

ALIVE AND WELL, THE GOOD FAITH PRINCIPLE IN TURKISH CONTRACT LAW

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INTRODUCTION

From an economic perspective the default rules of contract law try to mimic the fully specified contract. They allocate risk to the cheapest cost avoider or the cheapest insurer, as parties would have done in their mutual interest. They also specify norms to curb opportunistic behavior, which leads to an unwanted redistribution of wealth between parties rather than increasing each party's wealth. Thus contract law tries to allocate risks and imposes contractual, pre-contractual and post-contractual duties ideally in a way which fair but self interested parties would have chosen themselves had they cared to specify them. However the rules as laid down in the law might sometimes lead to unintended and absurd consequences. They might fit for many cases but not for all cases.

Good faith is a principle prominent in civil law countries but less so in common law countries, which allows courts to deviate from the black letter rules. It provides them with flexibility to change the outcome of a deductive decision on the basis of the law if they regard it as absurd. The principle of good faith thus empowers the judiciary to deviate. The alternative to such a flexible blanket clause would probably not be an equally flexible contract law, which is continuously updated by parliaments, but stickiness and incapacity to react to unforeseen problems of adjudication. Parliaments cannot change the laws so often as it would be required. They cannot micromanage contract law. If such principles like good faith are not used, one consequence could be that the law cannot adapt to new situations, but lacks innovativeness and convincingness of its outcome. Another consequence could be that parties write long contracts containing all contingencies and parties' duties and try to come close to the fully specified contract. This might explain that contracts in legal orders, which use the good faith principle only reluctantly like in England are often much longer than in civil law countries like Germany, where contracts are less complete and shorter. The upside of this effect is that parties get incentives to write contingencies into the contract and do not so much rely on adjudication and interpretation and on trust in courts and their capability to act as their agent and find the decision which *ex-ante*, when forming the contract they would have themselves chosen. The downside is higher transactions costs of forming the contract.

The principle of good faith gives much power to the judiciary and this power can and has been misused for various purposes. Primarily, it can be misused in the sense of importing ideology into contract law.¹ In fact, under an unchanged contract law,

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¹ The principle of good faith, like other blanket clauses in civil law, had been badly misused during the period of totalitarianism that is in the Soviet Block as well as in Nazi Germany to distort the formal rules of contract law in favor of ideology and party line. In Nazi Germany, the principle has been

ideologically based courts can change contract law by misusing of the good faith principle and the flexibility, which it entails. Another danger is that it might lead to judicial activism in the sense that the judiciary based on principle of good faith develops the law in such a way that it replaces -to some extent- parliament. In fact, the main problem today is the overuse of the concept by the judiciary under the name of “maintaining justice”, with which social justice is meant, that is to redistribute wealth from the rich to the poor party and from the strong to the weak party. A third disadvantage is –following Hayek- that many important clauses of a contract on which parties and the black letter law remain silent, are stipulated by judges, who as outside observers might not have the information to act in the *ex-ante*- interest of all parties even if they had the best intentions to do so.

In this article, we discuss the principle of good faith from an economic perspective and relate this perspective to cases of the Turkish Supreme Court. We deal with contractual good faith and leave aside good faith in property law, which might -depending on the case- result in acquisition of ownership. We argue that if the principle of good faith is used to develop the contract law into an instrument to redistribute wealth in favor of weaker or poor parties, this can destroy the concept of contract as a social mechanism to generate mutual gains for the parties, which might lead to unwanted economic consequences in terms of efficiency losses. We argue that the principle of good faith must be carefully and reluctantly used to reconstruct the fully specified contract and that well informed judges, who understand the factual environment of a contract well, ask how the parties would have allocated the risk in a pre-contractual situation. We also examine and discuss the most important landmark cases of good faith in Turkish contract law and ask whether the decisions of the Supreme Court can be understood either as efforts to improve the risk allocation in the contract and remove opportunistic behavior and therefore is a valuable service to parties or whether these decisions reflect the motivation to redistribute wealth *ex-post* or to serve an ideological purpose and therefore affect or destroy private autonomy on which contract law is based.

I. A Comparison of Contract Law with and without the Good Faith Principle

Over the last decades, the good faith principle has been extended to worldwide use. It is for instance contained in the US Uniform Commercial Code² as well as in the UN

misused to avoid contracts, which did not follow the political line of the ruling party. After being occupied by the Soviet Russia, all judges in East Germany, who were contaminated with Nazism were dismissed. Therefore there were almost no judges in the East Germany anymore. The solution to such obstacle was found to be training new judges in a short period of time. Therefore new judges were trained in 6 months and they were especially educated to use such good faith principle. Similarly during the Nazi period there was the ideology to promote Nazism to contract law. A similar development could be observed in Russia after the Russian revolution when blanket clauses in contract law were instruments to adapt the function of contract law to serve ideological purposes. See Norbert Reich, *Sozialismus und Zivilrecht*, Athenäum Verlag, Frankfurt 1972. In Soviet Russia after the revolution, the inflationary use of blanket clauses in contract law was observed. After the revolution the first idea was to replace the old civil law by a new socialist civil law. However realization of such project was too difficult in practice. In the end, the rulers figured out that they could use blanket clauses such as good faith principle to overcome such obstacle.

² Reference to good faith can be found in various articles of the UCC. Especially see § 1-304 titled as “Obligation of good faith”: “*Every contract or duty within [the Uniform Commercial Code] imposes an obligation of good faith in its performance and enforcement.*” Despite such provision, in the United States, courts and scholars have tried to agree on the exact meaning of the concept. Miller/Perry, p.

Sales Law³. Likewise, in European Union law the principle of good faith is contained in the various rules of consumer protection⁴. It also shows up in the Principles of European Contract Law⁵ of the so-called Lando Commission and UNIDROIT Principles for Commercial Contracts⁶.

In spite of its dangers, it seems that there is general tendency to trust it as an instrument to improve the beneficial properties of contract law as a win-win-mechanism and not to impede them.⁷ However, English courts still reject the good

694. Summers regards good faith as an excluder, which “has no general meaning or meanings of its own, but which serves to exclude many heterogeneous forms of bad faith”. Summers, p. 195. For the distinguishable types of bad faith in contract case law see, Summers, p. 233 ff. Summer’s “excluder approach” is recognized by the Restatement. In Restatement (Second) of Contracts, §205 a, it is stated that “Good faith is defined in Uniform Commercial Code § 1-201(19) as “honesty in fact in the conduct or transaction concerned.” “In the case of a merchant” Uniform Commercial Code §2-103(1)(b) provides that good faith means “honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade.” The phrase “good faith” is used in a variety of contexts, and its meaning varies somewhat with the context. Good faith performance or enforcement of a contract emphasizes faithfulness to an agreed common purpose and consistency with the justified expectations of the other party; it excludes a variety of types of conduct characterized as involving “bad faith” because they violate community standards of decency, fairness or reasonableness. The appropriate remedy for a breach of the duty of good faith also varies with the circumstances.” Burton diverges from Summer’s definition and relates bad faith to exercising of discretion by one of the parties to the contract concerning aspects of the contract, such as quantity, price, or time. According to the author, “Bad faith performance occurs precisely when discretion is used to recapture opportunities forgone upon contracting - when the discretion-exercising party refuses to pay the expected cost of performance. Good faith performance, in turn, occurs when a party’s discretion is exercised for any purpose within the reasonable contemplation of the parties at the time of formation - to capture opportunities that were preserved upon entering the contract, interpreted objectively. The good faith performance doctrine therefore directs attention to the opportunities forgone by a discretion-exercising party at formation, and to that party’s reasons for exercising discretion during performance.” Burton, p. 373. Another major account of the duty of good-faith performance under common law is the “commutative justice”, which refers to the “enforcement of the parties’ actual agreement”. Miller/Perry, p. 712. Accordingly, the good faith principle protects the reasonable expectations of the parties, which they had while contracting.

³ See Article 7(1) CISG: “In the interpretation of this Convention, regard is to be had to its international character and to the need to promote uniformity in its application and the observance of good faith in international trade”.

⁴ See Article 3(1) of Council Directive 93/13/EEC of 5 April 1993 on unfair terms in consumer contracts: “A contractual term which has not been individually negotiated shall be regarded as unfair if, contrary to the requirement of good faith, it causes a significant imbalance in the parties’ rights and obligations arising under the contract, to the detriment of the consumer.”

⁵ Reference to good faith can be found in various articles of the PECL including Articles 1:102, 1:106, 1:201, 1:302, 1:305, 2:301, 3:201, 4:102, 4:107, 4:109, 4:110, 4:118, 5:102, 6:102, 6:111 and 8:109 PECL. Especially see Article 1.201: “(1) Each party must act in accordance with good faith and fair dealing. (2) The parties may not exclude or limit this duty.”

⁶ Reference to good faith can be found in various articles of the Principles including Articles 1.7, 4.8, 5.1.2, 5.3.3, 5.3.4. Especially see Article 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.” For a reference to bad faith see Article 2.1.15.

⁷ Hesselink states that good faith is not a norm of private law, let alone contract law. It is merely an instrument that the judge applies to create new rules. Good faith is “merely the mouthpiece through which new rules speak, or the cradle where new rules are born.” This results from the fact that in continental European systems, judge perceives himself as the person, who applies the law but refrains from creating a rule; changing an adopted rule or interfering with the contractual right of party autonomy (i.e., what parties freely agreed to). Therefore the judge needs to refer to concepts like good faith, which are already adopted by the democratically elected legislator. Hesselink, p. 645.

faith principle.⁸ In an often-quoted decision of the House of Lords of 1992, the duty to negotiate in good faith was rejected on the ground that it runs counter to the antagonistic interests of parties in business relations.⁹ English courts maintain the view that courts should interpret but not change contractual obligations.¹⁰ In other words, English courts leave it more to the parties to allocate all risks themselves.¹¹ This is not to say that flexible methods of interfering into contracts do not exist in English contract law but they have a more limited scope than the broad and overarching good faith principle.¹² What is the consequence of this? If parties have to be very careful to explicitly allocate risks and remove contingencies, which might open space for opportunistic behavior themselves and if otherwise one party bears the consequences, both parties have incentives to do this than in a jurisdiction in which such often remote risks are allocated by court decisions. This makes contracts potentially more authentic. But parties will also spend more time and effort to allocate risks. Consequently, making a contract is more costly in a jurisdiction in which the principle of good faith does not exist and in which the authority of courts to cut into a contract is more limited. In fact, it is well known that contracts are much longer in England than for instance in Germany, where the good faith principle is extensively used and

⁸ “Faced with a problem in contract, the Common lawyer is as likely as not to try to solve it with an implied term. But the Civil lawyer will probably resort to a rule, whether it be a broad and fundamental precept such as the German requirement of good faith (Treu und Glauben)...” Nicholas, p. 950. Common law lawyers regard good faith principle as “...an invitation to judges to abandon the duty of legally reasoned decisions and to produce an unanalytical incantation of personal values.” Bridge, p. 413; also see Zimmermann, p. 15 ff. According to Steyn, there is no need for adoption of good faith principle in English law as long as the courts take into consideration the reasonable expectations of the parties in accordance with the own pragmatic tradition of English law. Steyn, p. 442. Also arguing that other mechanism in English law lead to some of the legal results, which are deal with good faith principle under other legal systems, see Zimmermann, p. 45 ff. On the other hand, according to Piers, good faith has always played an important role in English law, without an explicit reference to the concept. However, unlike civil law countries, it has never taken root as a general principle. Piers explain this with the difference between the civil law system and common law system in the sense that the civil law’s deductive method of reasoning results in creating and referring to abstract principles such as good faith as the foundation of practical findings. On the other hand, common law’s inductive reasoning constitutes a structural reluctance to adopt overarching, general principles. Piers, p. 167-168.

⁹ “...the concept of a duty to carry on negotiations in good faith is inherently repugnant to the adversarial position of the parties when involved in negotiations. Each party to the negotiations is entitled to pursue his (or her) own interest, so long as he avoids making misrepresentations.” Walford v. Miles [1992] 2 AC 128, 138. Also see Zimmermann, p. 39 ff.

¹⁰ Teubner argues that such divergence of the English law can be explained by the liberalization of the world markets, which led to establishment of more than one form of capitalism. Teubner, p. 24 ff. According to the author, “the British economic culture does not appear to be a fertile ground on which continental bona fide would blossom.” Teubner, p. 27. Laithier objects to such argument and states that if such analysis was correct, American and Scottish legal systems, which are subject to similar type of capitalism, would not recognize good faith as well. Laithier, §II B 1.

¹¹ Musy, p. 6; Goode, p. 2. However, Goode states that unlike the old common law, the modern English courts “... began to try to help the weaker party, as by reducing the rigour of the caveat emptor rule in the sale of goods and by imposing certain duties of good faith in a range of other situations”. Goode, p. 1. For detailed information on good faith in English law, see J.F. O’Connor, Good Faith in English Law, Dartmouth, Aldershot 1990; Simon Whittaker, Good Faith, Implied Terms and Commercial Contracts, Law Quarterly Review, Vol. 129, No. 3, 2013, pp. 451-469. On the assessment that the Anglo-Canadian law does not need to legislate a standard of good faith, see Bridge, p. 425.

¹² According to Piers, English courts and scholars are increasingly inclined to apply rules guided by the notion of good faith and exploring the implications of the principle. Piers, p. 168-169. In the opinion that English law already applies a variety of good faith-related principles, Sims states that “This is best visualised as a set of circles, concentrically placed around the basic moral notion of honesty, which is the minimum standard of behaviour required by the law from all contracting parties. From this centre point, the different applications of good faith spread out in everwidening circles.” Sims, p. 232.

therefore contracts are also more costly.¹³ In England, contracts often contain long laundry lists of duties, obligations, non-competition clauses and other risks, which are explicitly taken care of, whereas this cannot be observed to the same extent in German contracts.¹⁴

If one compares the two solutions, there is an upside and a downside of each of them. The self-restraint of English courts takes the will of the parties as displayed in the contract itself more seriously, which excludes to the larger extent a benign kind of paternalism alien to the idea of contract law. The extended use of good faith however provides the parties with a valuable public service, which serves the same purposes as the rules of contract law themselves, namely to fill in gaps in incomplete contracts¹⁵ and to reduce pre-contractual and post-contractual opportunistic behavior of parties.¹⁶ If courts can be trusted to restrict themselves on this purpose, the good faith principle is preferable.¹⁷

Even in the countries, which accept the principle of good faith, there is general scholarly agreement that the good faith principle, which can fundamentally change a contract, should be used as a last resort if the formal rules of the contract law lead to absurd consequences. This opinion has also been expressed by the Turkish Supreme Court in its decision from 1984: *"...with the rule set forth under Article 2/2 of the Civil Code, an exception is brought to the absoluteness of the Law and right. However, also considering the subsidiarity of this rule, at first the relevant legal provisions shall apply to each case; in some exceptional cases, where the legal provisions which applies causes unjust results, the rule under Article 2.2. can be*

¹³ Here one can quote the saying that a contract, which is 5 pages in Hamburg is 50 pages in Britain and 500 pages in New York.

¹⁴ Referring to the different approaches of civil law system and English law with regard to good faith, Sims argues that the legal methodology remains the same. Therefore it is not surprising that when developing their law of "Treu und Glauben", German courts adopted a common law technique by building up a body of case law to clarify the individual applications of the overarching concept. Sims, p. 232.

¹⁵ Ayres/Gertner, p. 87.

¹⁶ Mackaay/Leblanc regard good faith as the opposite of opportunism and propose a three-step test to operationalize opportunism: *"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."* Mackaay/Leblanc, p. 26. *In fact, Mackaay defines bad faith as the legal term for opportunism.* Mackaay, *The Economics*, p. 12. Opportunistic behavior is inefficient because it encourages parties to take precautions and write longer contracts to deter such behavior and legal uncertainty. This increases the transaction costs and reduces the net gain from the contract. Sepe, p. 27; Mackaay, p. 20. The ultimate precaution would be to forego a contemplated contract altogether and if many potential contractors choose this behavior, the entire market would shrink. Mackaay, p. 13. Mackaay perceives good faith as a last resort tool to prevent opportunistic behavior. In fact, the law provides a range of specific anti-opportunism concepts but sometimes none of such concepts will maintain to curtail a specific manifestation of opportunism. In such cases, courts would resort to good faith. Mackaay, p. 20.

¹⁷ Despite the large ideological difference between the Continental-European legal system and English law, in practice there is no huge difference between the two legal systems. Goode explains the similar opinion with the following words: *"In many cases we arrive at the same answers as you but by a different route. Thus there are numerous situations in which we do not find it necessary to require good faith because we impose a duty which does not depend on good faith."* Goode, p.4.

resorted to in a way to correct the injustice.”¹⁸ This is to be welcomed but it seems that this self restraint was not followed in all cases. We present here an old case,¹⁹ in which in our view the Turkish Supreme Court resorted to the good faith principle prematurely and not as a matter of last resort. Under Turkish law, the tenant is protected against termination of the contract with some exceptions. One exception is the personal use if the owner uses the flat personally. The owner of a real estate sold one percent of his ownership rights to a third person, who then claimed to need the flat for his personal use and wanted to evict the tenant. The Supreme Court came to the conclusion that this transaction was made for the sole purpose to evict the tenant and to circumvent the rules, which protect him and that the owner of the one percent share had no real interest in using the flat for his own purpose. It concluded that this fake transaction violated the principle of good faith. This would not have been necessary given the facts of the case because if the new owner had no intention to use the flat for himself but only to pretend its use to evict the tenant this would straightforwardly be a fictitious transaction and therefore his claim is invalid straightaway without need to use the good faith principle.

II. Economic Functions and Pitfalls of the Good Faith Principle

A. Income Redistribution with Efficiency Loses

1. Good faith as a mechanism to maintain fairness and to redistribute wealth

Fair contracts are win-win constellations, which make all parties better off.²⁰ If such contracts do not carry adverse effects on third parties, they are mechanisms to generate Pareto improvements,²¹ which welfare economists regard as the most obvious and least debatable societal improvements. The role of contract law is therefore to allocate risks in a cost efficient way and to keep the contract fair by curbing opportunistic behavior, which might occur before or after the conclusion of the contract and lead to an unwanted transfer of wealth from one party to another party. The whole body of the contract law can be conceptualized as an endeavor to guarantee the fairness of the contract in the sense of the avoidance of opportunistic behavior²² and the cost efficient allocation of risk²³.²⁴ The welfare economic underpinning of the contract as the Pareto improvement is not questioned but supported by any of these rules of contract law. Therefore any rule of contract law, which would redistribute wealth between the parties in such a way that self-interested

¹⁸ “... Medeni Kanunun 2/2. maddesindeki kuralla, Kanunun ve hakkın mutlaklığı kuralına istisna getirilmektedir. Ancak, bu kuralın taliliği (yani ikinciliği) de gözetilerek; öncelikle her meseleye ona ilişkin kanun hükümleri tatbik edilecek; uygulanan kanun hükümlerinin adalete aykırı sonuçlara neden olabildiği bazı istisnai durumlarda da, 2/2. maddedeki kural, haksızlığı tashi edici bir şekilde uygulanabilecektir.” Yarg. İBGK, 25.1.1984, E. 1983/3, K. 1984/1. In the same vein, also see, Schwarz, p. 204; Dural/Sarı, p. 215; Sungurbey, p. 123; Oğuzman/Barlas, p. 258-259; Akyol, p. 17; Berner/Merz, Art. 2, N. 49; Oğuzman, p. 408. For a study on redundant reference to the good faith principle in Turkish Supreme Court decisions, see Oğuzman, p. 407 ff; also see Oğuzman/Barlas, p. 260, fn. 369.

¹⁹ Yarg. 6 HD 8.6.1953 1953/5970, K. 1953/4240.

²⁰ Veljanovski, p. 111.

²¹ Cooter/Ulen, p. 283; Shavell, p. 61; Shavell, Foundations, p. 293.

²² Posner, p. 94; Kaplow/Shavell, p. 1705.

²³ Harrison, p. 91; Schwartz, p. 143.

²⁴ Schäfer/Ott, p. 277.

but fair and non-opportunistic parties would never have agreed to it would question the very idea of the contract as a mechanism to increase wealth.

It is obvious that not only the contract as stipulated by the parties themselves, but also the contract law in the books with its collection of default and mandatory rules are incomplete and that often new constellations arise which have to be decided. If the good faith principle would be used exclusively to curb opportunistic behavior and to allocate risks in a cost efficient way, little room for controversy would exist. The suspicion against the good faith principle is however that it opens up the possibilities for courts to fix terms of contract, which fair but self-interested parties would never have agreed to, which aim at redistributing wealth from one party to the other and question the win-win property of the contract.²⁵ If this happens parties would react to this and not conclude a favorable contract, which makes both parties better off. This might lead to huge negative effects for the economy. We illustrate this with two obvious cases:

Example 1:

Contract laws usually contain a rule under which partial delivery of the specific performance can be rejected.²⁶ If, for instance, a supermarket buys a thousand packs of rice, the seller is not entitled to make the delivery in several parts. The rationale for this rule is that it saves costs to the buyer, who gets distracted from accepting and storing the merchandise. Assume that the seller, who wanted the whole delivery, discovers that one bag is missing. Has then the buyer a right to refuse specific performance? It is obvious here that the delivery of a bag one day later would not distort the business. Therefore the parties if they had allocated this risk in a fully specified contract in the pre-contractual situation would have uplifted the general rule of contract law for this specific case. If the principle of good faith does the same and uplifts the formal rule and does not allow one party to sit on his rights-even when he has no or only a trivial advantage but causes a huge loss to the other party- the principle of good faith provides a valuable service because it does not impose a rule to which self-interested but fair parties would not have agreed in the pre-contractual negotiations.²⁷

²⁵ According to Sepe, good faith should be a default rule rather than a mandatory rule because the parties are in better condition to evaluate the efficiency condition for good faith. Therefore, the parties must be given the option to choose a literal interpretative regime, where the contract serves as the only evidentiary base that the courts will use in enforcing their agreement". Sepe, p. 57.

²⁶ For instance, this is explicitly set forth under Article 84 (1) of Turkish Code of Obligations.

²⁷ Here, one may quote the opinion of Justice Posner from the decision *Market Street Associates Limited Partnership v. Frey*, 941 F.2d 588, 595: "*The concept of the duty of good faith like the concept of fiduciary duty is a stab at approximating the terms the parties would have negotiated had they foreseen the circumstances that have given rise to their dispute. The parties want to minimize the costs of performance. To the extent that a doctrine of good faith designed to do this by reducing defensive expenditures is a reasonable measure to this end, interpolating it into the contract advances the parties' joint goal.*" According to Sepe, this is one of the clearest descriptions of the law and economics approach to good-faith. Sepe, p. 19, fn. 53.

Example 2:

This example refers to a case of Brazilian contract law, in which the Supreme Court prolonged a rental contract for an indefinite period of time.²⁸ In Rio de Janeiro, a landlord rented his house to a tenant, who used the house as an elderly asylum. However the tenant failed to pay his rents for consecutive months. Therefore, the landlord applied to the Court and asked for the eviction against the tenant. In fact, it is set forth under the Brazilian Landlord-Tenant Law (Law No. 12112/2009) that the landlord can evict the immovable, when the tenant fails to pay the rent stipulated in the contract. In its decision of 2012, the Appeal Court of Rio de Janeiro court prolonged the deadline given to the defaulter tenant to leave the rented house as a form to protect the elderly residents of the asylum.²⁹ The Court stated that the “social function of the contract” is one of the contract law pillars and it is related to the human dignity, which is protected under the first article of the Brazilian Federal constitution, which allows a more humanized view in spite of a predominantly profitable vision.³⁰ In this case, the court, using the principle of good faith and the derived principle of “the social function of contract”³¹ prolonged the duration of the

²⁸ We thank Flavianne Fernanda Bitencourt Nóbrega for valuable information on the good faith principle in Brazil. She provided us with cases and informed us about Brazilian and Latin American legal developments, on good faith in contract law, especially the dogmatic concepts of “social function of a contract” and “constitutionalization of contract law” which extends human rights, originally rights vis a vis the state to the contractual partner.

²⁹ Decision of the Court of Appeal – Rio de Janeiro – Appeal Process Number: RJ 0024579-49.2010.8.19.0004, Court Judge: Des. Ademir Pimentel, Date of Judgment: 01/06/2012, Thirteenth Civil, Landlord: Ivan Felipe, Tenant: Ezio Huais.

³⁰ The new Brazilian Civil Code, enacted in 2002, which came into force in 2003, introduced two important general clauses: “social function of contracts” and “objective good faith”. These general clauses were codified, respectively, in article 421 and article 422 in the chapter of General Provisions of Contracts. The legal provision of article 421 says *ipsis litteris* that “the freedom to contract shall be exercised by virtue, and within the limits, of the social function of contracts” and the article 422: “the contracting parties are bound to observe the principles of probity and good faith, both in entering into the contract and in its performance”. The general clauses of social function of contracts and good faith are generally used by Brazilian Courts in leasing contracts (house, vehicles etc.) against the term of the contracts to allow the lessee to keep the possession of immovable or movable good. The Brazilian leading case of green soybean forward contract sale, which was signed between rich traders (buyers) and poor farmers (sellers) in the year of 2003, illustrates one of the most challenging adjudication of the social function of contract and the good faith general clauses just after the new civil code came into force in 2003. In this case, the judges have changed the terms of the contract applying the “social function of contracts” with the purpose of balancing inequality and redistributing wealth. Before court intervention, this type of forward contract sale “created an environment of private credit that collaborated to finance and to expand the Brazilian soybean production. However, after the lawsuits of the poor farmers and the Courts adjudication of Good faith on 2003, there was a decline from 80% to 20% on signing this type of contract”. Nóbrega, *The Economic Analysis*, p. 39. “Those soybean farmers who did not breach their contracts have also been negatively affected by the strategic reactions of trading and processing companies. The concept of “social function of the contract” introduced in Brazilian civil code led to a higher degree of instability in contracts, raising transaction costs and motivating private economic sanctions” Rezende/Zylbersztajn, p. 207-208.

³¹ A prevailing and widest interpretation (strongly recognized in literature and jurisprudence) of “social function of contract” is proposed by Diniz, who sees the social function as some kind of contractual “super-principle”, comprising precepts of public order, good customs, objective good faith, contractual equilibrium, solidarity, distributive justice, etc. According to the author, it should comprise every constitutionally and/or legally recognized value, which might be said to have a “collective” or “non-individualistic” character. Each one of these social values could thus be used in interpreting the contents of social function. See Maria Helena Diniz, *Curso de direito civil brasileiro*, v. 3. Teoria das obrigações contratuais e extracontratuais. 23. ed., rev. e atual. de acordo com a Reforma do CPC. São Paulo: Saraiva, 2007. Timm states that the social function of contract is regarded as “... a phenomenon

contract.³² In other words, the principle of good faith was used in to prevent evacuation of the flat making the landlord a charitable donator. If we compare this case with the above first case, the difference is striking. In a pre-contractual situation, the landlord would most probably never have agreed to such a clause in the contract, if both parties had taken this risk into account. He would probably have agreed to an extension of contract for some days or weeks in case of a severe distress of his tenant but he would not have agreed to a long and might be indefinite time prolongation of the contract without receiving the rental payment. In other words, the principle of good faith as it is used here is not to maintain the win-win constellation of the contract under fair conditions but to destroy it and distribute wealth ex-post from one party to the other party. The economic consequences of this jurisdiction are mostly unintended as they will lead to more empty flats since the best legal advice one can give to landlords is to ask for a bank guarantee for an indefinite time, which would exclude tenants with low budget and no commercial good name from access to such contracts. From an economic perspective this is a waste of economic resources. Unfortunately, this feature of contract law can be observed in many developing countries.³³

2. Legitimacy of Income Redistribution through Civil Law

Legitimacy of income redistribution by way of civil law deserves further elaboration. For instance in many countries the laborers are protected against the employer by way of minimum wages.³⁴ However from an economic perspective such cases of income

referred to as “publicization”, “socialization” or even as “constitutionalization” of Private Law, which results in institutes traditionally belonging to Civil Law – such as the contract and property – being guided by redistributive criteria inherent to Public Law.” Timm, p. 14. According to Schmidt, from a legislative perspective, the Brazilian provision of “social function of contract” is a unique clause, which is not found in any other country. Schmidt, p. 476.

³² Latin American countries adopt statutes of other countries and they come up with dogmatic concepts that you cannot find in Europe. Within this scope, social function of a contract, which is an official dogmatic concept that is not found in Europe. Another example is the constitutionalization of the contract, which extends contractual rights to the contract. Although this concept was originally created in German literature, according to Nóbrega, the new Constitution of 1988 that restored the democratic regime in Brazil, represented a change from the liberal individualism legal order (strict rule based) to a social welfare legal order (principle and standard oriented). The “hyperinflation” of principles, general clauses and vague concepts in the new legal order favored a decentralized judges-made law system, with the mission to pursue the “social justice.” These shift to a more standard-oriented system and opened the door for judicial activism that weakened contract enforcement, increasing uncertainty. Nóbrega, p. 185.

³³ Hans-Bernd Schäfer met a merchant in New Delhi, who had bought a flat for his 10 year old son and left the flat empty for fear that he might never be able to evict the tenant, when his son wanted to live there about 10 years later.

³⁴ For a selection of legal studies in the literature regarding the economic effects of minimum wages, see Jacob Mincer, Unemployment effects of Minimum Wages, *Journal of Political Economy*, Vol. 84, No. 4, 1976, pp. 87-104; Kerry L. Papps, The Effects of Social Security Taxes and Minimum Wages on Employment: Evidence from Turkey, *Industrial and Labor Relations Review*, Vol. 65, No. 3, 2012, pp. 686-707; Daniel S. Hamermesh, Minimum Wages and Demand for Labor, *Economic Inquiry*, Vol. 20, No. 3, 1982, pp. 365-380; Jeffrey P. Thompson, Using Local Labor Market Data to Re-Examine the Employment Effects of the Minimum Wage, *Industrial and Labor Relations Review*, Vol. 62, No. 3, 2009, pp. 343-366; Charles Brown, Curtis Gilroy and Andrew Kohen, The Effect of the Minimum Wage on Employment and Unemployment, *Journal of Economic Literature*, Vol. 20, No. 2, 1982, pp. 487-528; Peter Linneman, The Economic Impacts of Minimum Wage Laws: A New Look at an Old Question, *Journal of Political Economy*, Vol. 90, No. 3, 1982, pp. 443-469; Alfred Alexander Garloff,

distribution comes with its own cost of causing collateral damages. More specifically, setting minimum wages might increase the rate of unemployment.³⁵ Especially if the minimum wage set by the State is too high, the unemployment rate further increases. In fact in such cases a small group of people who are employed are highly protected but the unemployed group is left with no protection at all. In other words, despite the protection of the employed people, the unemployed people get worse than before.³⁶

Interference in well functioning markets by reducing private autonomy therefore often comes at high costs in terms of economic efficiency and often leads even to huge collateral damages for those groups, which should be protected by the intervention. This is not to say that contracts lead or can lead to social justice. They are structurally unfit for justice, but can realize win-win constellations.

3. Interfering into the freedom of contract for Reasons of Social Welfare

The legitimacy of cutting into the freedom of contract for reason of social welfare is to some extent dependent on what mechanisms exist outside the civil law to achieve distributive justice. Economists usually propose to redistribute wealth for social reasons through a redistributive tax system and a public social welfare system and to leave private autonomy and freedom of contract, which generates more wealth intact. Scandinavian countries like Denmark are examples of states, in which the legal order does not interfere heavily into contracts and the market, but still achieve a high level of distributive justice through the tax and public social security system. The rationale for this is that redistributing taxes causes fewer losses in terms of wealth and economic efficiency than interfering in markets and contracts. If however such a system does not exist or is in its infancy the urge to use contract law for purposes of social justice is big even if it might lead to dysfunctional markets and heavy social losses in terms of a country's wealth. This tendency can be observed in many developing countries and emerging market economies. The good faith principle can and is used for such purposes, as we have shown for the case of Brazil.

B. Enhancement of Efficiency through Good Faith Principle

The principle of good faith however, as it was developed by European and especially German scholars is not aimed at changing the contract into a mechanism of redistributing wealth but of enhancing and increasing the genuine function of a contract and preserve it as an institution to generate mutual gains under fair

Minimum Wages, Wage Dispersion and Unemployment in Search Models: A Review, *Zeitschrift für ArbeitsmarktForschung*, Vol. 43, No. 2, 2010, pp. 145-167.

³⁵ On the contrary opinion, see Card/Krueger, p. 1 ff. "*Some of the new evidence points toward a positive effect of the minimum wage on employment; most shows no effect at all.*"

³⁶ The established view among economists is in favor of income distribution in some cases. Accordingly, if we have a workable market order, which can lead to economic efficiency but not justice, income must be redistributed. However, if we redistribute the income we must consider its costs in terms of collateral damages. In one of his works, Okun compared the income distribution -from the rich to the poor- with carrying water with a leaky bucket. Okun, p. 91 ff. According to the author, when you redistribute incomes you must find the bucket with the smallest possible hole. But the contract law is the one of the "buckets" with the largest hole. If contract law is inappropriate for income distribution, which tools may be used? In this case, the bucket with the smallest hole is transfer payments. Transfer payments -through tax system- from the government must be used to support the people who earn too little. In fact it is cheaper than the collateral damages of the minimum wages. See Okun, p. 101 ff.

conditions, in economic terms to increase economic efficiency. It saves parties' transactions costs.

The following example demonstrates this³⁷: Two medical doctors practiced in Hamburg and K./Württ. As both moved to the other place they agreed to swap their practices. Shortly later, the doctor, who moved to Hamburg decided to come back to K./Württ. as his motive to live in Hamburg was lost. He opened a new practice in the vicinity of his old practice. The other doctor went to the court which ruled that the doctor could open a practice in Hamburg but not in the same vicinity for a certain time, about two or three years.³⁸ The parties had not stipulated a non-competition clause. However the good faith principle worked as an implied non-competition clause. In fact, the court asked the following: if fair parties would have thought about this risk, how would they have allocated it? It decided that parties would have included a non-competition clause into the contract. This is an ex-post imposition of a non-competition clause in the contract by the court with a re-distributional effect. The court does however not intend wealth redistribution for a social reason. It tries to make this and all similar future contracts more efficient in the sense of maintaining the ex ante win-win constellation and not get it uplifted by unfair or opportunistic behavior of one party.³⁹

In practice, a court can use enhance efficiency through good faith principle in three ways: by (i) uplifting a mandatory rule, (ii) uplifting a default rule, and (iii) allocation of risks when the law is silent.

1. Uplifting a mandatory rule

The principle of good faith can enhance efficiency by uplifting a mandatory rule as the following example shows. The manager of a company sold a piece of the company's land for a bargain price to an employee as a kind of bonus for his long service. The contract was in written form but not notarized and therefore did not meet the mandatory form. The manager assured the employee that he could trust him and they had a contract. However, the transfer of title was not made later on on the ground that the contract was not valid.

In this case, the good faith principle may enhance efficiency if the court uplifts the mandatory rule. Otherwise application of the mandatory rule would expose the

³⁷ NJW 1955, 337.

³⁸ For the responses from different legal disputes to the same problem, see Case 19: Doctors swapping practices in Zimmermann/Whittaker, p. 481 ff.

³⁹ According to the English perspective, the courts just want to know what the parties have actually decided, they do not want to tell the parties how they should have decided. Therefore, if this case was brought to an English court, the court would probably argue that if they wanted a no competition clause, they should have written it in the contract. The court would say that the parties have not reallocated the risk and that the risk falls on the person who has taken over the practice in Hamburg. On the other hand, German court would argue that the parties have failed to include such a non-competition clause but they would have done it if they had thought about it. Therefore the court must impose non-competition obligation. One can concede that English courts come closer to the genuine will of the parties if the absence of good faith forces them to write fully specified contracts. But the transactions costs are high. Also the Hayekian argument that courts lack the information to mimic them seems to be overstretched in many such cases.

employee to manipulating practices of the management and board of the company, as he has no realistic chance to insist on meeting the form requirement.

2. Uplifting a default rule

There are some cases in which the contract remains silent but the default rules clearly specify the risk. However sometimes it is clear that the specification of the risk in this particular case is questionable. Depending on the features of the case, if the court sticks to the law (default rule), one gets absurd results. In such cases, good faith principle provides the judge with flexibility that he would otherwise not have.

At this point one can make reference to the default rule regarding the rejection of partial performance. In such case, even though the risk was explicitly specified in the default rules, an exception can be made if it is required by the principle of good faith. For instance, if the seller offers to deliver 999 packs of rice to the market (instead of 1000) and offers to deliver the remaining one pack the other morning, it would be against to the principle of good faith if the buyer rejects such partial delivery. Therefore the court uplifts the default rule.

3. Allocation of risks when the law is silent

There might be cases, where both the contract and default rules are silent about a matter. In other words, in such cases both the contract and default rules are incomplete and they remain silent about the risk allocation with the consequence that the risk allocation is neither fair nor cost saving. In such cases, the principle of good faith can provide an efficient risk allocation. For instance, in the example of medical doctors who swapped their practices, the good faith principle can lead to such an efficient risk allocation.

III. “Taming the Monster” Through an Internal Dogmatic Structure.

A. Consequences of Applying Good Faith Principle

In this section we show, that the good faith principle is not a portal leading to unlimited and willful judicial interpretation, but has an internal structure which limits its use, even though it can be used for an indefinite number of legal requirements and might lead to almost all thinkable legal consequences. For instance, the judge can invalidate the contract, change the price, uplift or change a clause in the contract, grant an injunctive relief, damages, the disgorgement of profits or a removal claim.

An obvious critique of the principle of good faith is therefore its generality and broad scope. The judge might become a kind of “philosopher king”. In this article we abstain from any endeavor to give the principle a legal definition or to add one to the existing catalogue of definitions. For our purpose it is enough to say that it endows judiciaries with an almost unlimited power to interfere into the contract, that it is used as a last resort, when all other methods of interpretation lead to absurd consequences and that the willfulness in most civil law jurisdictions is removed by giving the principle a highly differentiated internal structure.

Jurisdictions, which make extensive use of the principle of good faith developed safeguards to give it structure and to avoid its inflationary use, thus “domesticating the monster” (Zimmermann).⁴⁰ More specifically, lawyers in such countries can rely on well-elaborated legal dogmatic forms,⁴¹ which define terms and conditions under which the principle of good faith can be used.⁴² Thus legal security and predictability can be maintained and deviations from the basic concept of a contract can be prevented.⁴³ In other words, the good faith principle is concretized by splitting it up into categories and subcategories (Fallgruppen).⁴⁴ As a result, the good faith principle loses the character of being a blanket check in the hand of the judge with which he can interfere into any contract as he pleases and according to what he believes is just.⁴⁵ It imposes a series of well-defined checks and legal consequences. Therefore, it gives contract law an innovative flexibility and the possibility to avoid absurd and unforeseen consequences of the formal law without turning law into politics. This dogmatic structure, which reduces its willfulness, can also be observed in Turkish contract law which makes the civil law system in Turkey similar to the continental European system, not only in terms of black letter law, but also in terms of the dogmatic structure which governs the use of the good faith principle. For the benefit of our international readership we give here an overview, which is simplified but not overly simplistic and aimed at showing the differentiated structure of the good faith principle in Turkey.

Table 1 - The Dogmatic Structure of the Good Faith Principle in Turkish Contract Law

Subcategory	Legal Requirements	Legal Consequence
culpa in contrahendo ⁴⁶	-willfully or negligently violating rules of conduct and damaging the other party during contract negotiations	-compensation of reliance damages under the norms of contract law

⁴⁰ Zimmermann/Whittaker, p. 22. Similarly, according to Mackaay, good faith is a guiding principle, which underlies many specific “crystallizations” of prevention of opportunism; however considering the need for legal certainty, it is too general to be applied routinely. Mackaay, p. 17.

⁴¹ These legal dogmatic forms are mainly as follows: culpa in contrahendo, contract with protective effect for a third party (Vertrag mit Schutzwirkungen zugunsten Dritter), liability for breach of trust (Vertrauenshaftung), adaptation of the contract to the changed circumstances (clausula rebus sic stantibus), interpretation and gap filling of laws, interpretation and gap filling of legal transactions, side obligations (Nebenpflichten) and rules of conduct (Verhaltenspflichten).

⁴² For detailed information on these legal dogmatic forms in different countries, see Hesselink, p. 624 ff.

⁴³ Brox, §32, Rdnr. 689; Hesselink, p. 623; Zürcher/Baumann, Art. 2, No. 16.

⁴⁴ Medicus, §15, Rdnr. 137ff.; Hesselink, p. 623; Hausheer/Jaun, Art. 2 ZGB, Nr. 15; Hürlimann-Kaup/Schmid, §7, Nr. 260; Palandt/Grüneberg, § 242, No.2. Schmidt explains this by stating that the legal doctrine has developed an “inner system” (Binnensystem) of good faith. Staudinger/Schmidt, § 242, No. 87. According to Hesselink, in near future, there will be a practical need to abolish such inner system since it will not be manageable due to the enormous number of cases based on good faith. Hesselink, p. 644.

⁴⁵ MüKo/Roth/Schubert, § 242, Nr. 25.

⁴⁶ In Turkish law culpa in contrahendo is regarded as a subcategory of good faith. Kırca, p. 142; Hofer/Hrubesch-Millaueer/Roberto, Nr. 03.98; Riemer, Nr. 23; BK/Hausheer/Aebi-Müller, Rz. 160.

contract with protective effect for a third party (<i>Vertrag mit Schutzwirkungen zugunsten Dritter</i>) ⁴⁷	-close connection of the third party with the contract, -the creditor's interest in protection of the debtor, -foreseeability for the responsible party of the interest of the third party at the time of the contract formation, -the third party's need for protection ⁴⁸	-compensation of damages of the third party under the norms of contract law
liability for breach of trust (<i>Vertrauenshaftung</i>) ⁴⁹	-a special legal relationship between the parties arising from principle of good faith, -acts of one of the parties must have caused other party's trust, which is worth protection, -the trusting party must be disappointed against the principle of good faith, -there must be appropriate causal link between the act and the damage, -the damage must be caused by faulty behavior ⁵⁰	-compensation of (in principle) reliance damages under the rules of contract law
adaptation of the contract to the changed circumstances (<i>clausula rebus sic stantibus</i>)(Article 137 TCO) ⁵¹	-rise of a condition, that at the time of the conclusion of the contract could not be foreseen by the parties and it can also not be expected that the parties should have foreseen it with a reason not originating from the debtor, -change of the facts present at the time of the conclusion of the contract against the debtor, in such a way that, demanding performance from him results against the principles of good faith, -non-performance by the debtor yet or if already performed performance by reserving his/her rights arising from the excessive difficulty of performance.	-adaptation of the contract, -termination of the contract if adaptation is not possible

⁴⁷ Similar to culpa in contrahendo, in Turkish law contract with protective effect for a third party is regarded as a subcategory of good faith. Kırca, p. 103; BK/Hausheer/Aebi-Müller, Rz. 195 ff.; Hofer/Hrubesch-Millauer/Roberto, Nr. 03.103.

⁴⁸ See Gauch/Schluep, Band II, Nr. 3913.

⁴⁹ Gauch/Schluep, Band I, Nr. 982h; ZK/Baumann, Rz. 105 ff.; Riemer, Nr. 24; Hofer/Hrubesch-Millauer/Roberto, Nr. 03.89.; BK/Hausheer/Aebi-Müller, Rz. 175 ff; Kırca, p. 195.

⁵⁰ See Gauch/Schluep, Band II, Nr. 982e ff.

⁵¹ Clausula rebus sic stantibus principle arises from the principle of good faith. Hürlimann-Kaup/Schmid, Nr. 279; ZK/Baumann, Rz. 443; BK/Hausheer/Aebi-Müller, Rz. 225 ff.; Riemer, Nr. 51. However after the reform of the Turkish Code of Obligations, it has been specifically regulated under Art. 137 of TCO.

side obligations (<i>Nebenpflichten</i>) (breach of which constitute a case of positive breach of contract (<i>Positive Vertragsverletzung</i>))	These are either: -breach of obligations, which do not have an independent purpose but serve to appropriate performance of the main and accessory obligations (<i>Leistungsbezogene Nebenpflichten</i>) (such as duty of information, documentation, co-operation, disclosure etc.), or -breach of rules of conduct (<i>Verhaltenspflichten</i>) (such as duty to protect and care) ⁵²	-compensation of expectation or reliance damages
obligation to contract ⁵³	-the claimant's need to contract, -the addressee's dominant position, -the claimant's request, -lack of no valid legal reason for the rejection of the claimant's request.	-obligation to contract, -compensation of damages arising from not contracting
principle of trust (<i>Vertrauensprinzip</i>) in formation, interpretation and gap filling of legal transactions ⁵⁴	-the addressee's rightful acceptance (under the principle of good faith) that one's behavior is a declaration of will directed at him.	-formation of contract as rightfully trusted by the addressee
misuse (abuse) of right ⁵⁵	<i>Alternative requirements:</i> -having no legitimate interest in using the right, or -gross disproportionality between the interest in usage of right and the damage to be given to another person, or -acting against the created trust (contradictory behavior), or -use of rights, which are based on one's immoral act	-loss of using such right, -injunctive relief against the right holder
obligations resulting from facts of the debtor (<i>Faktische Vertragsverhältnisse</i>)	-benefiting from a publicly available service without a contract	-compensation of expectation or reliance damages under the rules of contract law

In Turkey as in other civil law countries it occurs quite seldom that the Supreme Court uses the principle of good faith directly. The court takes resort to one of these well developed subcategories and would make direct use of the principle only in cases in which the established use of the good faith principle within one of the subcategories would lead to absurd legal consequences. This occurs very seldom.

⁵² See Schwenzer, Nr. 67.08 ff.

⁵³ Oğuzman/Barlas, p. 182.

⁵⁴ Riemer, Nr. 18 ff.; BK/Hausheer/Aebi-Müller, Rz 98.

⁵⁵ Misuse (abuse) of right is regulated under Art. 2/II TCC as follows: "The legal order does not protect an explicit misuse of a right." ("Bir hakkın açıkça kötüye kullanılmasını hukuk düzeni korumaz.")

B. Example: Culpa in Contrahendo and Precontractual Disclosure Liability Arising from Good Faith Principle

One outflow of the good faith principle is the doctrine of culpa in contrahendo, which was developed in an article by Rudolph von Jhering⁵⁶ and has entered the contract law system in many countries, including Turkey, where it is regarded as a subcategory of good faith. This principle contains two basic aspects. The first is that contract law should not look at the formation of a contract as a magic moment after which both parties are fully committed to all obligations from the contract, whereas before the contract formation, there exists no contractual obligations whatsoever and parties can only resort to the institutes of tort law or unjust enrichment. On the contrary the culpa in contrahendo doctrine postulates that in the process of contract formation, there arise contractual duties in the shadow of the contract, which does not exist yet. The second aspect of this doctrine is that it limits the legal consequences of a breach of contractual duties to compensation of reliance damages -since no contract was formed but in the process of contract formation one party inflicted harm on another party.

The working of good faith under culpa in contrahendo shows that the good faith principle in this emanation does not allow a court to engage in free speculations about what parties should do and what the legal consequences are when they have not done it, on the contrary the court has to carefully examine whether a breach of duty can be observed and if so reliance damage is the legal consequence.. In this emanation of the good faith principle, therefore, the balance between the necessary flexibility of the law and its structure is carefully kept. We restrict ourselves here to discuss the economic rationale of this rule with regard to the duty of one of the parties to disclose information, which is valuable for the other party to decide whether it should conclude the contract and accept the discussed terms.

We present a hypothetical case, where an expert of carpets knows that on flea markets and antique markets, one sometimes finds a carpet of historical significance and value. Therefore, he regularly visits such markets. On one of these occasions, he discovers that a carpet, which is offered at a price of 2,000 Turkish liras is actually a 700 year old carpet with religious significance and of art historical importance and a national treasure and that it is worth 2,000,000 Turkish liras, that is thousand times as much as the price offered. The carpet had been preserved unused in the loft of the house, recently discovered by a family and sold to the carpet dealer. Neither the family nor the carpet dealer had any idea about the true value of the carpet. The carpet dealer sells the carpet for 2,000 Turkish liras to the art specialist, who sells it for 2,000,000 Turkish liras to a national museum. The carpet seller gets notice of this and takes action against the buyer, claiming that the buyer would have had a duty to disclose his knowledge.

The information that was not disclosed was very valuable for the seller and he would certainly not have concluded the contract at the negotiated price with the information. Therefore it could be argued that such information had to be disclosed. However, if one analyzes this case from an economic and from a legal policy perspective, this view must be rejected. Assume that such a rule actually exists in Turkish law and the

⁵⁶ For the author's famous work, see Culpa in contrahendo: oder Schadensersatz bei nichtigen oder nicht zur Perfektion gelangten Verträgen, Jahrbücher für die Dogmatik des heutigen römischen und deutschen Privatrechts, IV. Band, 1. Heft, 1860, Friedrich Mauke, Jena 1860.

seller would have to be put in a position as if the information had been disclosed. The art expert could not make much profit from his superior knowledge. If he discloses the true value, he must pay the price of it. If he does not disclose he makes no profit. Consequently, he would lose any incentives to exploit his superior knowledge and look for valuable pieces of art in flea markets and antique markets. This holds for all such experts and the most likely result is the following: The carpet seller would sell the carpet for 2,000 TL to a buyer, who uses it as a rug in his house and the extraordinary religious and national value of the carpet remains forever undetected. Economically speaking, the carpet should be placed for display in a museum because this is the highest valued use of the carpet. Contract law is an instrument to shift resources to the highest valued use. In this case, a disclosure rule would destroy the rationale of contract law and lead to an outcome in which the extraordinary value of this resource cannot be exploited.⁵⁷

Now we proceed to another case, in which the rationale is different and in which a duty to disclose preserves the economic function of the contract and does not destroy it. Suppose that the member of a municipal city council has insider knowledge that on the next session of the city council, zoning regulation will be changed and a large area of agricultural land will be transformed into residential land. This decision would increase the price of the land from 1 Turkish lira to 100 Turkish liras per square meter. The member of the council buys a large plot of land from a farmer at the price of 1 TL per square meter without disclosing the imminent decision of the council. A week later, the decision is taken and the price of the respective agricultural land increases accordingly. The seller takes action and claims that the buyer has violated his duty to disclose the information and therefore the contract is void.

This case fulfills the criteria of a duty to disclose because there exists a fundamental difference between this and the first case. In the first case, a duty to disclose would destroy any incentive to collect and make use of this information. In this case however, if this information had not been produced, there would, unlike in the carpet case, be no danger or even possibility that this information does not reach those for whom it is valuable. It is made public for everyone at no cost immediately after the decision of the city council that the land, which was used as the grazing land, can now be used for residential purposes.⁵⁸ Unlike in the carpet case, here the information is not socially productive but only privately productive.⁵⁹ It can only lead to a transfer of wealth from the seller to the buyer but it cannot increase the wealth of the nation.

⁵⁷ Another example may be quoted from the work of the famous philosopher Cicero. Owner of a ship in Alexandria loads his ship with corn and goes to Rhodes, where there is a famine. Due to the conditions in the island, he sells the corn at a high price. However this ship owner is aware that three other similar ships will arrive the island in a short time. Should this ship owner be obliged to disclose to the people that other ships will arrive in a short time? Cicero, Book III, XII, p. 97. According to Thomas of Aquinas the answer is no! According to him, "the goods are expected to be of less value at a future time, on account of the arrival of other merchants, which was not foreseen by the buyers. Wherefore the seller, since he sells his goods at the price actually offered him, does not seem to act contrary to justice through not stating what is going to happen. If however he were to do so, or if he lowered his price, it would be exceedingly virtuous on his part: although he does not seem to be bound to do this as a debt of justice." Aquinas, II, II Q77 (Article 3), Reply to Objection 4.

⁵⁸ We assume here, for convenience, that the latter is the higher valued use.

⁵⁹ Similarly, according to Kötz, under certain conditions, information, which is material to the other party's decision, may exceptionally be withheld. The author sets the criteria to apply the exception as follows: "*First, the information must be 'productive.'* ... *Secondly, the information must not have been acquired costlessly, but be the fruit of active research.*" Kötz, p. 18.

Consequently, any cost incurred to getting such information is a waste of resources and to incur such cost should be discouraged. It should for instance be discouraged to sit for hours in a city council meeting or even become a city council member for the only purpose to acquire inside information, which allow for the unfair redistribution of but no increase of wealth. From an economic point of view, therefore, the legal order should impose a duty to disclose and allow the aggrieved party to avoid the contract due to fraud and ask for reliance damages under the culpa in contrahendo doctrine.

The differentiation between productive and unproductive information was introduced by an article of Jack Hirshleifer⁶⁰ and goes back to a seminal article of Friedrich von Hayek⁶¹. The insights of these authors were later adapted to law and economics and especially to economics of pre-contractual disclosure.⁶² Von Hayek, in his seminal article dated 1945 on the use of knowledge in society realized that one of the basic functions of a market economy lies in its capacity to make use of information, which is very valuable for the society but scattered among different individuals. The very idea of the social productivity of a contract comes according to Hayek from the fact that one individual might have information to use an economic resource much better than the owner of this resource and that this function should be preserved and protected by the rules of the contract law. Later Hirshleifer observed, however, that some economic transactions occur not because the buyer has some socially valuable information, which the seller does not have but that he has only a “foreknowledge”, which a little later everybody has with no cost and whose use cannot improve the allocation of resources.⁶³ Accordingly, to produce socially valuable information should be encouraged and therefore be made profitable, whereas to use foreknowledge should be discouraged and made unprofitable.⁶⁴

This analysis has shown several results. First, it shows that the principle of good faith, which -via the rule of culpa in contrahendo- extends contractual obligations into the phase of precontractual negotiations can serve a valuable purpose. Second it shows that to impose a general duty to disclose into precontractual situation is too unspecified and can sometimes lead to unintended consequences, which might even destroy the very economic rationale of contract law as analyzed by von Hayek. Third it shows that the principle of good faith is not a loose cannon on board of a ship allowing for unlimited interpretation but constrained to a sequence of clearly defined tests and results.

⁶⁰ The author differentiates between “foreknowledge” and “discovery”. The latter, being the “correct recognition of something that possibly already exists, though hidden from view” can be extracted through human act; hence increases social wealth. Hirshleifer, p. 562 ff.

⁶¹ Hayek, F. A.: The Use of Knowledge in Society, The American Economic Review, Vol. 35, No. 4, 1945, pp. 519-530.

⁶² Cooter/Ulen define productive information as the information, which can be used to produce more wealth. “In contracts, redistributive information creates a bargaining advantage that can be used to redistribute wealth in favor of the informed party.” Cooter/Ulen, p. 357.

⁶³ Foreknowledge “will, in due time, be evident to all” and “... it does only the value of priority in time of superior knowledge.” Hirshleifer, p. 562.

⁶⁴ Hirshleifer, p. 573; Eisenberg, p.1665. Similarly, Shavell states that any private information that is foreknowledge must be disclosed to reduce the incentive to wastefully acquire information, which lacks social value. Shavell, Acquisition, p. 21.

Over time the evolving internal structure of the good faith principle sometimes transfers parts it into formal law, as is for instance the case with the culpa in contrahendo doctrine⁶⁵, which after a long development of judge made law was formally introduced into the German civil code in a reform of the civil code in 2002 (§ 311,2). In Germany it is therefore not any more a part of the good faith principle as a blanket clause but integrated in the formal contract law. The same observation holds for the positive breach of a contract, which imposes obligations on a party different from the specific performance, whose negligent violation might lead to a contractual claim of expectation damages. One can argue that some of the dogmatic subcategories of good faith over time get more and more structure until they ripen into black letter law and are formally enacted.

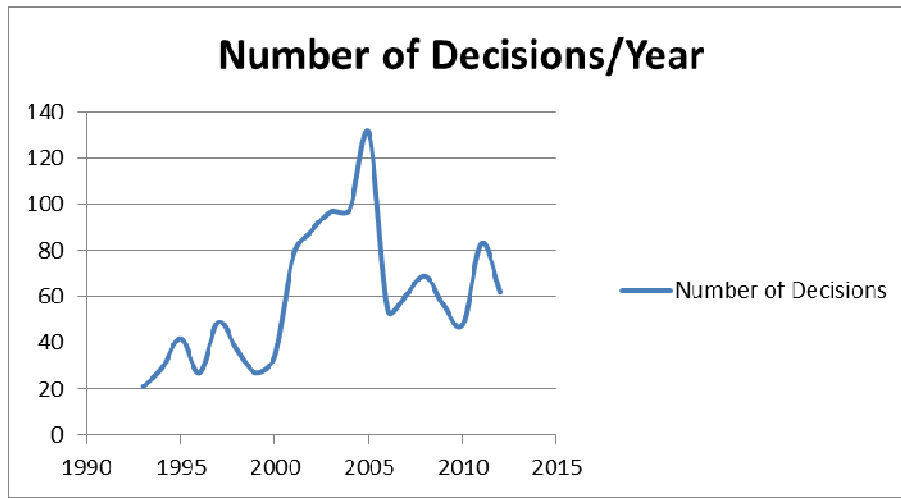
IV. Good Faith from an Economic Perspective in Turkish Law

Now we analyze decisions of the Turkish Supreme Court and discuss two aspects. Does the court use the good faith principle to redistribute wealth in a way to cause efficiency losses or does it try to allocate risk efficiently and curb opportunistic behavior? Does the court use the good faith principle within the internal dogmatic structure using categories and subcategories (Fallgruppen) to channel its use and curb judicial activism or do judges use the principle freehandedly? We discuss especially those Supreme Court cases, which are found in textbooks on contract law in Turkey, as those cases play a prominent role in shaping the views of Turkish lawyers, scholars and judges.

We also tried to find out, how important the use of this principle in Turkish law actually is. This is difficult, because Supreme Court decisions are not officially published in the internet or anywhere else. There exist datasets of Supreme Court cases, which are used by Turkish law firms and were assembled and marketed by private companies. These datasets are neither complete nor are they representative. Neither are the numbers of the following table, which we retrieved from one of them. All figures must therefore be regarded with caution. Neither the absolute numbers nor the changes over time represent any convenient level of accuracy. But the numbers still show, that the good faith principle is factually an important principle of Turkish contract law and is often used by the Supreme Court.

⁶⁵ In Germany the culpa in contrahendo doctrine is –unlike in Turkey or in Brazil- technically not a subcategory of the good faith principle. It was developed as an analogy to §§ 122, 179, 307, 463 S.2, 663 BGB. For positive breach of contract (positive Vertragsverletzung) again another analogy holds, namely to §§ 280, 286, 325, 326 BGB.

Table 2 -The Good Faith Principle in Turkish Courts, 1993-2013



A. Lifelong Care (YİBGK. 5.6.1957 E. 1953/13 K. 1957/20)

The plaintiff concluded a lifelong care provision contract with a person and fulfilled all of his obligations arising from the contract until the death of the other party. . Following his death, when the plaintiff claimed the consideration set forth under the contract, the heirs of the deceased argued that the contract is invalid because of breach of the form requirement. The court rules that, once a lifelong support contract or an adoption contract is fulfilled, following the death of the party who receives lifelong support or the party who adopts a child, it constitutes a misuse of right to claim invalidity of the contract due to breach of form requirements.

The court put the form requirement of a notarized contract aside. This can be criticized on the ground that this form requirement is not only pure formalism but protects vital interests of a house owner against impulsive decisions to buy or sell. In this case, however, the plaintiff could show that it was in the long run and clear interest of the deceased to receive his services. If this contract were invalid many situations could arise in which one party invests very heavily into the contract, without getting the specific counter-performance. This reasoning is therefore in line with economic reasoning, namely, preserving the Pareto improving property of a contract against opportunistic behavior.

B. Wooden Bars (Yarg HGK. 13.1.1965 E.2 K.16)

We add here another good illustrative example, which is not related to contract law. Despite being in accordance with the construction legislation, blocking the sea view of a neighbor by constructing wooden bars constitutes misuse of right if the constructing neighbor has no interest in such construction.

It is obviously inefficient if the owner of a right could use make use of this right with the only purpose to inflict a damage to another person. Therefore, in Turkish law as in the law of many other jurisdictions, one finds the misuse of a right as a limit to the right owner, which is efficiency enhancing.

C. Water Service Subscription (Yarg. 13. HD 24.5.2004 E. 2003/17444 K. 2004/7862)

This case is related to the “obligation to contract”, which originates from the principle of good faith. In this case the state water supply company rejected to make a subscription contract and to supply water service to the owner of a flat by arguing that his previous tenant, who has already evicted the flat has some unpaid bills. The Supreme Court decided that the company is monopoly; hence it has the obligation to contract.

The specific aspect of this case is that the supplier of the water service is a monopoly. The customer has no other choice than to buy his water from this monopoly and also water is a basic good, whose purchase is necessary whatever the costs are. Monopolies have therefore to be controlled with regard to the prices they charge and with regard to the terms and conditions under which they supply their products. Contract law has here to mimic to a certain extent the rules of public and administrative law. If the company operated in a competitive environment, there would be no need for the legal system to interfere but at the same time it would then be highly improbable that a corporation imposed such a clause on a customer for fear to lose him. It is therefore fully in line with economic reasoning that in monopoly markets, the legal system must cut deeper into the freedom of contract than is reasonable or acceptable in well-functioning markets.

D. Illegal Electricity Usage (YHGK 20.12.2000 E. 2000/3-1803 K. 2000/1813)

In this case, the respondent used electricity illegally without signing a contract with the relevant institution and being subscribed. The court ruled that in accordance with the principle of good faith, there is a (contract-like) obligatory relationship between the respondent and the supplier. Therefore, the price calculated by the institution under the Electricity Tariff Regulation must be paid. In other words, the plaintiff cannot argue that his enrichment is lower than the price to be calculated under the Electricity Tariff Regulation or that the institution is not impoverished as much as the amount claimed. These defenses would however be available without using the good faith principle that is if the plaintiff would have to base the claim either on tort law, which leads to damage compensation or on unjust enrichment. In both cases either the amount of damages inflicted to the company or the defendant’s unjust enrichment might be lower than the regulated price for electricity.

Also this case shows that the result is not only in line with fairness or justice, but that an alternative solution would lead to wrong incentives. If one would not assume a contract in this case, which entitles the electricity company to collect the actual price for electricity, this would give incentive to all consumers of electricity to consume electricity without contract and later on burden the electricity company with the costs of a burden of proof for the damages or the amount of unjust enrichment. This would then lead to an increase of illegal electricity consumption.

E. The Bridal Gift (Yarg 2 HD 26.10.1972 E 6437 K 6134 (İBD 1972))

In this case a minor, the respondent, donated a good to his prospective wife. 11 years after they married, he claimed that such donation was invalid due to his lack of

capacity. According to the court, such claim is against the good-faith principle. In this decision, the Supreme Court does not expressly refer to any sub-categories of good faith but it can be induced that the court relates the respondent's act as misuse of right.

It is difficult to make a clear statement on whether this solution is not only in line with the idea of protecting women or the idea of fairness or the idea of justice but whether it is also in line with efficiency consideration. It is clear that this decision, if it is a general rule, comes at a cost of reducing the protection of minors by a judge made rule. The protection of minors has a high economic value because if minors could conclude valid contracts, the resources, which they would transfer would in many cases not go to the highest valued user. The protection of minors therefore does not only protect the minors themselves but also serves the purpose of not wasting resources. If therefore the courts reduced this protection, it comes at a cost and it is impossible to say *prima facie* whether these costs can be regarded as tolerable. The court however made clear that it regarded the time lag between the formation and the refutation of the contract as essential. If the man had refuted the contract shortly after the marriage or after one or two years, the ruling would have come close to an uplifting of the protection of minors and would then be a wealth redistribution, which can be hardly defended on economic grounds. After 11 years, however, the situation might be different.

The economic rationale for adverse possession applies already to some extent here. In addition, the court has stressed the fact that in Turkey donations from the husband to the bride before marriage are in Turkey a very wide spread and common custom. Therefore one can at least insinuate that this ruling destroys incentives for post-contractual opportunistic behavior by not allowing the husband to refer to the invalidity of the contract upon formation. Even if it is undeniable that this judge made rule comes at the cost of reducing the protection of minors and as explained even at an economic cost, it might still have an efficiency gain in terms of reducing opportunistic behavior after the marriage is concluded.

F. Allocation of Jointly-Owned Immovable (Yarg 6 HD 19.4.2005 E. 2005/2112 K. 2005/3863)

In a joint ownership, parties allocated their immovable by a written protocol (against the official form requirement, which requires parties to conclude such contract at the land registry) and each owner rented back his part of the immovable within the last couple of years. While everybody used his/her part as such, one of the parties sold his/her share to a third person. Following such sales, one of the shareholders wanted to use his preemption right. The court ruled that if a party, who did not object before, wants to use his/her preemption right, this is against the principle of good faith. Also in this decision, the Supreme Court does not expressly refer to any sub-categories of good-faith but it can be induced that the court relates the respondent's act as misuse of right.

Again, this is a ruling in line with economic considerations. It is aimed at curbing post-contractual opportunistic behavior. The mandatory form requirement (that the parties must conclude such contract at the land registry) is set aside by the court because its rationale does not apply in this case and the right from it is used in an

opportunistic way. Form requirements like written form or notarized form have the rationale of protecting an actor against impulsive or uninformed decisions, which are not in line with his constant motives and long run preferences. The actor might regret the decision after reconsidering it. They have therefore a similar rationale as for instance cool-off periods in consumer contracts. In the present case, the co-owners of the land had agreed to end their co-ownership and replace it by single ownerships after splitting up the land. The co-owners had also reached an agreement on the division and distribution of the assets between them. The use of the land by the single owners had been agreed in a former protocol and only after a considerable time one of the co-owners made use of his formal right. It is therefore obvious that he did use his right because he regretted his prior decision as being wrong given the changed circumstances at the time of decision making but because new circumstances had arisen, which made it advantageous for him to opt-out of the original contract.

G. High Interest Rate (YHGK 7.4.2004 E. 2004/3-203 K. 2004/213)

This case concerns a cell phone subscription contract and the interest rate applicable to overdue bills. The interest rate is not set in the contract but the GSM operator is given the authority to set it unilaterally. The GSM operator applied an interest rate of 12% per month, which is higher than the 8% interest rate applied by the competitors. The court rules that the GSM operator's freedom to set the interest rate is not unlimited and it is misuse of right to use such freedom in a way to apply 12% interest rather than 8%.

We express here some doubt about this decision. First, it must be understood that this is not a case of a judicial control of standard form clauses.⁶⁶ The avoidance of this clause in a case of judicial control of standard form clauses would in our view be no problem as asymmetric information between the drafter of the contract and the consumer makes this clause a surprising clause, which for this reason alone would make the clause void.

The Supreme Court assumed that the clause is in principle valid as if it had been negotiated between the parties but it then proceeds in maintaining that the only way this clause can be used without violating the good faith principle is to fix an interest rate, which is not higher than the interest rate of competing companies. We believe that this is over stretching the principle of good faith because to fix an interest rate for overdue bills, which is not only higher than the market rate but also even higher than that of competitors might be a legitimate business strategy. If the GSM operator makes it clear to the subscriber that it becomes very costly for a subscriber not to pay bills when they are due this practice signals to all buyers that subscribers who pay their bills are very welcome but the subscribers who do not pay on time are not welcome to the company and should go to some other GSM operator. The high interest rate can therefore be regarded as a kind of contractual fine for not paying bills correctly. The high interest rate deters the defaulting customers and saves the company costs to control money transfers to send reminders, to open court procedures etc. and therefore as the company concentrates on the good customers, it can offer them a lower price for the specific performance. Another company might concentrate

⁶⁶ Judicial control of standard form clauses entered into Turkish consumer protection law with an amendment dated 6 March 2003.

on less reliable customers and offer them a contract in which they do not levy overdue charges at all but finances these extra costs with a higher price, which attracts customers who are not punctual. To sort out the viability and validity of business models is part of the functioning of the market and should not be made possible or impossible by way of court decisions.⁶⁷

If a company wants to concentrate its business operations on good customers, and wants to leave the other customers to their competitors, there is nothing to be criticized as long as the customers do not suffer from the exploitation of either market power or asymmetric information and both is excluded here. This is in our view one of the very few cases in which an undue use of the good faith principle is made, which cuts into private autonomy in a way which a fair but self interested party might not have agreed to if negotiated during the time of contract formation.⁶⁸

We must however emphasize, that the decision can be criticized on economic grounds only, if the interest clause in the contract was not surprising for the customer and that therefore no asymmetric information existed between the parties. The decision would be in line with economic reasoning, if one assumed that the buyer typically does not read or understand the clause, which leaves the fixing of the interest rate to the seller.

H. Long Lease over Foreign Currency (YHGK 7.5.2003 13-332/340)

In this case, parties concluded a five years long lease contract based on foreign currency (US Dollars). Approximately 6 months after the contract formation a sudden and severe currency depreciation doubled the value of the rent in terms of Turkish liras. The court considered the possibility that such changes might lead to a collapse of the contract, a subcategory of the good faith principle. However particularly in this decision and in general, the court rules that change in currency is foreseeable; hence no adaptation is possible. Again this is fully in line with economic considerations. In Turkey sudden exchange rate changes are not seldom. Typically parties, who make a contract denominated in foreign currency, take this into account. They either explicitly or implicitly allocate this risk via the price of the lease contract. If a court would change the price in favor of the plaintiff, this would lead to a reallocation of a risk in his favor, which he has already accepted as part of the rental price. This price would typically be higher, if the rental contract had been concluded in local currency.

I. Agricultural Lease (YHGK, 11.11.2009 E. 2009/14-456 K. 2009/496)

In this case, the court accepted that in an agricultural lease, if the amount of products is very low due to force majeure or natural disaster (in this case excessive draught), adaptation (decrease) of the contractually stipulated lease price is applicable. In fact, in the case, the lease contract concerned an olive grove and the court ruled that

⁶⁷ If we interpret this clause then the interpretation would imply that at least the GSM operator has some reasonable discretion and is not forced to fix an interest rate, which is exactly the market interest rate of the competitors. One could also agree that the principle of good faith becomes again important if the user of this clause makes an unreasonable use of his discretion.

⁶⁸ The only way to defend this decision would be to regard it as a quasi consumer protection case in the sense that such clauses remain unknown to the buyer before he enters into the contract; hence they are not to be taken into consideration. However, this possibility, which would legitimize the avoidance of the unexpected clause, is not given in the decision.

excessive draught was extraordinary and unforeseeable at the time of contract formation.

This is related to exceptional low probability events, which parties do not foresee and stipulate in the contract, this can be regarded as an efficiency increasing reconstruction of the fully specified contract as parties typically do not consider very remote events and internalize them into the price. Here the default rule is replaced, under which the stipulated price must be paid regardless of the amount of product harvested. Again the case is in line with economic reasoning. Foreseeable damages and risks become explicitly or implicitly part of the contract. Either the parties allocate them explicitly in a way, which differs from the default rule, or if the parties do not alter the default rule the risk allocation of the black letter law is reflected in a lower price for the good or service, which compensates the tenant for the risk from foreseeable harvest fluctuations. If however the risk is unforeseeable and remote in the sense that most sellers do not take it into account the default rule would lead to an *ex-post* income redistribution, for which no provision in the price was made. Some doubts about this case however still remain, if one compares it with the previous case, in which the court ruled that the risk of heavy currency devaluation can be foreseen and become part of the price. One can argue that a draught period is also foreseeable in agricultural production.

J. The Propane Cylinder (YHGK 6.5.1992 E. 1992/13-213 K. 1992/315)

The case concerned the explosion of a malfunctioning and not gastight propane cylinder. The explosion not only inflicted damages to the buyer of the cylinder, but also to a third person whom the buyer called in for help and who was injured in spite of trying to take necessary precautions. Although there is no contractual relationship between the third person and the seller, the court rules that the contract between the seller and the buyer is a „contract with protective effect for a third party“⁶⁹ (Vertrag mit Schutzwirkung zugunsten Dritter). Therefore the third party has a contractual claim -not only the weaker tort claim- against the supplier and consequently the relatively long contractual limitation period of 10 years applied to the case.

⁶⁹ For detailed information on contract with protective effect for a third party, see Marc Liebmann, Der Vertrag mit Schutzwirkung zugunsten Dritter: eine Untersuchung zur Rechtsgrundlage und zum Anwendungsbereich des Vertrages mit Schutzwirkung zugunsten Dritter unter besonderer Berücksichtigung der Dritthaftung von Experten, Peter Lang, Frankfurt am Main-Berlin-Bern-Bruxelles-New York-Oxford-Wien 2006; Winfried Puhle, Vertrag mit Schutzwirkung zugunsten Dritter und Drittschadensliquidation, Peter Lang, Frankfurt am Main-Bern 1982; Antonios Karampatzos, Vom Vertrag mit Schutzwirkung für Dritte zur deliktischen berufsbezogenen Vertrauenshaftung : zugleich ein Beitrag zum Ersatz fahrlässig verursachter reiner Vermögensschäden, Nomos, Baden-Baden 2005; Samuel Siegrist, Der Vertrag mit Schutzwirkung zugunsten Dritter nach schweizerischem Recht, Dissertation, Zurich 1997; Werner Urban, "Vertrag" mit Schutzwirkung zugunsten Dritter und Drittschadensliquidation : vergleichende Untersuchung zur Integration in ein System des vertraglichen Drittschutzes, Dissertation, Frankfurt am Main 1989; Claus Dickes, Der Vertrag mit Schutzwirkung für Dritte in den Fällen der Auskunftshaftung, Dissertation, Mainz 1992; Ziegler, Hans-Berndt, Verträge mit Schutzwirkung zugunsten Dritter, Dissertation, Marburg 1978; Hirth, René-Alexander, Die Entwicklung der Rechtsprechung zum Vertrag mit Schutzwirkung zugunsten Dritter in ihrer Bedeutung für den Ausgleich von Drittschäden im Zahlungsverkehr, Duncker&Humblot, Berlin 1991; Kümmeth, Klaus-Wilhelm, Die dogmatische Begründung des Rechtsinstituts des Vertrages mit Schutzwirkung zugunsten Dritter, Dissertation, Berlin 1976.

The economic analysis of this case again requires to answer the question whether in the pre-contractual situation, the buyer and the firm delivering the gas would have agreed in a fully specified contract to extend the contractual liability on persons other than the parties of the contract themselves. One could ask what kind of protection the contract serves because the victim has a tort claim in any case and is entitled to damage compensation. However under Turkish law, the limitation period for contractual claims is longer than for tort law claims. The protection level of contract law is therefore higher than the protection level of tort law.⁷⁰

In a fully specified contract, the company delivering the gas would agree to this additional level of protection by extending the contract to third persons only if the buyer would be willing to pay the expected differential costs of a better protection by contract law, as compared to tort law. The buyer however would only be willing to pay this additional price for the better protection for persons for whom he cares or feels a special obligation, like members of his family or other people very close to him but not to strangers. It is remarkable that the Turkish court makes just this distinction and extends the protective effect of the contract exclusively to those people who are close to the contracting party but not to strangers. It uses therefore an implicit economic logic as the distinction between people close to the party and people not close to the party is just the same as the distinction between those people for whom the party would be willing to pay for the additional protection (compared with the protection under tort law) and those for whom he would not be willing to pay.⁷¹ Again this decision represents only another example to reconstruct the fully specified contract and is in line with the economic reasoning. And again this case does not display any reason to assume that any ex-post income redistribution or wealth redistribution for social purposes is concerned. This, of course, includes people one asks for help in the own house. Again there is no ex-post income redistribution, which has its base not in a fair distribution of contractual risks.

K. Invalid Sales of Flats (YİBK 30.9.1988 E. 1987/2 K. 1988/2)

A landowner signed a contract with a contractor, according to which the contractor had to construct a building on the landowner's land in return for ownership of one or

⁷⁰ In Turkish law, the injured party has a better legal position under contract law than tort law. This has four main reasons: the longer limitation period, strict liability for employees and assistants, presumption of faulty breach and compensation of pure economic losses. First, in tortious claims, the limitation period is 2 years after learning the damage and the offender and 10 years after the tortious act (TCO Art. 72); whereas limitation period for contractual claims is 10 years (TCO Art. 146). Second, in tortious liability, the employer may be released from liability by proving that he showed the due level of care in choosing, instructing and inspecting the employee (TCO Art. 66/2); whereas if the employee damages the other party to the contract, the employer has no such possibility to be released from liability by proving his due level of care (TCO Art. 116). Third, in tortious act, the injured party must prove the fault of the offender (TCO Art. 50/1); however in breach of contract, the burden of proof is reversed, which means that the breaching party must compensate unless he/she can show that he has no fault (TCO Art. 112). Finally, in tort law, pure economic losses can be recovered only if there is a protective norm, or the offender must have acted intentionally and against good faith; however if there is a contractual relationship exists between the offender and the injured party, such losses are always recoverable.

⁷¹ "In the disputed case, the seller (dealer of propane cylinder) has no contractual primary obligation to the plaintiff, who is a third party to the sales contract; however the protection obligation that the debtor has to the creditor extends to the people, who are closely connected to the creditor or under protection due to their close connection to the performance."

more flats for the contractor. Before starting with the construction works, to finance his work the contractor sold these flats to third parties with invalid –not notarized contracts. The buyers paid the price for the flat. Later the contractor argued that he had no obligation to transfer the title of ownership to the buyer without a valid contract. A particular and typical feature of the case is that the value of the flat had risen in the meantime to a higher level than the price the buyer had paid...Without the contract the buyer would have had only a claim from unjust enrichment, which includes the repayment of the price plus interest, but the buyer would lose any gain from the price increase of the real estate. The court ruled that the invalidity claim due to the disregard of form requirements constitutes an abuse of right.

One could argue that this is an obvious case of culpa in contrahendo as it concerns a violation of pre-contractual duties of the seller. The contractor as an expert on real estate knows or must have known that the contract had to be concluded in official form and not to disclose this to the buyer is a clear violation of pre-contractual duties. However the rule of culpa in contrahendo would entitle the buyers only to damage compensation and only the negative interest, which excludes profits made from the specific contract. The court decided that this is a misuse of a right and the court must transfer the title to the buyer so that he can then receive the benefit from the substantial increase in value. Again one can argue that this solution is in line with economic reasoning because it prevents parties from engaging in ruthless opportunistic behavior in the pre-contractual situation to trick the partner into a contract and finance an investment without letting him participate in its return. Otherwise opportunistic construction firms could finance their investment by shifting all risk to the buyer. They could transfer the title of ownership if real estate prices decrease during the period of construction. And they could deny transferring the title, whenever prices of real estate increase and thus get a cheap credit from someone who believed to become owner. From an economic perspective, it is therefore to be welcomed that the Supreme Court did not use the culpa in contrahendo rule but the abuse of right rule, which restores the contract, protects the legitimate expectations of the buyers, and financiers of the project, who are not familiar with form requirements.

L. Non-disclosure (Yarg 13 HD 13.11.1995 E. 1995/9375, K. 1995/9860)

A civil servant concluded an exclusive distributorship agreement with a merchant but failed to disclose the information that he is a civil servant. Under Turkish law it is forbidden for civil servants to engage in any commercial activity. Therefore, the contract between the parties is invalid.⁷² According to 13th Chamber of the Supreme Court, it is against good faith principle not to disclose that he is a civil servant and he cannot engage in commercial activity. Consequently, the court rules that the civil servant will be liable due to culpa in contrahendo, a subcategory of good faith in Turkish law, which leads to compensation for the reliance damages.

⁷² In its decision dated 12 March 1997, the Assembly of Civil Chambers, which is the higher chamber of the Supreme Court interpreted the rule, which prohibits conclusion of commercial contracts by civil servants. Unlike the 13th Chamber, the Assembly ruled that such contracts are not invalid due to prohibition in the law. According to the court, the civil servant will, however, be liable due to non-performance of his contractual obligations. See Yarg HGK, 12.3.1997, E. 1996/13-850 K. 1997/186.

The case above shows that the Turkish Supreme Court applies a duty to disclose information in a way that it serves a productive purpose. The duty to disclose and resulting damage compensation in case of violation, provides incentives not to engage in a legally forbidden transaction. Without this duty to disclose, there arise incentives to trick a merchant into an invalid contract and to invest in such a contract and this investment might be sunk and lost before he corrects his error. Therefore this rule prevents resources from being wasted. The decision is in line with economic reasoning. In general it seems that the Turkish Supreme Court does not use the rule of pre-contractual disclosure indiscriminately and especially not in such cases in which non-disclosure generates incentives to gather socially productive information.

CONCLUSION

In the introductory parts of this article, we pointed to the huge potential benefits but also to the pitfalls of the good faith principle. The principle might be used or misused as an instrument to redistribute wealth between contractual parties in a way in which these parties would not have agreed under fair conditions in a pre-contractual situation. Also, courts might use the principle to support ideology as could be observed in the period of totalitarianism in European countries.

The potential benefit of the good faith principle is however is that it provides courts with the flexibility to avoid unintended and absurd consequences of the formal law, which fair parties themselves would have avoided in a fully specified contract in the absence of transactions costs. This excludes unfair distributional effects, which neither party would have agreed to as well as unnecessary costs of risk allocation. If the court restricts the application of the good faith principle to these functions, it provides elasticity, which otherwise would not exist, if courts would strictly use the rules laid down in black letter law. And it saves transactions costs to the parties and is therefore in line with economic reasoning.

We discussed the landmark cases of Turkish law and asked whether the decisions of the Supreme Court can be understood either as efforts to improve the cost efficiency of risk allocation in a contract and remove opportunistic behavior and therefore are a valuable service to parties and saves them transactions costs or whether these decisions reflect the motivation to redistribute wealth ex-post or to serve an ideological purpose and therefore affect of private autonomy on which the concept of contract is based.

We reached the conclusion that the Turkish Supreme Court refrains from ex-post redistribution of wealth for purely social reasons or from ideological bias. This does not only hold with respect to the cases discussed in this paper, but is a general feature of all cases we could reach in the database of the decisions of the Turkish Supreme Court -even though we cannot exclude that such a case might also exist. The principle of good faith in Turkey is therefore as in many other western jurisdictions a valuable service for parties to allocate risks in a fair and equitable way and spare them transactions costs.

What explains this remarkable feature, which seems for instance to be different from the situation in Latin American countries? For instance, in Brazil concepts like “the social function of a contract” or the “constitutionalisation of contract law” are used to

infringe the idea of a contract as a consensual agreement in favor of a more equitable income distribution to which the contracting parties would not have agreed under fair conditions. We could not find such tendencies in the Turkish jurisdiction. We propose here a tentative explanation. Turkish contract law is a legal transplant from the Swiss Civil Code and Code of Obligations introduced in 1926. Since then Turkish legal scholars and courts did not develop their own indigenous dogmatic superstructures on this code but they followed and adapted the European developments, especially in Switzerland and Germany. This applies also for those legal dogmatic developments, which give the principle of good faith a solid interior structure and split it up into categories and subcategories with different legal elements and consequences. Therefore the Turkish contract law not only inherited the black letter law but judges, lawyers and scholars also use the dogmatic developments, which give structure to such blanket clauses like the good faith principle and prevent them from developing into something which is opposed to the idea of contract.⁷³

⁷³ If one reads a Turkish monography on civil law or law of obligations, one would see that most of the references are made to Swiss or German books and articles.

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