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The Principle of Good Faith in Contractual Relations

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Abstract

The principle of good faith obligates the parties to act in good faith both during the conclusion of the contract and throughout its performance. This obligation means that neither party should harm the other solely to gain benefits from the contract. The significance of the principle of good faith is underscored by the fact that it is a fundamental principle in modern law, philosophy, and business, forming the basis of contractual relationships in most legal systems, including French, German, and others. In contrast, in English law, the principle of good faith was only recently introduced through various statutes and conventions. This article does not propose creating a new concept regarding the principle of good faith but rather offers a coherent explanation and approach to understanding and interpreting the concept. Given the scope of the topic, it is impossible to exhaustively address this issue within the format of this article. The aim is to examine the peculiarities of applying the principle of good faith in contractual relationships within various legal systems and, most importantly, to address issues regarding its justification, as the issue of justification reflects the state of both the legal culture of the country and the development of justification techniques. The research primarily employs comparative law and analytical methods. Using the comparative law method, the study compares the research object with similar issues in the legislation of other countries. This aspect of the methodology plays a significant role in the work. Since civil law in Georgia is influenced by continental European law, it is crucial to include countries with similar legal systems in the research. Additionally, using this method

allows us to examine the experiences of common law countries, enabling a review of international approaches to the research issue and concluding which of these approaches would be most priority, flexible, and effective for Georgian legislation.

Keywords: The Principle of Good Faith, Pre-contractual Relations, culpa in contrahendo, Freedom of Contract

Introduction

The behavior of all subjects of civil law is based on the principle of good faith, which is regarded as a normative concept. The principle of good faith obligates parties to act in good faith both at the time of contract formation and during its performance. This obligation implies that neither party should cause harm to the other solely to derive benefits from the contract. However, there is no specific definition of this norm, and courts have the discretion to determine whether the principle of good faith and the obligation of fair dealing have been violated.

The role of the principle of good faith in contractual relationships is noteworthy, as it is directly related to the notion of fairness, which generally demands more than mere honesty in human behavior. It requires that parties do not act contrary to the "spirit" of the contract. Good faith is a principle of civil circulation, and therefore the stability of civil transactions depends on it. This principle presupposes not only the existence of rights but also the fulfillment of obligations, which involves the responsibility of participants in civil transactions to treat each other's rights with respect and consideration.

A fundamental dilemma related to this topic is the differing approaches and the ambiguity of the norm. There exists a significant gap in understanding the legal nature of the principle of good faith (Schlechtriem, 1997, p. 5). This gap refers to the open-ended nature of the norm, where lawmakers often have to apply it abstractly. As for the differing approaches, it is debatable whether the principle of good faith contradicts the principle of freedom of contract or whether the specific deficiencies of good faith restrict the parties.

The article discusses both national and international court practices, focusing on the significant interpretation of the principle of good faith by the Supreme Court of Georgia. The object of the study is the principle of good faith, while the subject of the research is the application of this principle in contractual relations, both in international and local practices, as well as doctrinal definitions. To this end, the present work utilizes writings from professors, doctors of legal sciences, and practicing lawyers.

The Principle of Good Faith as a Fundamental Value of Contracts

The principle of good faith addresses gaps in contracts and is considered a moral obligation for the parties involved. Its main goal is to prevent unfair outcomes. It helps interpret specific contract terms and obligations, aiming to avoid undesirable results (Jorbenadze, 2006, p.67). The principle plays a key role in contracts, preventing exploitation and filling gaps or clarifying ambiguities (Markovits, 2012, p.293). Common law has long recognized the obligation to uphold good faith in contract performance, requiring the debtor to act in good faith (Markovits, 2012, p.272-273).

In the contract formation process, which involves offer and acceptance, the parties must agree on fair terms. This means neither party should act in bad faith, such as by deceiving or coercing the other.

The importance of good faith is highlighted by the fact that a contract's validity can depend on it. Under European contract law, a party may reject a contract or its terms if there is a significant imbalance between the parties, either in the process or the substance of the agreement. This happens when one party takes advantage of the other's lack of experience or negotiating power in bad faith (Khunashvili, 2014, p.57).

The principle of contract performance ensures that both parties can rely on each other to meet their obligations. It promotes trust and stability in the relationship, with good faith at the core of this commitment. In essence, entering a contract with someone involves a shared responsibility to perform it in good faith.

The Application of the Principle of Good Faith in Pre-Contractual Relations

Most European legal systems recognize the principle of good faith in pre-contractual relations. This includes the right of each party to negotiate freely. However, if a party negotiates or terminates negotiations in bad faith, they must compensate the other party for any harm caused. In some countries, judicial practice has reinforced the principle of good faith in these pre-contractual interactions (Ioseliani, 2007, p.36).

Culpa in Contrahendo

The first theory related to pre-contractual obligations is *culpa in contrahendo* (Saleilles, 1907, p.12), which holds that parties must negotiate in good faith (Nedzel, 1997, p.112). This theory was founded by Rudolf von Jhering, who argued that law should be understood through its interpretation (Khunashvili, 2014, p.156). Jhering's theory greatly influenced the German Civil Code, which incorporated elements of his theory by imposing strict liability in pre-contractual relations (Kessler & Fine, 1964, p.401).

In German law, the principle of good faith is essential throughout the entire life of a contract, from formation to termination. This means parties must adhere to good faith not only during contract negotiations but also during performance. One key concept, *culpa in contrahendo*, holds parties accountable for any breaches during the negotiation phase before a contract is concluded. This ensures that parties negotiate with honesty and integrity, preventing unfair conduct that could invalidate the contract (Khunashvili, 2014, p.158).

Determining liability in pre-contractual negotiations is controversial, but certain situations clearly indicate liability (Beale, Kotz, Hartkamp, Tallon, 2002, p.243). For example, if negotiations are not intended to result in a contract, this violates the principle of good faith. Additionally, unjustly terminating negotiations when the other party expects a contract, or disclosing confidential information received during negotiations, also breaches good faith. Causing harm during negotiations or entering into a void contract when one party is aware of the situation is similarly a violation (Palmieri, 1993, p.120).

In French law, it is argued that the negotiation stage is not contractual and does not incur liability unless a contract is concluded (Khunashvili, 2014, p.149). However, the principle of good faith remains crucial in contractual relations. Georgian law recognizes pre-contractual obligations and liability, requiring good faith during negotiations to protect the rights and interests of parties involved in contract preparation.

In summary, the principle of good faith is central to contract formation. Parties are obligated to act in good faith, whether or not a contract is concluded or we are referring to the negotiation process.

The Principle of Good Faith in a Contemporary International Context

The principle of good faith is one of the most widely recognized provisions in European contract law, established through codified civil codes. Influenced by European codifications, especially the German Civil Code, this principle is reflected in various articles of the Georgian Civil Code (Ioseliani, 2007, p.12). In Georgia, the foundation for this principle was laid by the 1995 Constitution, which states that the exercise of human rights and freedoms should not violate the rights and freedoms of others (Khunashvili, 2014, p.36). This demonstrates that the Constitution requires individuals to respect the rights and interests of others and refrain from violating them while exercising their own rights. It also prohibits the abuse of rights, implicitly establishing an obligation to act in good faith. Although the Constitution does not explicitly define good faith, it suggests principles of loyalty, care, and respect for others' interests (Khunashvili, 2014, p.36).

The Civil Code defines good faith generally, stating that contracts must be performed in accordance with this principle, and that parties must act in good faith during contractual relations. It also emphasizes that no party should pursue only their own interests when fulfilling obligations. However, the lack of a precise definition of good faith in the law means it is an indeterminate concept. This allows for a flexible evaluation of behavior based on good faith, rather than providing a strict definition. The indeterminate nature of the principle gives courts broad discretion to consider the specifics of each case when making decisions (Jorbenadze, 2006, p.39-40).

A key clarification regarding good faith was made by the Supreme Court in Case No. 1338-1376-2014 (2015). The court reaffirmed the importance of good faith in contractual relations, addressing the misuse of rights by a creditor in a case involving a breach of the duty of good faith and care between creditor and debtor. The court clarified that good faith underpins the behavior of all civil law participants, viewing it as a foundational concept in modern law, philosophy, and business. Good faith implies that parties in civil transactions act responsibly and respect each other's rights. It serves as both a normative and subjective tool, helping resolve gaps in law and contracts.

The principle of good faith primarily requires a party to not only fulfill their obligations properly but also to perform them in good faith, considering and respecting the legitimate interests of the other party. Violating this requirement can lead to liability, not only during the performance of contractual obligations but also during pre-contractual negotiations and in later stages of fulfilling primary obligations.

According to the Supreme Court, the functions of good faith imply that in any obligation-based legal relationship, a creditor cannot refuse to help a debtor fulfill their obligations, especially when such assistance is necessary for the debtor to meet their responsibilities. The court emphasized that cooperation between the parties, consideration of the other party's interests, and special care for the rights and property of the other party (as outlined in Article 316, Paragraph 2 of the Civil Code) are vital for the healthy development of such relationships.

The court also pointed out that the specific circumstances in the case provided a logical basis for considering the forced auction of real estate by the bank—an extreme measure to satisfy the creditor's demands—as a misuse of rights, contradicting Article 115 of the Georgian Civil Code (Case No. 1338-1376-2014, 2015). Furthermore, Article 317 of the Civil Code refers to a party's culpable actions as the basis for liability in pre-contractual relationships, raising concerns about whether it aligns with the principle of good faith, as the concepts of culpability and good faith differ.

In English law, parties are not required to act in good faith. Professor Goode has explained this by stating, "In England, it is difficult to grasp the concept of good faith; we do not fully know what it means" (Goode, 1992). There are reasons for this negative stance: first, it is argued that general principles should be formulated by Parliament, not the courts; second, the principle of good faith is seen as a potential violation of contractual freedom, with parties being bound only by the terms they agreed upon; third, good faith is seen as introducing non-legal criteria; and finally, it is considered to create legal uncertainty (Khunashvili, 2014, p.29). However, the concept of good faith has gained increasing attention among legal scholars, mainly due to directives issued by the European Commission (Brownsword, 1996, p.111). It has been incorporated into recent uniform laws, including the United Nations Convention on Contracts for the International Sale of Goods (CISG), the UNIDROIT Principles of International Commercial Contracts, and the Principles of European Contract Law (PECL) (Apaydin, 2019, p.4).

Historically, common law systems have placed less emphasis on the principle of good faith, but this has changed in recent years with new provisions and court decisions recognizing its growing importance. A notable example is the case *G. Percy Trentham Limited v. Archital Luxfer Limited and Others*, heard by the English Court of Appeal. The case involved two contracts for supplying and installing double-glazed windows, focusing on the offer and acceptance process. The parties indicated that the contract was formed through their actions rather than a formal written agreement. Lord Stein noted that, under English law, the parties' expectations and any conditions not explicitly stated in the contract are typically not considered when determining the contract's terms (Khunashvili, 2014, p.30-31).

In terms of the content of the principle of good faith, Lord Benham's comments in *Interfoto Picture Library Ltd v. Stiletto Visual Programmes Ltd* (1988) are significant. He suggested that the principle of good faith is best understood through expressions like "playing fair" and "telling the truth." He emphasized that good faith involves conducting business openly, transparently, and honestly (Jorbenadze, 2006, p.30).

In a related case, the High Court of England ruled that minority shareholders had suffered unfair prejudice due to the forced removal of two directors. The court found that the majority shareholders had violated an explicit duty of good faith in the shareholders' agreement by failing to uphold the terms protecting the directors' positions. In determining whether the duty of good faith had been breached, the court referred to the case *Unwin v. Bond* ([2020] EWHC 1768 (Comm)), which established five key principles regarding good faith duties. These principles are as follows:

1. Act honestly.
2. Stay true to the shared objective, as outlined in the relevant agreement.

3. Do not misuse power for ulterior motives.
4. Deal with each other fairly and transparently.
5. Consider the other party's interests.

In a recent ruling, *Compound Photonics Group Ltd; Faulkner v. Vollin Holdings Ltd* (2022) EWCA Civ 1371, the Court of Appeal reversed the High Court's decision. The High Court had interpreted an express obligation in a shareholders' agreement to act in good faith as requiring parties to adhere to universal minimum standards of conduct whenever a contractual duty of good faith exists. The Court of Appeal, however, ruled that a broad, universal approach should not be adopted. Instead, the usual principles of contractual interpretation should apply, and there is no inherent "minimum" standard of conduct for a duty of good faith. While the core meaning of a good faith obligation is to act honestly, its scope can vary depending on the specific context and the terms of the agreement. As stated by Snowden LJ in *Compound Photonics*, "Depending on the contractual context, a duty of good faith may be breached by actions taken in bad faith. This could include conduct considered commercially unacceptable by reasonable and honest individuals, even if it is not necessarily seen as dishonest" (EWCA Civ 1371).

This case offers insights for both those advocating for the introduction of good faith duties in English contract law and those opposing it. The ruling emphasized that good faith clauses should be interpreted carefully, taking into account the specific context in which they are used. The Court of Appeal cautioned against applying rigid standards to contractual parties without considering their unique circumstances. At the same time, the case highlights that parties should be cautious when using an express good faith clause to fill gaps in a contract or encourage fair behavior. Due to the vagueness of the concept, such clauses may lead to claims based on broad or subjective interpretations.

For those wishing to include an explicit duty of good faith in contracts, it is recommended to define the scope of this duty clearly, specifying the actions that are (or are not) required to fulfill it. However, this can be challenging, as "good faith" is often used as a catch-all to address uncertainties in a contractual relationship. The term may be seen as too complex or difficult to define fully, and any attempt to include a more detailed definition might be rejected by one of the parties.

It is also interesting to consider how good faith is regulated in American law. The Uniform Commercial Code (U.C.C.) directly recognizes the obligation to act in good faith during the performance of every contract or obligation under this law (Auer, 2001, p. 13-14). However, American law does not impose a duty of good faith in pre-contractual relations (Nedzel, 1997, p.112). In American contract law, good faith is a term that lacks a definitive,

positive understanding and functions instead as an exclusionary concept, meaning it excludes various interpretations depending on the context (Schlechtriem, 1997, p.54). Good faith in the United States is thus seen as a final safeguard. On the international stage, the U.S. plays a dual role, bridging the gap between common law countries and civil law jurisdictions with its approach to good faith and fair dealing.

When discussing the principle of good faith, it is important to consider its regulation in German law. In German legal doctrine, *Treu und Glauben* (honesty and good faith) is a central principle in both obligation law and civil law as a whole (Khunashvili, 2014, p.23). This term demands that individuals act in accordance with social and moral standards. The principle of good faith is also linked to the term *Syntagma*, which refers to a general provision that addresses the increasing difficulty of regulating economic sectors through legislative norms alone, as these sectors are rapidly changing. As a result, there is often a need for more general provisions whose legal significance is growing. The use of such general, or indeterminate, norms is justified by the impossibility of the legislature regulating every relationship, leaving room for judicial law to develop in specific cases. In German law, the principle of good faith is seen as a general legal norm rather than an evaluative category.

There are two main purposes for applying the principle of good faith: first, to foster trust between contracting parties based on the expectation that they will act in good faith; and second, to restore fairness and correct relationships when necessary (Khunashvili, 2014, p.25).

In Germany, the principle of good faith is often seen as a supplementary condition in contracts. It is used to fill gaps when a contract lacks specific provisions. Judges are required to consider what the parties should have disclosed but did not, in light of the overall goal of the contract. As such, the principle of good faith plays a complex role in the supplementary interpretation of contracts, helping to regulate the behavior of legal participants. When needed, it can fill gaps in a contract, modify terms, or even void the contract (Khunashvili, 2014, p.53).

In contrast, the approach to good faith in French civil law differs. Until the mid-20th century, the principle of good faith was not extensively studied in French jurisprudence. However, the French legal approach to this principle has since evolved. Good faith is no longer considered a "dead principle." French law places significant limits on judges' ability to freely interpret contracts, with the determination of contract content and the authenticity of agreements being largely restricted. Free interpretation by judges was traditionally seen as unacceptable interference with the parties' expressed will. Articles 1134 and 1135 of the French Civil Code mention *bonne foi* (good faith) as a criterion for both the performance and content of contracts. Scholars have noted that, despite restrictions on contractual freedom, parties are still

bound by the principle of good faith during both the contract formation and performance processes. This duty of good faith includes obligations of loyalty and cooperation during contract performance (Musy, 2000, p.5). Contract formation is not seen as an obligation of the parties, but fair negotiation is required.

Below is a practical example illustrating the principle of good faith in real-world contexts:

Example: Contract Negotiations in Business

Scenario: A company is negotiating a contract with a supplier for the delivery of raw materials. During the negotiations, the supplier revealed that they can deliver the materials within 30 days, but due to unforeseen circumstances, they may need an additional 5 days. The company, aiming to take advantage of the situation, insists on a firm 30-day delivery date and threatens to cancel the contract if the supplier doesn't meet that date.

Application of Good Faith: The principle of good faith would require the company to be reasonable and fair in its approach. By insisting on an unrealistic deadline and threatening the supplier with cancellation, the company acts in bad faith. Good faith would demand that the company shows understanding of the supplier's situation and works collaboratively to adjust the terms without causing unnecessary harm to the other party.

Real-World Context: In business dealings, parties must not exploit technicalities or hold each other to overly strict terms when one side faces genuine difficulties. This is especially important when the issues are beyond the control of the other party, as it would not be in line with good faith to take advantage of such situations.

Conclusion

This article explores the court's discretion in determining whether the principle of good faith and the duty of fair dealing have been violated. The court has the flexibility to depart from established rules, fill gaps in contracts, and interpret terms when necessary. This flexibility arises from the adaptability of the principle of good faith, which allows courts to create legal mechanisms to protect rights. The principle should not be viewed simply as a tool to assess dishonesty but as a broader, general obligation. While the principle of good faith is clearly important, the research highlights that it faces various legal and substantive challenges. Addressing these issues and establishing clearer regulations is essential.

The incorporation of contract law principles, especially the principle of good faith, into Georgian legislation, inspired by the German Civil Code, is a positive step. However, the lack of a precise definition of good faith remains a point of debate. This ambiguity, however, is what provides the principle with

its flexibility, enabling it to adapt to changes in society and law. It is important that judicial law evolves on a case-by-case basis. In this way, the principle of good faith not only fills gaps when legal norms are unclear but also plays a key role when there is insufficient legislative guidance on a particular issue. It acts as a safeguard against unfair outcomes that might arise from rigid or incomplete legal applications.

From the above, it is clear that the primary goal of the principle of good faith is to protect the interests of a party whose rights are either not directly covered or inadequately covered by existing legal norms. This is where the court's role as a "creator of law" becomes essential, particularly in regulating contractual relationships with gaps in defining norms. A key example of this is a significant interpretation provided by the Supreme Court, explaining that good faith means acting responsibly and respecting the rights of others in civil transactions. Good faith serves as both a normative and subjective tool for resolving gaps in law and contracts.

Special attention should be given to the importance of applying the principle of good faith in existing contracts, where legal relations arise. However, this principle is also relevant in pre-contractual relationships, before a contract is concluded. Article 317 of the Civil Code links culpable actions to liability in pre-contractual relationships. However, this formulation needs revision, as culpability and good faith are distinct concepts. It might be more appropriate to use the term "not good faith," which would provide the court with greater flexibility in interpretation and avoid associating it with legal violations that could result in excessive costs.

It is crucial that the principle of good faith is not limited to isolated cases and contractual relationships. It should be more broadly applicable, allowing for greater judicial intervention. Additionally, there should be no specific prohibitions that prevent parties from acting in bad faith. Given that the Civil Code does not provide an exhaustive list of contracts, legal relationships that are not explicitly regulated by law may arise. In these cases, parties will seek to enter into contracts with greater accountability and consideration for each other's interests.

While the debate continues on whether there should be a general duty to negotiate in good faith before a contract is formed, the reality for many commercial law advisors is that good faith obligations will inevitably play a role during negotiations. Early-stage agreements are often established to guide the negotiation process itself. Rather than allowing traditional debates to dominate the discussion, we should focus on identifying the specific good faith duties that arise during negotiations and consider the underlying principles that define those obligations.

In conclusion, the full protection of the principle of good faith will be achieved when it is more frequently applied and substantiated by the courts. It

is crucial to eliminate significant gaps and refine the principle at the legislative level.

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