Mid Essex Hospital Services NHS Trust v Compass Group
[2013] EWCA Civ 200

The contract

The Mid Essex Hospital NHS Trust ('the Trust') entered into a contract with a company called Medirest under which Medirest (referred to as 'the Contractor' in the contract) would provide catering and cleaning services for a hospital run by the Trust.

Clause 3.5 of the contract provided that: 'The Trust and the Contractor will co-operate with each other in good faith and will take all reasonable action as is necessary for the efficient transmission of information and instructions and to enable the Trust...to derive the full benefit of the Contract...'.

Clause 5.8 of the contract provided that should Medirest's performance prove defective, then 'the Trust may by notice to the Contractor award Service Failure Points [SFPs]...[against the Contractor]...'. A schedule to the contract provided that a 'Minor Performance Failure' would incur 2 SFPs; a 'Medium Performance Failure' 6 SFPs; and a 'Major Performance Failure' 20 SFPs.

Clause 5.8 of the contract further provided that should Medirest incur any SFPs, then 'the Trust shall be entitled to levy payment deductions against the monthly amount of the Contract Price payable to the Contractor...' A schedule to the contract provided that the Trust would be entitled to deduct £5 for a Minor Performance Failure, £15 for a Medium Performance Failure, and £30 for a Major Performance Failure.

Clause 28.1.10 of the contract provided that should Medirest incur more than 1,400 SFPs over a six month period, then the Trust would be entitled to terminate the contract.

Clause 28.4 provided that 'The Contractor may terminate the Contract...if the Trust...has committed a material breach of the Contract' and the Trust did not correct the breach within a reasonable period of time after having been notified of the breach.

What happened next

Once the contract was up and running in April 2008, Medirest committed numerous breaches of contract, resulting in its incurring more than 1,400 SFPs in the first six months of the contract, and during every rolling six month period thereafter. However, the Trust did not immediately terminate the contract (as it would have been entitled to), but instead sought to make deductions from the amount of money it was obliged under the contract to pay Medirest each month.

In March 2009, the Trust and Medirest agreed that the Trust should deduct £20,000 a month from its contractual payments to Medirest for the next four months. This the Trust did, making deductions in March, April, May and June 2009. By July 2009, continued breaches by Medirest had resulted in the relationship between Medirest and the Trust seriously deteriorating. Medirest's proposal that the Trust should go back to paying it the full contractual amount from July onwards was rejected out of hand by the Trust, which instead informed Medirest that according to its calculations, it was entitled to make deductions of

£711,307 from the money it owed Medirest. The Trust subsequently and unilaterally deducted £137,834 from its July 2009 payment to Medirest, and then on July 27 2009 purported to terminate the contract with Medirest, arguing that Medirest had incurred 82,470 SFPs over the previous six months.

However, while Medirest's performance had been bad, it had not been *that* bad. The Trust's calculation of how many SFPs Medirest had incurred under the contract was seriously flawed. For example, the Trust had awarded 56,360 SFPs against Medirest on August 20 2008 for allowing a chocolate mousse that it was providing hospital patients to go out of date; and 29,075 SFPs for providing some spoons that were unsatisfactory. Medirest challenged the Trust's calculation of the number of SFPs it had incurred under the contract (while still admitting that it had incurred more than 1,400 over the last six months). However, the Trust stood its ground and deducted £106,032 from its August 2009 payment to Medirest.

This was the final straw for Medirest, which had its solictors write to the Trust, invoking Clause 28.4 of the contract, informing the Trust that it had committed various material breaches of the contract, and that if these breaches were not corrected, then Medirest would terminate its contract with the Trust.

The Trust took legal advice, and discovered that its calculations of how many SFPs Medirest had incurred under the contract were seriously mistaken. On September 9, 2009 – one day before the deadline Medirest had set for correction of the material breaches that it alleged the Trust had committed – the Trust's solicitors wrote to Medirest undertaking to repay the sums deducted from its payments in July and August and to review its process for evaluating Medirest's performance. Medirest then received £243,875 from the Trust the following day. However, Medirest was not satisfied with this, and notified the Trust that it was terminating its contract with the Trust.

The Trust subsequently withdrew the notice it had issued in July 2009 that it was terminating its contract with Medirest, and issued a new notice that was to have effect from 23 October 2009 onwards. Medirest agreed with the Trust that the contract would terminate on 23 October 2009, and that it would then be up to the courts to sort out who had been entitled to terminate, and for what.

Cranston J's judgment at first instance

It was agreed on all sides that Medirest had incurred more than 1,400 SFPs in the six months before the Trust purported to terminate the contract in October 2009, and so that termination was justified. The question was really whether the Trust had committed material breaches of contract that would have entitled Medirest to terminate in September 2009. If the Trust had, then that would have disabled the Trust from suing Medirest for any losses resulting from the contract between the Trust and Medirest being cancelled from October 2009 onwards.

At first instance, Cranston J held that Medirest had been entitled to terminate the contract under clause 28.4. This was because the Trust had committed two material breaches of contract:

(1) Cranston J read Clause 3.5 of the contract as imposing on the Trust an obligation to co-operate in good faith with Medirest, and he found that the Trust had failed to do this.

(2) Cranston J held that the power enjoyed by the Trust under Clause 5.8 to 'levy payment deductions' against the monies that the Trust was contractually obliged to pay Medirest, and to award SFPs against Medirest could not be exercised in an 'arbitrary, irrational or capricious manner' and that the Trust had breached this term in awarding ridiculously huge amounts of SFPs against Medirest for very trivial failures, and in deducting correspondingly huge sums from its monthly contractual payments to Medirest.

The Court of Appeal's decision

The Trust appealed to the Court of Appeal (CA). The CA reversed both aspects of Cranston J's decision.

(1) The CA read Clause 3.5 not as imposing a free-standing obligation on the Trust to co-operate in good faith with Medirest (as Cranston J had done), but as imposing an obligation on the Trust to co-operate in good faith *in taking* 'all reasonable action as is necessary for the efficient transmission of information and to enable the Trust...to derive the full benefit of the Contract.' So any failures by the Trust to act in good faith had to relate to a failure to co-operate with Medirest in transmitting information, or in enabling the Trust to benefit from the contract. But no such failures had occurred in this case.

(2) The CA held that a duty not to act in an 'arbitrary, irrational or capricious manner' in exercising a discretion under a contract would only be implied where the 'discretion involved making an assessment or choosing from a range of options, taking into account the interests of both parties' ([83], per Jackson LJ). In such a case, a duty not to act in an 'arbitrary, irrational or capricious manner' because the 'contract would not make sense without it...[it] would [be] absurd...to read the contract as permitting the party in question to exercise its discretion in an arbitrary, irrational or capricious manner' ([82], per Jackson LJ). But it was quite different where the contract gave a party a discretion 'whether or not to exercise a contractual right' ([83]). This was the case with Clause 5.8 which provided that if Medirest's performance under the contract was defective in some respect, the Trust *could* award SFPs against Medirest and it *could* deduct money from its monthly contractual payments to Medirest. Jackson LJ held (at [92]) that there was no justification for implying into Clause 5.8:

> a term that the Trust will not act in an arbitrary, irrational or capricious manner. If the Trust awards more than the correct number of [SFPs] or deducts more than the correct amount from any monthly payment, then that is a breach of the express provision of clause 5.8. There is no need for any implied term to regulate the operation of clause 5.8.

While the Trust had not breached an implied term in clause 5.8 that they would not act in an 'arbitrary, irrational or capricious manner' in deciding whether or not to award SFPs against Medirest or deduct money from its monthly contractual payments to Medirest (because there was no need for such a term to be implied), it had breached clause 5.8 by awarding too many SFPs against Medirest and by deducting too much money from its contractual monthly payments to Medirest. However, the Court of Appeal considered that these breaches were not 'material', within the terms of Clause 28.4, given that they had ended up having no effect on the operation of the contract (as the Trust had repaid the money they had wrongfully deducted pursuant to its incorrect calculation of how many SFPs Medirest had incurred, and had undertaken to review its methods for making those calculations). So those breaches of

Clause 5.8 did not justify Medirest in terminating the contract with the Trust in September 2009.

Points arising out of the CA's decision

(1) The refusal to imply a term that a discretion to exercise an absolute contractual right will not be exercised in an 'arbitrary, irrational or capricious manner' is of a piece with the general stance of English law against finding people liable for, or disabling people from, 'abusing their rights': see, for example, *White & Carter Councils* v *McGregor*. But this is only a general stance, and there are plenty of *specific* examples where the law will prevent someone exercising a right that they would otherwise enjoy under the law when it would be 'arbitrary, irrational or capricious' to do so. See, for example, s 15A of the Sale of Goods Act 1979, which prevents a business buyer of goods rejecting those goods on the basis that they are not of satisfactory quality if 'the breach is so slight that it would be unreasonable to reject them.' Perhaps the best justification of the CA's decision not to imply a term that the Trust's absolute contractual right to levy SFPs against Medirest, or to make deductions from its monthly contractual payments to Medirest, would not be exercised in an 'arbitrary, irrational or capricious manner' is that the Trust could not *ever* have acted in an 'arbitrary, irrational or capricious manner' in levying SFPs that it was entitled to levy, or in making deductions that it was entitled to make under Clause 5.8. As Jackson LJ noted (at [91]):

> The Trust is a public authority delivering a vital service to vulnerable members of the public. It rightly demands high standards from all those with whom it contracts. There may, of course, be circumstances in which the Trust decides to award less than the full amount of [SFPs] or to deduct less than it is entitled to deduct from a monthly payment. Nevertheless the Trust could not be criticised if it awards the full number of [SFPs] or if it makes the full amount of any deduction which it is entitled to make.

So it's the arms-length – almost adversarial – nature of the relationship between the Trust and Medirest which meant that Medirest could expect no mercy from the Trust if it failed to perform properly under the contract. If the Trust did have mercy on Medirest and failed to levy the full number of SFPs awardable against it, or deduct the full amount of money deductible from the monthly contractual payments, then that would always be a concession to Medirest, never something that Medirest could claim to be contractually entitled to.

(2) The CA judgments provide some useful pointers on contractual interpretation:

(i) *Good faith*. If a term in a contract requires a party to act in 'good faith' what does that mean? Jackson LJ held that 'the content of a duty of good faith is heavily conditioned by context' ([109]). Two possible interpretations seemed to be distinguished:

(a) a weak interpretation, according to which a party who is required to act in good faith is merely required to act honestly (*Manifest Shipping* v *Uni-Polaris Insurance* [2001] UKHL 1, if you want an authority);

(b) a strong interpretation, according to which a party who is required to act in good faith is required to observe reasonable commercial standards of good dealing and to act consistently with the purposes of the contract and the legitimate expectations of the other party (*CPC Group* v *Qatari Diar Real Estate Investment* [2010] EWHC 1535 (Ch)).

In this context, the CA held that 'good faith' bore its weak meaning, with the result that Clause 3.5 of the contract merely required the parties to 'work together honestly endeavouring to achieve the two stated purposes' (i.e. transmission of information, and enabling the Trust to benefit from the contract) ([112], per Jackson LJ). Given this, the Trust

had never failed to act in good faith as it had always honestly thought itself entitled to do what it did.

(ii) *Material breach*. Clause 28.4 of the contract provided that Medirest could terminate if the Trust committed 'material' breaches of its contract with Medirest. Jackson LJ held (at [126]) that 'In my view this phrase connotes a breach of contract which is more than trivial, but need not be repudiatory' and, in this context, the breach had to be more than 'more than trivial' – it had to be 'substantial'.

(3) So far we have been focussing on Jackson LJ's judgment, with which the other two members of the CA agreed. But the two other judges contributed some useful *dicta* in their own judgments:

Lewison LJ (at [141]): 'it is not generally a breach of contract merely to assert rights which the contract does not confer.'

Beatson LJ (the author of *Anson on Contract*!) (at [154]): 'The contract in the present case is a detailed one which makes specific provision for a number of particular eventualities... In a situation where a contract makes such specific provision, in my judgment care must be taken not to construe a general and potentially open-ended obligation such as an obligation to "co-operate" or "to act in good faith" as covering the same ground as other, more specific, provisions, lest it cut across those more specific provisions and any limitations in them.'