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Are you obliged to act reasonably?

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Are you obliged to act reasonably?



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COMMERCIAL CONTRACTS OFTEN CONTAIN provisions that allow one party to take a certain step, or to make a particular decision, which will have an impact on another contracting party. Commenting on such a situation in *Abu Dhabi National Tanker Co v Product Star Shipping Ltd (The 'Product Star')* [1993], Leggatt LJ said that 'where A and B contract with each other to confer a discretion on A, that does not render B subject to A's uninhibited whim.' In other words, the court will normally imply a term limiting the decision maker's discretion.

This article briefly considers the leading case of *Socimer International Bank Ltd (in liquidation) v Standard Bank London Ltd* [2008], where the Court of Appeal held that, where a contract confers an absolute discretion on one party, that party must exercise its discretion honestly, in good faith and not arbitrarily, capriciously, perversely or irrationally. The article goes on to consider three more recent cases which consider the *Socimer* test, and whether instead the objective standard of reasonableness should apply in the circumstances.

THE SOCIMER TEST

In *Socimer*, the Court of Appeal had to consider a provision in a forward sales agreement that gave the defendant bank an absolute discretion, following a default by the claimant bank, whether to liquidate or retain a portfolio of emerging market debt instruments to satisfy the total unpaid amount due. The question before the Court of Appeal was whether the defendant's contractual obligation was to conduct an honest but subjective valuation of the portfolio of assets, or whether, as a matter of contractual implication the defendant was under a duty to take reasonable care to determine their true market value.

The Court of Appeal held that there was no obligation to take reasonable care to arrive at the true market value of the assets. The decision maker's discretion was limited, as a matter of necessary implication, only by concepts of honesty, good faith, and genuineness and the need for the absence of arbitrariness, capriciousness, perversity and irrationally. Subject to those limitations (which reflect the narrow, public law, *Wednesbury* standard of reasonableness),

the decision maker was entitled to act in accordance with its own best interests.

BARCLAYS v UNICREDIT BANK

In *Barclays Bank plc v UniCredit Bank AG & anor* [2012] The claimant bank (Barclays) entered into three synthetic securitisations of loan portfolios with the defendant group of banks (UniCredit). The securitisations were embodied in three deeds of guarantee. The guarantees provided for Barclays to receive quarterly payments and a fixed fee. The guarantees also contained a clause which stated that, where a regulatory change occurred, UniCredit could terminate the guarantees early, provided that it had obtained the prior consent of Barclays. In determining whether or not to grant such consent, Barclays was required to act in a 'commercially reasonable' manner.

Changes were made to the regulatory treatment of the guarantees, which adversely affected UniCredit's ability to obtain capital relief which the guarantees were designed to achieve. UniCredit, thereafter, sought the early termination of the guarantees. Barclays responded by stating that it would not consent unless it was paid the balance of five years' fees, which amounted to €82m. UniCredit refused to pay the fees and claimed that Barclays' demand for the fees was not a commercially reasonable ground for declining consent. Barclays issued proceedings seeking a declaration that it had acted in a commercially reasonable manner in refusing to consent.

A 'COMMERCIALLY REASONABLE MANNER'

In considering what was meant by a 'commercially reasonable manner', Popplewell J considered both the line of cases culminating in *Socimer*, and a number of landlord and tenant cases where a lease expressly required the landlord not to unreasonably withhold consent to assignment or subletting by the tenant and where it was held that it was not necessary for a landlord to prove that the conclusions that led them to refuse consent were justified, provided they were conclusions which a reasonable person might reach in similar circumstances.

Popplewell J held that the correct approach to the application of the clause was as follows:

- 1) As the clause expressly restricted Barclays' discretion to act in a commercially reasonable manner, it was not sufficient for Barclays to show merely that the decision was made in good faith and was not arbitrary, capricious or irrational (the *Socimer* test).
- 2) The question was not whether the decision was justified, but whether a reasonable commercial person in Barclays' position might have reached such a decision (as per the landlord cases).
- 3) In determining what was commercially reasonable, Barclays was entitled to take into account its own commercial interests. It was not obliged to carry out a balancing exercise between its interests and Unicredit's interests.
- 4) Barclays' commercial interest was in earning profits from its fee income under the guarantees. Barclays would be entitled to refuse consent in order to protect its fee income unless the nature or amount of the fee income was so disproportionate to Unicredit's obligation to pay that no commercially reasonable person in Barclays' position could have reached such a decision.

On the facts, Popplewell J had little hesitation in concluding that Barclays had acted in a commercially reasonable manner in refusing to consent unless and until it recovered five years' fees. When Barclays entered into the deal it had a reasonable and legitimate expectation that it would be entitled to its fee income for a minimum of five years, come what may. UniCredit had expressly agreed to pay Barclays a minimum of five years' fees if there was an optional termination by it as a result of a rating event, which might have had the same effect as a regulatory change. Barclays' expectation of a minimum of five years' fees was protected under the terms of other early termination provisions which expressly dealt with the point. Further, UniCredit had failed to show why Barclays' insistence on five years' fees was unreasonable.

YILPORT KONTEYNER TERMINALI VE LIMAN ISLETMELERI AS v BUXCLIFF KG

The claimant in *Yilport Konteyner Terminali Ve Liman Isletmeleri AS v Buxcliff KG* [2012]

'In Barclays v Unicredit, it was held that an express term to act in a "commercially reasonable manner" imposes greater limitations on the decision maker than the Socimer implied term.'

was the operator of the port of Yilport in Turkey. The first and second defendants were the owners and managers of a vessel. The vessel collided with another ship while en route to Turkey. The vessel's port side was pierced by the bow of the other ship both above and below the waterline and two out of eight holds were flooded such that five tiers of containers were fully submerged and a sixth tier was partially submerged.

The claimant gave the defendants permission to berth the vessel at Yilport to discharge the cargo on terms which were set out in a letter of understanding (LOU). The LOU provided, among other things, for the defendants to pay:

'... all inward and outward charges including but not limited to tuggage, pilotage, port duties, berth dues, stevedoring, crantage and all other charges levied in accordance with the terms and conditions of Yilport'.

Those terms and conditions, in effect, entitled the claimant to determine the rates, tariff and pricing that the defendants would be charged.

After the cargo was unloaded the claimant presented the defendants with a bill for the work that it had undertaken in relation to the vessel. The defendants refused to pay the bill in full, although they did make a part payment on account. The claimant issued proceedings for the balance.

ACTING UNREASONABLY?

It was common ground that the claimant's right to fix the charges payable by the defendant was not an unfettered one. However, there was a dispute about the scope of the limitations on that right. The defendants argued that there was an implied term that the charges made by

the claimant must be reasonable. The claimant, on the other hand, relied on *Socimer* and argued that:

- 1) The limitations on the claimant's freedom of decision were that the claimant must have exercised its power or discretion honestly or in good faith and must not have done so arbitrarily or capriciously.
- 2) Unreasonableness in this context was analogous to *Wednesbury* unreasonableness.
- 3) Pursuant to the *Wednesbury* test, the decision remained that of the decision maker, in contrast to the situation where the arbiter on entirely objective criteria was the Court itself.

Having noted that the scope of any implied term will depend on the 'circumstances of the particular contract', the judge accepted the defendants' submissions that, in this case, the relevant test was one of reasonableness, in the broader objective sense, rather than the narrower *Wednesbury* standard of reasonableness (which, in *Socimer*, was equated with 'rationality').

In reaching this conclusion, the judge was influenced by the fact that the claimant was claiming, subject only to very limited restrictions, to have the right to set the price that it was paid for services rendered and that it was unable to cite a case in which the court had been prepared to hold that a contract conferred on a party such a wide discretion in relation to the primary contractual obligation (*Socimer*, for example, concerned the right of a party to determine the value of assets where the contract with the other party was terminated as a result of that other party entering into liquidation). Against

'The Court of Appeal accepted that where, as in Socimer, a contract gave one party the right to make an assessment or to choose from a range of options, a term would be implied that this discretion should not be exercised in an arbitrary, capricious or irrational manner.'

that background, the judge took the view that a reasonable user of the claimant's services would, upon reading the terms and conditions, understand them to be recording the claimant's right to charge a higher price for its work than would arise under its standard rates in the given circumstances, rather than conferring a discretion which was as broad as the one claimed by the claimant.

This victory was, however, a pyrrhic one for the defendants. The judge went on to hold that reasonableness would depend on the facts and circumstances of each particular case and, in this case, most of the sums claimed by the claimant were reasonable.

MID ESSEX HOSPITAL SERVICES NHS TRUST v COMPASS GROUP

In *Mid Essex Hospital Services NHS Trust v Compass Group UK and Ireland Ltd (trading as Medirest)* [2013], Mid Essex Hospital Services NHS Trust (the Trust) engaged a contractor (Medirest) to provide catering and cleaning services at two hospitals in Essex. Clause 5.8 of the contract between the parties provided that, in the event that the services provided by Medirest fell below the required standard, the Trust 'shall be entitled to levy payment deductions' from the monthly contract price and 'may award service failure points'. Both the deductions and the service failure points were to be calculated by agreed mechanisms, which were set out in the contract.

Medirest argued that this provision was subject to an implied term that in exercising its rights under clause 5.8, the Trust would not act in an arbitrary, capricious or irrational manner (and that it had breached this implied term by awarding an excessive

number of service failures and making payment deductions representing more than half the payment due for a six-month period).

The Court of Appeal accepted that where, as in *Socimer*, a contract gave one party the right to make an assessment or to choose from a range of options, a term would be implied that this discretion should not be exercised in an arbitrary, capricious or irrational manner. (Jackson LJ also commented that it would be very difficult to exclude such an implied term although he accepted that it would not be 'utterly impossible' to do so.) In this case, however, the contract contained precise rules as to how service failure points and deductions should be calculated and the discretion involved a simple decision whether or not to exercise an absolute contractual right in accordance with those rules. The contract already contained a 'control mechanism' which limited the Trust's rights under clause 5.8 such that it was not necessary to imply a term that the Trust would not act in an arbitrary, capricious or irrational manner.

KEY POINTS

Where a contract confers on one party an absolute discretion to take a decision, choosing from a range of options which will have an impact on the interests of another contracting party, the court will, as a bare minimum, imply a term that the discretion must be exercised in good faith in a manner which is not arbitrary, capricious or irrational. Subject to those limitations, the decision maker will be entitled to act in accordance with its own best interests.

It is very difficult, albeit not 'utterly impossible', to exclude such an implied term.

Where, however, the only choice conferred on a contracting party is whether or not to exercise an absolute contractual right provided under the contract, no such term will be implied.

In *Barclays v Unicredit*, it was held that an express term to act in a 'commercially reasonable manner' imposes greater limitations on the decision maker than the *Socimer* implied term. The test was whether a reasonable commercial person in the decision maker's position might have reached the same decision as the one taken.

The scope of any implied term will depend on the 'circumstances of the particular contract'. Where the relevant discretion is to determine the price payable under a contract, especially without a choice of options, it is more likely that the discretion will be limited by an objective standard of reasonableness, rather than the narrower *Socimer* test of rationality.

Where a contract contains its own 'control mechanism', it will not be necessary to imply a term that a discretion must be exercised in good faith in a manner which is not arbitrary, capricious or irrational.

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Abu Dhabi National Tanker Co v Product Star Shipping Ltd (The 'Product Star') [1993] 1 Lloyd's LR 397

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Barclays Bank plc v UniCredit Bank AG & anor [2012] EWHC 2655 (Comm)

Mid Essex Hospital Services NHS Trust v Compass Group UK and Ireland Ltd (trading as Medirest) [2013] EWCA Civ 200

Socimer International Bank Ltd (in liquidation) v Standard Bank London Ltd [2008] EWCA Civ 116

Yilport Konteyner Terminali Ve Liman Isletmeleri AS v Buxcliff KG [2012] EWHC 3289 (Comm)