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Analyzing the Consequence of Violating Principle of Good Faith on Commercial Contracts within the Saudi Legal Framework

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Abstract

There is no doubt that the principle of good faith in contracts is essential, including what relates to commercial company contracts. Therefore, it is a very important matter for both contracting parties to adhere to it. If one of them fails to adhere to it, this will be grounds for ruling that the validity and enforceability of the contract is invalid. The Saudi legislator - although did not explicitly refer to this issue - did not neglect to implement it as a basic principle. When we look at the pillars of the objective public and private company contract, we find their close connection to this principle, and if one of them is missed, a serious consequence will result, which is the statement that the contract is relatively or absolutely invalidity. This study explores the consequences resulting from violating principle of good faith on commercial contracts within the Saudi legal framework. This research used the inductive and analytical approach to investigate the research problem. This research found that the Saudi legislator stated that the violation of good faith leads to the invalidating the partnership's contract, absolutely or relatively. It was also recommended that the Saudi legislator should refer to it independently in one or several articles, whether in the Commercial Companies Law, or in other relevant regulations.

Keywords: *Company, contract, corporate system, good faith.*

Introduction

Good faith is indeed a crucial principle for material transactions among people. As the Kingdom of Saudi Arabia operates according to the provisions of Islamic Sharia , it has rightfully given good faith its legal due. Therefore, the application of good faith is evident in various Saudi regulations, including those pertaining to companies and commercial transactions. This research seeks to demonstrate the impact of good faith principle on commercial company contracts.

Research objective

The research objectives that we seek to achieve - God willing - are as follows:

1. Revealing the extent of the Saudi legislator approves the principle of good faith, and explaining the impact of violating it.

2. Explaining the extent to which the principle of good faith contributes to achieving justice, preserving rights, and combating fraud and deception.

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Research questions

The research problem lies in the factors that the effects of the principle of good faith have not been explicitly demonstrated in various legal texts. It has only been mentioned in a few provisions and requires further investigation beyond the text to adequately showcase its effects.

Methodology

This research was based on the inductive and analytical method. We collected a wide range of research sources and references. We started by defining terms in both language and within the legal system. We conveyed the information in my own style, focusing on meaning rather than adhering strictly to the original wording unless direct quotation was necessary.

The research comprised two sections and a conclusion. The first section involved defining the terms of the research title, encompassing the definition of "good faith," "contract," and "companies" in the Saudi system. The second section delved into the impact of violating the principle of good faith in the Saudi system, addressing the absolute and relative invalidity of commercial companies. The conclusion encapsulated the most prominent results and recommendations.

Good faith

Good faith in the Saudi legal system

The Saudi legal system, along with other legal frameworks, does not offer an independent definition of "good faith." Despite the absence of a direct definition, it is regarded as an essential principle in all legal relationships and is presumed to be implicit in all circumstances. Legal scholars have presented various definitions for "good faith," each facing its share of criticism. One notable definition by Dr. Shirzad Sulaiman characterizes good faith as a "commitment to directing the will to achieve the direct purpose of concluding the contract in a manner that aligns with the legitimate justifiable interests of the other party." Scholars have shown considerable differences in defining "good faith," with each definition receiving criticism. To be concise, I have highlighted the most notable definition by Dr. Shirzad Sulaiman, who regards good faith to one's intentions which are aimed at fulfilling the contract's direct purpose in a way that respects the legitimate and justifiable interests of the other party.

Contracts in the Saudi legal system

The Saudi regulations address the aspect of contracts by specifying their provisions and various principles, as evident in the Commercial Companies Law. However, there is no specific definition of a contract as a source of obligations. Nevertheless, we can refer to legal scholars' opinions to clarify the definition of a contract. There are various definitions, but I will mention the prevailing one, which is: "The agreement of two or more wills, leading to a legal consequence, whether it be the establishment, transfer, modification, or termination of an obligation.".

Companies in the Saudi legal system

A company is an institution in which people carry out joint work; In order to make a profit. The term "company" procedurally refers to a legal entity that is established according to the provisions of the Saudi Companies Law (SCL) based on an incorporation contract or articles of association. It involves two or more individuals committing to contribute either money, work, or both, with the aim of making a profit and sharing the resulting profits or losses.

The effect of violating the principle of good faith in the Saudi system

The effect of violating this principle appears when one of the pillars of the contract of public or private commercial companies is non-existent. Failure to do so will result in the company being invalidated. Although this invalidation is consistent with the general rules of invalidation in terms of type, it differs from it in terms of effects. This is because if the principle is that the invalidation of contracts results in returning the contracting parties to the state they were in before contracting, that is, the invalidation has a retroactive effect that goes back to the time of concluding the contract. The judiciary modified the provisions of the general rules, such that the effect of invalidation was limited to the future rather than the past, as a result of its application of what is known today as the theory of the actual company. This effect can be clarified in light of the following two categories:

The commercial partnership is absolutely invalid

Before delving into this requirement, it is important to elucidate the general meaning of invalidity as per legal scholars. Some have defined it as "the legal penalty for the contract not fulfilling all of its elements and fulfilling its conditions. The contract for a company encompasses both general and specific substantive elements, along with formal elements. The general objective elements comprise consent, subject matter, reason, and eligibility. On the other hand, the specific objective elements include multiple partners, offering shares, intention to participate, and sharing profits and losses.. The formal elements are encapsulated in writing and publicity.

The absolute nullity is the nullity that gives every party - whether a partner or a third party - the right to invoke it. The court rules on it ex officio, and it cannot be corrected by ratification, nor is it subject to prescription. Yet, the absence of some objective elements of the commercial partnership results in the absolute nullity of the partnership contract. Upon reflection, we can identify the cases in which the partnership contract is absolutely null and void, as follows: the absence of the consent of one of the partners, the absence of the capacity of one of the partners, the omission of an essential objective element, and the lack of legitimacy of the partnership's premises or its cause.

The impact of absolute nullity on the partners

The partners are affected by absolute nullity in such a way that the partnership contract is treated as though it never existed. As a result, the partners are restored to the state they were in prior to entering into the partnership contract. If the partners had contributed shares to the partnership, those shares are returned to them.

In cases where the partnership has conducted business activities and incurred profits or losses, these must be distributed based on the shares, following the legal distribution outlined in the SCL. Therefore, the distribution of profits and losses cannot be based on the terms of the contract, as the contract is considered to be completely invalid.

The impact of absolute nullity on others

The general rule, as we have observed, is that it is permissible for anyone with an interest to invoke absolute nullity due to its connection to the principles of public law, and the court has the authority to rule on it ex officio. However, the question arises: Is it permissible for the partners to invoke it against a person of good faith?

The right of a person of good faith to invoke nullity against the partners is affirmed, while the partners are prohibited from invoking it against a person of good faith. The statute of limitations does not apply to the right to invoke this nullity. This clearly illustrates the influence of the principle of good faith in contracts, where a person embodying this principle is entitled to maintain their position unless the partners can prove otherwise. The partners are not permitted to invoke nullity against such a person, giving them a stronger position.

To exemplify the impact of this principle, consider a scenario where a company was established with the intention of trading in alcoholic beverages and purchased a car from a merchant for distributing these prohibited substances. If the nullity of the company is later revealed, the partners would not be allowed to refuse payment to the merchant based on the illegitimacy of the company, especially if it is proven that the merchant was unaware of this illegitimacy. This lack of knowledge on the part of the merchant serves as evidence of their good faith.

The relationship between absolute nullity with good faith

The absolute nullity, as discussed in the previous sections, is closely related to the principle of good faith. The circumstances in which the absolute nullity of a partnership contract is ruled are, in fact, evidence of bad faith on the part of one or both of the contracting parties. If the contract is made with the absence of consent, capacity, or the omission of an essential objective element of the partnership, such as the plurality of partners, the contribution of shares, the intention to participate, the sharing of profits and losses, or if the cause or premises of the partnership are unjustifiable, all of these circumstances are considered evidence of bad faith. Therefore, the ruling of absolute nullity in these cases is necessary, and the situation must be reverted to its state prior to the contract.

The relative nullity of the commercial partnership

Relative nullity is a type of nullity that can only be invoked by those who choose to do so in their own interest. The court is not authorized to rule on it ex officio, and it cannot be rectified through explicit or implicit ratification. When considering the general or specific objective elements of companies, relative nullity occurs in cases where one of the partners lacks capacity, or when one of the partners is affected by a defect of consent and approval (such as mistake, fraud, or coercion). Therefore, relative nullity affects both the contracting parties and third parties. This can be further clarified as follows:

The impact of relative nullity on lacking capacity and defective will persons

When the partnership contract is ruled null and void at the request of a person lacking capacity or a person affected by a defect of consent and approval, the partner's status is terminated. They are not required to contribute their share if they have not already done so, and they are not entitled to a share of the profits. Any profits they have received must be returned, and they are not held responsible for any losses. The nullity affects them exclusively, and does not extend to the other partner(.

The impact of relative nullity on others

We have noted that relative nullity can only be invoked by those who establish it for their own benefit, as defined. Therefore, it is not permissible for others to invoke it. For instance, the creditors of the partnership are not permitted to invoke relative nullity to absolve themselves of their debts to the partnership. This right remains exclusive to the partners or one of them, particularly those affected by a lack of capacity or a defect of consent and approval.

The relationship between relative nullity with good faith

Like the relationship between absolute nullity and good faith, relative nullity has a solid relation with the principle of good faith It is noted that the circumstances in which the legal system rules relative nullity are indicative of the bad faith of the contracting parties or one of them. If one or more contracting parties lack capacity, or if one of them is affected by a defect of consent and approval, such as coercion, mistake, or fraud, the termination of the partner's status at their request is a consequence. They are not required to contribute their share, and they are not entitled to a share of the profits. They are not liable for any losses because the partnership is considered void from its inception for them. In partnerships of persons, the nullity affects the entire partnership contract, causing it to collapse for all partners. However, in partnerships of capital, the nullity only affects the partner lacking capacity or affected by a defect of consent and approval, and not the other partners. These circumstances can only occur due to bad faith on the part of some of the contracting parties. It is impossible for a person to enter into a contract with another while knowing that they lack capacity unless the other person is acting in bad faith. Similarly, it is also impossible for someone to enter into a contract with another whose consent and approval are affected by a defect unless their intention is tainted by bad faith. Therefore, the aggrieved party has the right to claim nullity for their own benefit.

Conclusion

The most important results obtained from this research. The principle of good faith in dealings between people, in general, and in the formation of contracts, in particular, is of great importance. It ensures that transactions are conducted with peace of mind and comfort, reducing the need for legal intervention in dispute resolution. The impact of breaching the principle of good faith in partnership contracts under the Saudi legal system is evident in the nullity of both absolute and relative types. This underscores the utmost importance of prioritizing the realization of this principle.

Based on the findings of this modest research, we have arrived at a few recommendations that are subject to constructive criticism. The recommendations are as follows:

1. In light of the paramount importance of the principle of good faith, as established in this research, it is recommended that the Saudi regulator explicitly incorporate it into one or several provisions, whether in the commercial companies law or in other relevant regulations.

2. It is proposed that the Saudi regulator establish a criterion for this principle, which, as indicated in the first section, entails directing the will to achieve the direct purpose of entering into the contract in a manner that aligns with the legitimate and justifiable interests of the other party.

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