

Discretion is the better part of valour

Jason Rix examines contractual discretion and absolute contractual rights



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'Where a contract is found to include a contractual discretion, the authorities show it will be subject to an implied term that the person exercising the discretion does so honestly and in good faith, with regard to the contract.'

Freedom of contract is a common term but it could potentially lead to uncommon pitfalls. Not all elements of a contract can be specified upfront. So businesses routinely, and sensibly, include contractual decision-making powers in their contracts to address this. However, when it comes to making the decision, the person doing so needs to be aware that there may well be implied restrictions on what they can decide and the bases on which they can reach that decision.

Until recently, the key distinction was between decision-making involving an exercise of absolute contractual rights, on the one hand, and the exercise of a contractual discretion on the other. Absolute contractual rights are unfettered – so the decision-maker is free to act as they choose. The exercise of a contractual discretion is not – a term is implied, as a matter of contractual necessity, that in essence the decision-maker acts rationally.

The distinction between the two was explored by the Court of Appeal in *Mid Essex Hospital Services NHS Trust v Compass Group UK and Ireland Ltd (t/a Medirest)* [2013]. The dispute there was about whether the health trust had correctly applied 'service failure points' under a catering supply agreement. The court held that the agreement contained precise rules for determining this issue; the calculation did not involve the exercise of a discretion as there was only one answer. This was different to the cases which involved making an assessment or choosing from a range of options, taking into account the interests of both parties. In those cases,

unlike *Mid Essex*, the implied term to act rationally operated as a necessary control mechanism on an otherwise unfettered decision.

So what, now, are the different legal standards to which parties will be held when making a decision under a contract and in what circumstances? Below is a guide to help identify and navigate the differences.

Absolute contractual rights: complete freedom to act

A classic example of an absolute contractual right is the right to terminate a contract. As the court noted in *TSG Building Services plc v South Anglia Housing Ltd* [2013], in relation to an express right to terminate on notice: either of the parties 'for no, good or bad reason could terminate at any time'. All that matters in this case is whether you have the right to terminate under the contract or as a matter of law. Other examples of absolute contractual rights from recent case law are set out below:

- In *Shurbanova v Forex Capital Markets Ltd* [2017] the court had to consider Forex's revocation of trades carried out through its dealing desk by Shurbanova, on the basis that they were 'abusive' within the meaning of its terms of business. The court held that there was no implied term that in reaching its decision Forex had to act rationally. If this were the case then the same reasoning would apply to whether a party chose to rescind to misrepresentation rather than seeking damages. The court held that could not be right.

- *UBS AG v Rose Capital Ventures Ltd* [2018] concerned a bank's entitlement to call for repayment of a loan. UBS granted a mortgage to Rose Capital. The mortgage contained various special conditions including that UBS could demand early repayment on three months'

Where a contract is found to include a contractual discretion, the authorities show it will be subject to an implied term that the person exercising the discretion does so honestly and in good faith, with regard to the contract. The implied term also requires that the discretion must not be exercised arbitrarily, capriciously,

capriciously, irrationally or perversely. In the *Wednesbury* sense, not reaching a 'conclusion so unreasonable that no reasonable authority could ever have come to it'. The controversy is whether, and to what extent, a public law test should be deployed in a private law dispute. The answer to this very much depends on the context. The modern approach derives from the *Braganza* case which is discussed in more detail below.

One aspect of the *Wednesbury* test, stressed by the Supreme Court in the *Braganza* case, is that the decision-maker should disregard matters which they ought not to take into account, and conversely, must not refuse or fail to take into account matters which they ought to take into account. The decision-maker has to go through a proper process and, just as importantly, evidence that process.

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notice without the need for a triggering event. The court held that since UBS's right to terminate on notice was unilateral there was no conflict of interest to be weighed between the parties, so there was no need to imply a term to act rationally.

Contractual discretion: duty to act rationally

Contractual discretion, in contrast to an absolute contractual right, is not a simple decision as to whether or not to exercise a right, rather it involves, as explained in the *Mid Essex* case, making an assessment or choosing from a range of options and taking into account the interests of both parties. Recent examples of cases where the court has found there to be a contractual discretion include:

- determining, for the purposes of paying death in service benefit, whether someone who went missing overboard on a vessel had committed suicide (*Braganza v BP Shipping Ltd* [2015]);
- deciding whether or not to consent to a share option being exercised (*Watson v Watchfinder.co.uk Ltd* [2017]);
- assessing 'fair market value' under the Global Master Repurchase Agreement (2000 version) (*LBI EHF v Raiffeisen Bank International AG* [2018]); and
- a non-defaulting party determining its 'loss' under the 1992 ISDA Master Agreement (*Lehman Brothers Special Financing Inc v National Power Corporation* [2018]).

irrationally or perversely. Finally, the more unlikely the outcome of a decision, the stronger the evidence required to justify that decision.

What does this mean in practice?

Firstly, although, technically, the term is implied as a matter of fact, and in theory could be overridden by express terms, the court is very reluctant to accept this is the intention of the parties. To quote the Court of Appeal in *Mid Essex*, 'Such a term is extremely difficult to exclude, although I would not say it is utterly impossible to do so.' This means that even saying that something is to be determined in a party's sole and absolute discretion is not enough to prevail over the implied term. In *Socimer International Bank Ltd v Standard Bank London Ltd* [2008], the contract in question contained various references to the seller acting 'in its sole and absolute discretion'. Nonetheless, the Court of Appeal ultimately held that the test of rationality applied.

Secondly, and this is more controversial, the test derives from public law and the judicial review of a public authority's decision: specifically the duty not to act 'unreasonably' in the *Wednesbury* sense (after the decision in *Associated Provincial Picture Houses Ltd v Wednesbury Corporation* [1947]). In that context, the source of the authority's power is important. In the contractual context, therefore, so the argument goes, you have to look at the clause conferring the decision-making powers. Moreover, the reference to acting honestly and in good faith is more easily understood in the negative: not acting dishonestly or in bad faith. It links up with the reference to not acting arbitrarily,

Documenting the process

The importance of documenting the process can be seen in the *Watchfinder.co.uk* case, where the relevant contractual provision stated:

The Option may only be exercised with the consent of a majority of the board of directors of the Company.

The board thought, wrongly, that it had an unconditional right to veto the exercise of the option. To make matters worse, the board minutes gave no indication of the basis for the decision. This meant the court was unable to find that the decision had been properly reached. When making a decision under a contract it is therefore important to carefully document the reasoning behind the decision.

More evidence required to support unlikely outcome

The point about the strength of evidence is best illustrated by the *Braganza* case. Here a company had to assess whether a man, who had gone missing overboard a vessel, had committed suicide. If he had, his wife was not entitled to death in service benefits. The act of committing suicide was viewed by the court as particularly improbable as the man in question was a practising Catholic. In order to determine that he had indeed killed himself, strong evidence was therefore needed. In other words, the more

unlikely something is, the more cogent must be the evidence required to persuade the decision-maker that it has indeed happened.

Both process and outcome important

Not only is the process important, but so too is the outcome – it must not be so unreasonable that no reasonable person could have arrived at the same outcome. That said, as the Court of Appeal noted in *Socimer*, the decision remains that of the decision-maker and is hence viewed from the decision-maker’s perspective. This means it is possible for the decision-maker to favour their interests over those of another party.

Two alternative standards

The distinction between contractual discretion (duty to act rationally) and an absolute contractual right (complete freedom to act) had seemed tolerably clear. However, the court has, nevertheless, seen fit to interpose two alternative standards respectively, below and above that of rationality.

Not to act vexatiously

The lower of these is an implied standard not to act vexatiously. In *Property Alliance Group Ltd v The Royal Bank of Scotland plc* [2018], the clause in question said: ‘The Lender may, at any time, require the Valuer to prepare a Valuation of each Property’. The natural meaning is that the lender could request a valuation for any reason. However, according to the Court of Appeal, the lender could not do so, for example, for a purpose unrelated to the lender’s legitimate commercial interests; or if doing so could not rationally be thought to advance them. In other words, the lender could not order the valuation simply to cause trouble. Although it used the phrase ‘rationally’, the court stressed that the standard was lower than that for the exercise of a contractual discretion.

Objective reasonableness

The higher standard is one of objective reasonableness. The contrast in drafting that will activate this standard as opposed to one of rationality is illustrated by considering the language in the ISDA Master Agreement which is what the court had to do in *Lehman*

Brothers (mentioned above). Whereas ‘loss’ is something the non-defaulting party ‘reasonably determines in good faith’ under the 1992 ISDA Master Agreement (a rational decision), in order to determine the close-out amount the determining party must ‘act in good faith and use commercially reasonable

absolute right. Finally, you may be able to say that the decision-maker having an absolute right is part of the contractual price of the deal.

However, unless you have chosen objective reasonableness or, in contrast, can be certain that the decision-maker is exercising an absolute right, you

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procedures in order to produce a commercially reasonable result’ under the 2002 ISDA Master Agreement (an objectively reasonable decision). Using a single indicative quotation when a firm quotation and an actual transaction is shortly to be available was held not to be objectively reasonable but might have passed the rationality test.

A further scenario example which shows what objective reasonableness may entail is *Crowther v Arbuthnot Latham & Co Ltd* [2018]. The case concerned the basis on which a bank could refuse to consent to the sale of a property, over which it held security, where it had agreed that it would not unreasonably withhold or delay its consent (a commonly deployed phrase). The court held that the touchstone of reasonableness in this case was that the sale should be at arm’s length and be at fair market value. On the facts, the bank’s reasons for refusing consent had no connection with getting a proper value; rather it was because the sale would leave the bank with less security. So while it might have been rational to refuse to give consent, the court held it was not objectively reasonable to do so.

Conclusion

Faced with this confusion of standards, what are you to do? On the drafting side, you have some tools. If it is objective reasonableness you want you can say so. For the other standards, you have less control. Something is less likely to be seen as a contractual discretion if you have drafted a control mechanism (like service credits and debits) than if you have not. If you can say the decision-maker’s choice is binary (like whether to terminate) then it is more likely to be seen as an

will find yourself in the confused middle ground. In this case you need to think carefully about process and evidencing the basis of any decision, in the same way a public authority fearing challenge may have to. You will also be constrained, without good reason, from taking extreme positions. You should, however, generally be able to act in your own commercial interest. ■

Associated Provincial Picture Houses Ltd v Wednesbury Corporation [1947] EWCA Civ 1
Braganza v BP Shipping Ltd [2015] UKSC 17
Crowther & anor v Arbuthnot Latham & Co Ltd [2018] EWHC 504 (Comm)
LBI EHF v Raiffeisen Bank International AG [2018] EWCA Civ 719
Lehman Brothers Special Financing Inc v National Power Corporation & anor [2018] EWHC 487 (Comm)
Mid Essex Hospital Services NHS Trust v Compass Group UK and Ireland Ltd (t/a Medirest) [2013] EWCA Civ 200
Property Alliance Group Ltd v The Royal Bank of Scotland plc [2018] EWCA Civ 355
Shurbanova v Forex Capital Markets Ltd [2017] EWHC 2133 (QB)
Socimer International Bank Ltd v Standard Bank London Ltd [2008] EWCA Civ 116
TSG Building Services plc v South Anglia Housing Ltd [2013] EWHC 1151 (TCC)
UBS AG v Rose Capital Ventures Ltd & ors [2018] EWHC 3137 (Ch)
Watson & ors v Watchfinder.co.uk Ltd [2017] EWHC 1275 (Comm)