

# COMMERCIAL BRIEFING

## Reasonable determination: a contradiction in terms?

The concept of a “reasonable determination” is often introduced into a contract as a consequence of negotiations led by lawyers. It is a familiar situation: one party wants, or even needs, the right to make a particular determination; the other party agrees, but subject to a boundary of reasonableness within which that determination may be made.

However, many lawyers may not fully appreciate where this boundary actually falls. Many may even assume that the mere reference to a reasonable standard of behaviour implies that a determination must be made in an objectively reasonable way. However, as a string of recent cases highlight, that is often not correct. In fact, when used to describe a determination, the word “reasonable” often means nothing more than “rational”. Moreover, even when a contract does not provide any express limitations at all on the exercise of a party’s discretion, it is likely that limitations will be implied. The context is crucial.

As a result, parties to commercial contracts need to understand what a reasonable determination means in the context of their particular contracts and to ensure that they are not giving their counterparty too much, or too little, leeway in exercising contractual rights.

### Genuinely unfettered discretion

It is important first to acknowledge that a contractual right may be construed so as to provide a party with the genuinely unfettered ability to act as it sees fit. A typical right of this nature is a simple contractual termination right that is not subject to any limitations on its use. All else being equal, it is up to the party which benefits from that right to decide if and when to exercise it.

For example, in *Shurbanova v Forex Capital Markets Limited*, the High Court had to decide whether a clause in a foreign exchange contract afforded one party, the broker, the unfettered right to cancel a trade due to abusive trading on the part of the customer, or whether the right was constrained in some way ([2017] EWHC 2133). The court concluded that the right was unfettered. In reaching that

conclusion, the court relied principally on the fact that the contract did not, expressly or impliedly, require the broker to make any assessment about the impact of exercising the cancellation right. It simply required the broker to decide if it wanted to exercise the right, without the need to make:

- Any determination of a substantive matter.
- An evaluation that affects the interests of both parties, even though this would give rise to a potential conflict of interest.

### Implied limitations

However, the position becomes more complicated when a contract provides an element of discretion to one or more of the parties (see box “Meaning of a discretionary right”). Discretionary contractual rights are often found in commercial contracts. They most frequently consist of a right to determine how another party will be treated for a particular purpose.

For example, the contractual right at issue in *Socimer International Bank Limited (in liquidation) v Standard Bank London Ltd* afforded one party the right, in certain circumstances, to determine the price of a portfolio of assets, which was to be paid by one party to the other ([2008] EWCA Civ 116; see feature article “Sub-prime and credit crunch claims: how deep is your loss?”, [www.practicallaw.com/0-382-1883](http://www.practicallaw.com/0-382-1883)). This right was not expressed to be subject to any particular standard of behaviour. Nonetheless, the Court of Appeal concluded that, because the contract conferred on one party a power to make decisions that would have an effect on both parties, there was an implied term that the power must be exercised honestly, in good faith and not arbitrarily, capriciously, perversely or irrationally.

*Socimer* was not particularly revolutionary; it merely distilled and applied a long line of similar authorities. Nonetheless, the impact of the principles set out in the judgment is significant: without any express provision about the parameters within which a contractual discretion may be exercised, the courts will ordinarily imply a term requiring

the discretion to be exercised rationally and in good faith (see feature article “Good faith and commercial contracts: playing fair”, [www.practicallaw.com/2-603-0189](http://www.practicallaw.com/2-603-0189)).

It follows that, if a party wants to have a genuinely unfettered right to make a decision that affects one or more other parties to the contract, it should say so expressly and unambiguously. It is not enough merely to provide for one party to have the right to make a determination or exercise its discretion.

### Express limitations

Perhaps surprisingly, the position can become even more complicated when parties have sought to impose express limitations on the exercise of a discretionary right. This is neatly illustrated by two decisions arising out of two different versions of the International Swaps and Derivatives Association (ISDA) Master Agreement, both of which turn on the concept of reasonableness.

The first decision, *Fondazione Enasarco v Lehman Brothers Finance SA and another*, concerned the close-out provisions of the 1992 version of the ISDA Master Agreement ([2015] EWHC 1307; [www.practicallaw.com/8-616-5774](http://www.practicallaw.com/8-616-5774)). The relevant part of that agreement provides that, following an event of default, the non-defaulting party has the right to calculate its loss; that is, an amount that it “reasonably determines in good faith” to be its total losses and costs. This loss amount is then payable from one party to the other.

The High Court found that this provision does not impose a requirement that the non-defaulting party acts in an objectively reasonable manner in determining its loss. The non-defaulting party is merely required not to arrive at a determination that no reasonable non-defaulting party could come to. Expressed in these terms, the reasonableness test is substantially the same as the public law concept of reasonableness, as most famously set out in *Associated Provincial Picture Houses Ltd v Wednesbury Corporation* ([1948] 1 KB 223).

Viewed in isolation, the conclusion in *Enasarco* is certainly logically coherent, as

## Meaning of a discretionary right

In *Mid Essex Hospital Services NHS Trust v Compass Group UK and Ireland Ltd*, the Court of Appeal defined the concept of a discretionary right as something that involves making an assessment or choosing from a range of options, taking into account the interests of both parties ([2013] EWCA Civ 200; [www.practicallaw.com/1-526-6126](http://www.practicallaw.com/1-526-6126)). In other words, a discretionary right is a right that:

- If exercised, will have an effect on both parties.
- At least practically, cannot be exercised without the beneficiary of the discretion considering the nature and extent of that effect.

well as consistent with similar decisions in earlier cases. However, when set against the broader proposition that the courts will, as a matter of course, imply an obligation to act rationally and in good faith when exercising a discretion, it is difficult to see what, if any, meaning the word “reasonably” has been given. It is entirely possible that the word could be deleted from the 1992 ISDA Master Agreement without materially changing its meaning.

The second decision, *Lehman Brothers Special Financing Inc v National Power Corporation and another*, concerned the close-out provisions of the 2002 version of the ISDA Master Agreement ([2018] EWHC 487, [www.practicallaw.com/w-014-5040](http://www.practicallaw.com/w-014-5040)). In contrast to the 1992 version, the relevant part of the 2002 agreement provides that, following an event of default, the non-defaulting party:

- Has the right to calculate a close-out amount.
- In so doing, must act in good faith and use commercially reasonable procedures in order to produce a commercially reasonable result.

In *Lehman Brothers*, the High Court found that the relevant provision did impose a requirement for the non-defaulting party

to use procedures that are, objectively, commercially reasonable in order to produce, objectively, a commercially reasonable result. This might seem like an obvious outcome but that belies the complex arguments on both sides. Strikingly, the court commented that it wondered whether the courts have relied too heavily on the concept of rationality, and at times confined their interpretation of contracts to this minimum standard when wording used by the relevant parties might instead have lent itself to the interpretation that they intended that a higher standard would apply.

That is a fair question, which naturally leads to the possibility of this area of law being reshaped in the coming years. The natural tension between one party’s right to make a decision and another party’s right to impose conditions on that decision has arguably led to an unduly favourable position for decision makers. More immediately, it also leads contracting parties to wonder how they can actually achieve the result they intend and avoid a protracted and costly dispute.

### Avoiding uncertainty

There are several practical lessons to bear in mind arising from these decisions:

- If in doubt, parties should assume that a contractual right may be characterised by

the courts as discretionary and therefore subject to possible implied limits.

- At the drafting stage, parties should be careful to specify if they intend to be bound by:
  - objective standards of reasonableness;
  - rationality; or
  - no limitations at all on the exercise of discretionary rights.

The first and last of these standards will require particularly clear drafting to achieve. For example, it would be prudent to refer expressly to an “objective” standard of reasonableness or to “sole and absolute” discretion. In all cases, parties should also be careful that other provisions of their contract, such as an overriding express obligation of good faith, do not intersect with the exercise of the discretionary right.

- Where possible, it may be sensible to limit discretionary rights by reference to quantitative parameters rather than merely by reference to concepts such as reasonableness. For example, it may be possible to refer to a particular industry benchmark or to provide that a numerical determination must fall within a certain range.
- When exercising contractual discretion, parties should bear in mind that their decisions may be subject to review. In that context, it is important carefully to record why particular decisions are taken and the thought process that underpins them. At the very least, it is prudent to assume that decisions must be taken in good faith and on a rational basis.

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