties? Some of these considerations may have led Lord Goff of Chieveley in *The Pioneer Container* to say that it is now open to question how long the principles of privity of contract and consideration will continue to be maintained.<sup>6</sup> In my view the case for abandoning the privity rule is made out. But I have no radical proposals for the wholesale review of the doctrine of consideration. I am not persuaded that it is necessary. And great legal changes should only be embarked on when they are truly

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5 *Privity of Contract: Contracts for the Benefit of Third Parties*, Law Commission No 121, Cm 3329.

6 [1994] 2 AC 324, 335; see also *White v Jones* [1995] 2 AC 207, 262-263, per Lord Goff of Chieveley.

necessary. First, there are a few cases where even in modern times courts have decided that contractual claims must fail for want of consideration. On the other hand, on careful examination it will usually be found that such claims could have been decided on other grounds, eg the absence of an intention to enter into legal relations or the fact that the transaction was induced by duress. Once a serious intention to enter into legal relations and a concluded agreement is demonstrated in a commercial context there is virtually a presumption of consideration which will almost invariably prevail without a detailed search for some technical consideration.<sup>7</sup> On balance it seems to me that in modern practice the restrictive influence of consideration has markedly receded in importance. Secondly, it seems that in recent times the courts have shown a readiness to hold that the rigidity of the doctrine of consideration must yield to practical justice and the needs of modern commerce. The landmark case is the decision of the Court of Appeal in 1990 in *Williams v Roffey Bros and Nicholls (Contractors) Ltd*.<sup>8</sup> The important question arose whether there is sufficient consideration where the contracting party promised to pay an additional sum to the other contracting party simply in return for a further promise by the latter to perform his already existing contractual obligations. The orthodox view would have been that there was no consideration. But the Court of Appeal unanimously held that the defendants were bound by their promise since the promisee obtained a practical benefit. The court was obviously concerned that the doctrine of consideration should not restrict the ability of commercial contractors to make periodical consensual modifications, and even one-sided modifications, as the work under a construction contract proceeded. The reasonable expectations of the parties prevailed over the technical and conceptualistic reasoning.

Next I turn to the approach of English law to the concept of good faith. In the *jus commune* of Europe is a general principle that parties must negotiate in good faith, conclude contracts in good faith and carry out contracts in good faith.<sup>9</sup> The Principles of International Commercial Contracts published by Unidroit provide that in international trade, parties must act in accordance with good faith and fair dealing, and that they may not exclude or limit this duty.<sup>10</sup> In the United States the influential Uniform Commercial Code is explicitly and squarely based on the concept of good

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7 *The Eurymedon* [1938] P 41; [1938] 1 All ER 122.

8 [1991] 1 QB 1.

9 *Principles of European Contract Law, Part I: Performance, Non-Performance and Remedies*, prepared by the Commission on European Contract Law, ed by Ole Lando and Hugh Beale, Art 1.106, at 53.

10 Art 1.7, at 16-17.

faith. Elsewhere in the common law world, outside the United Kingdom, the principle of good faith in contract law is gaining ground. It is the explicit basis of many international contracts. Since the English law serves the international market place, it cannot remain impervious to ideas of good faith, or fair dealing. For my part I am quite confident that the City of London, and English businessmen generally, have no problem with the concept of good faith, or fair dealing. But English lawyers remain resolutely hostile to any incorporation of good faith principles into English law. The hostility is not usually bred from any great familiarity with the way in which the principle works in other systems. But it is intense. My impression is that the basis of the hostility is suspicion about what good faith means. If it were a wholly subjective notion, one could understand the scepticism. If it were an impractical and open-ended way of fastening contractual liability onto parties, it would deserve no place in international trade. But it is none of these things. While I accept that good faith is sometimes used in different senses, I have in mind what I regard as the core meaning. Undoubtedly, good faith has a subjective requirement: the threshold requirement is that the party must act honestly. That is an unsurprising requirement and poses no difficulty for the English legal system. But good faith additionally sets an objective standard *viz* the observance of reasonable commercial standards of fair dealing in the conclusion and performance of the transaction concerned. For our purposes that is the important requirement.<sup>11</sup> Used in this sense judges in the greater part of the industrialised world usually have no great difficulty in identifying a case of bad faith. It is not clear why it should perplex judges brought up in the English tradition. It is therefore surprising that the House of Lords in *Walford v Myles*<sup>12</sup> held that an express agreement that parties must negotiate in good faith is unenforceable. As the Unidroit principles make clear, it is obvious that a party is free to negotiate and is not liable for a failure to reach an agreement. On the other hand, where a party negotiates in bad faith not intending to reach an agreement with the other party he is liable for losses caused to the other party. That is the line of reasoning not considered in *Walford v Myles*. The result of the decision is even more curious when one takes into account that the House of Lords regarded a best endeavours undertaking as enforceable. If the issue were to arise again, with the benefit of fuller argument, I would hope that the concept of good faith would not be rejected out of hand. There is

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11 Farnsworth, "Good Faith in Contract Performance", in *Good Faith and Fault in Contract Law*, ed by Beatson and Friedman, 1995, 154-190.

12 [1992] 2 AC 128. It is important to note that at best the remedy for the breach of the undertaking to negotiate in good faith is the waste of costs of the injured party caused by the bad faith negotiations of the other.

no need for hostility to the concept: it is entirely practical and workable. Indeed from July 1995 the EC Directive on Unfair Terms in Consumer Contracts has been in operation in England.<sup>13</sup> The Directive treats consumer transactions within its scope as unfair when they are contrary to good faith. It is likely to influence domestic English law. Given the needs of the international market place, and the primacy of European Union law, English lawyers cannot avoid grappling with the concept of good faith. But I have no heroic suggestion for the introduction of a general duty of good faith in our contract law. It is not necessary. As long as our courts always respect the reasonable expectations of parties, our contract law can satisfactorily be left to develop in accordance with its own pragmatic traditions. And where in specific contexts duties of good faith are imposed on parties, our legal system can readily accommodate such a well tried notion. After all, there is not a world of difference between the objective requirement of good faith and the reasonable expectations of the parties.

That brings me to the interpretation of written contracts. Disputes about the meaning of contracts is one of the largest sources of contractual litigation, notably in respect of international contracts. The reason is, in the words of Oliver Wendell Holmes, that a word is not a transparent crystal. Clarity is the aim but absolute clarity is unattainable. And it is impossible for contracting parties to foresee all the vicissitudes of commercial fortune to which their contract will be exposed. Moreover, and quite understandably, business bargains have to be struck under great pressure of events and time. In passing, I add that it is therefore particularly tiresome for lawyers to expatiate on the quality of draftsmanship of commercial contracts. Judges must simply do the best they can with the raw materials they are given. Given the intractable nature of problems of construction, the solution of English law is not to ask what the parties subjectively intended but to ascertain what, in the context of the contract, the language means to an ordinary speaker of English. By and large, the objective approach to questions of interpretation serves the needs of commerce. It tends to promote certainty in the law and predictability in dispute resolution. But I must examine the matter in a little more detail. There is the rule that the court is not permitted to use evidence of the pre-contractual negotiations of the parties or their subsequent conduct in aid of the construction of written contracts even if the material throws light on the subjective intentions of the parties. Logically, these rules follow from the primary rule that the task of the court is simply to ascertain the meaning of the language of the contract. And the rationality of the law is important. But, if these rules were absolute and unqualified, the primary rule would

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13 Unfair Terms in Consumer Contracts Regulations, SI 1994/3159.



sometimes defeat the reasonable expectations of commercial men. Pragmatically, it has been decided that if pre-contractual exchanges show that the parties attached an agreed meaning to ambiguous expressions that may be admitted in aid of interpretation.<sup>14</sup> That is a substantial inroad into the primary rule in aid of the protection of the reasonable expectations of the contracting parties. More importantly, the courts have resorted to estoppel to temper the rigidity of the orthodox rule regarding the inadmissibility of subsequent conduct. Thus in the *Vistafjord*, the Court of Appeal authoritatively held that a party may be precluded by an estoppel by convention from raising a contention contrary to a common assumption of fact or law (including the interpretation of a contract) on which they have acted.<sup>15</sup> The operation of the estoppel is flexible: it only prevails so far as it would be unjust if one of the parties resiled from the agreed assumption. By this, it means the reasonable expectations of the parties can fairly be met. This is simply one of many examples of the percolation of promissory estoppel into contract law. Promissory estoppel is often used to soften the rigidity of classical contract law solutions in order to give effect to the reasonable expectations of parties.

The general approach of courts to problems of interpretation has undergone a substantial change in the last twenty-five years. There has been a shift away from a black-letter approach to questions of interpretation. The literalist methods of Lord Simmonds are in decline. The purposive approach of Lord Reid and Lord Denning, Master of Rolls, has prevailed. Two questions can be posed. First, what is literalism? This is easy. The tyrant Temures promised the garrison of Sebastia that no blood would be shed if they surrendered to him. They surrendered. He shed no blood. He buried them alive.<sup>16</sup> That is literalism. It has no place in modern law. Second, the significance of the trend towards purposive construction must be considered. It does not mean that judges now arrogate to themselves the power to re-write contracts for parties. It signifies an awareness that a dictionary is of little help in solving problems of construction. Often there is no obvious or ordinary meaning of the language under consideration. There are competing interpretations to be considered. In choosing between alternatives, a court should primarily be guided by the contextual scene in which the stipulation in question appears. And speaking generally, commercially minded judges would regard the commercial purpose of the contract

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14 *The Karen Oltmann* [1976] 2 Lloyd's Rep 708.

15 [1988] 2 Lloyd's Rep 343.

16 This example is given in *The Works of William Paley*, 1838 edn III, 60. Paley's moral philosophy influenced thinking on contract in the last century.

as more important than niceties of language. And, in the event of doubt, the working assumption will be that a fair construction best matches the reasonable expectations of the parties.

That brings me to the implication of terms. In systems of law where there is a general duty of good faith in the performance of contracts the need to supplement the written contract by implied terms is less than in the English system. In our system, however, the implication of terms fulfils an important function in promoting the reasonable expectation of parties. Three categories of implied terms can be identified. First, there are terms implied by virtue of the usages of trade and commerce. The assumption is that usages are taken for granted and therefore not spelled out in writing. The recognition of trade usages protect the reasonable expectations of the parties. Secondly, there are terms implied in fact, *ie* from the contextual scene of the particular contract. Such implied terms fulfil the role of *ad hoc* gap fillers. Often the expectations of the parties would be defeated if a term were not implied, *eg* sometimes a contract simply will not work unless a particular duty to cooperate is implied. The law has evolved practical tests for the permissibility of such an implication, such as the test of whether a term is necessary to give business efficacy to the contract or the less stringent test whether the conventional bystander, when faced with the problem, would immediately say "yes, it is obvious that there is such an implied term". The legal test for the implication of a term is the standard of strict necessity. And it is right that it should be so, since the courts ought not to supplement a contract by an implication, unless it is perfectly obvious that it is necessary to give effect to the reasonable expectations of parties. It is, however, a myth to regard such an implied term as based on an inference of the actual intention of the parties. The reasonable expectations of the parties in an objective sense are controlling: they sometimes demand that such terms be imputed to the parties. The third category is terms implied by law. This occurs when incidents are impliedly annexed to particular forms of contracts, *eg* contracts for building work, contracts of sale, hire, etc. Such implied terms operate as default rules.<sup>17</sup> By and large, such implied terms have crystallised in statute or case law. But there is scope for further development. In such new cases, a broader approach than applied in the case of terms implied in fact, must necessarily prevail. The proposed implication must fit the generality of cases. Indeed, despite some confusion in the authorities, it is tolerably clear that the court may take into account considera-

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<sup>17</sup> There is an excellent discussion of terms implied by law in Rakoff, "Implied Terms: Of 'Default Rules and Situation Sense'", in *Good Faith and Fault in Contract Law*, ed by Beatson and Friedman, 191.

tions of reasonableness in laying down the scope of terms to be implied in contracts of common occurrence: *Liverpool City Council v Irwin*,<sup>18</sup> *Scally v Southern Health and Social Services Board*.<sup>19</sup> This function of the court is essential in providing a reasonable and fair framework for contracting. After all, there are many incidents of contracts of common occurrence which the parties cannot always be expected to reproduce in writing. This type of supplementation of contracts also fulfils an essential function in promoting the reasonable expectations of the parties.

By way of conclusion I would acknowledge that the English law of contract is far from perfect. There is never a last and definite word on the law. Yet there has been progress. In a more formalistic era, courts sometimes neglected to consider the reason for a rule. But formalism is receding. Modern judges usually have well in mind the reason for a rule, and in a contract case that means approaching the case from the point of view of the reasonable expectations of the parties. Where contract law is still deficient it will usually be found that the cause is that the reasonable expectations of the parties have been ignored or given inadequate weight. The most serious structural defect in English contract law is the privity rule. Otherwise English contract law is generally capable of safeguarding the reasonable expectations of parties by its own pragmatic methods. It is therefore not surprising that English standard form contracts are widely used in international transactions. Even more important is the fact that English proper law clauses are widely used in international trade. Businessmen tend to be knowledgeable and they vote for the legal system of their choice with proper law clauses. They recognise that the English law of contract is admirably designed to cope with the challenges of a modern and changing business world. It draws its strength and vitality from a close adherence to the reasonable expectations of contracting parties.

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18 [1977] AC 239.

19 [1992] 1 AC 294.

