Lessons on exercising a contractual discretion post Braganza

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Contractual terms which give one contractual party the power to exercise a discretion or form an opinion as to relevant facts are commonplace in financial agreements. Whilst parties are free to negotiate such terms it is important to note that they do not confer completely unfettered rights: decision makers may be constrained by what has come to be known as the Braganza duty. Four recent High Court judgments cast some light on the nature of this duty and when it might arise.

What is the Braganza duty?

Where contractual terms give one party the power to make decisions which affect the rights of both parties there is a clear potential for a conflict of interest. As Lady Hale noted in Braganza v BP Shipping Ltd [2015] UKSC 17 (Braganza), where such terms exist the court will not intervene to re-write the bargain agreed between the parties but will seek to ensure that the contractual powers are not abused. It may do this by implying a term that the discretion may only be exercised honestly and in good faith and not in an arbitrary, capricious or irrational way.

In assessing whether a discretion has been exercised rationally the court will review the decision in a way that is analogous to the judicial review of an administrative decision of a public body, applying what is known as the Wednesbury test. Prior to Braganza, courts focused on that limb of the Wednesbury test which asks whether the decision was so unreasonable that no reasonable person acting reasonably could have made it. In Braganza, however, the Supreme Court recognised that in some cases an assessment of rationality should also include the other limb which involves reviewing the decision making process itself. Did the decision maker properly take into account relevant factors and exclude irrelevant factors?

The precise nature of the term to be implied will depend upon the terms and the context of the particular contract. The Braganza case arose in an employment context where the potential for conflict of interest when exercising a contractual discretion is heightened due to the imbalance of power between employer and employee. As Lord Hodge noted, an employment context "may justify a more intense scrutiny of the employer's decision-making process than would be appropriate in some commercial contracts."

When will the Braganza duty arise?

Two important issues fall for consideration.

First, there is the issue as to whether a particular contractual clause actually bestows a contractual discretion at all or whether it simply gives a party a contractual right or power to act in a certain way. If the latter is true then the Braganza...
duty will not apply.

Second, if the clause does give a party a contractual discretion, then consideration needs to be given as to whether the Braganza duty can be said to arise in the particular context.

Absolute contractual right or contractual discretion?

In Shurbanova v Forex Capital Markets Limited [2017] EWHC 2133 (QB) Waksman J had to decide whether a clause in an agreement between a foreign exchange broker and a retail customer gave the broker a pure contractual right to revoke a transaction due to abusive trading or whether the broker was constrained by a Braganza duty.

He concluded that a Braganza duty did not arise. The clause did not require the broker to make an assessment or judgment about a variety of outcomes but simply to decide whether it wanted to exercise an absolute contractual right to revoke. The clause did not give the broker a discretion to decide whether there had been abusive trading, that was for the court to decide. If the transaction was abusive then an absolute right to revoke arose. If not then any revocation in reliance on the clause would be of no effect.

The broker's power to revoke could not be turned into a Braganza type discretion. As Waksman J noted, a Braganza discretion will concern itself with a determination of a substantive matter, or an evaluation of some state of affairs which one party makes as the decision maker but which affects the interests of both, hence giving rise to a potential conflict of interest. Whilst an abusive trade could constitute an event of default under other provisions of this particular contract and thereby afford the broker alternative remedial actions in addition to revocation, it was meaningless to categorise this as a Braganza discretion. If it were one, then whenever a party had a choice as to whether to opt to rescind a contract for misrepresentation rather than seeking damages that could be characterised as a contractual discretion subject to the Braganza duty. That could not be right.

Contexts in which a Braganza duty may or may not arise

In Braganza the Supreme Court appeared to leave open the issue as to whether a Braganza duty might arise in contexts other than employment. In Lehman Brothers International (Europe)(in administration) v Exxonmobil Financial Services BV [2016] EWHC 2699 (Comm) commercial parties had contracted with each other on the wholesale financial markets and one party had a contractual discretion involving the valuation of securities in case of default.

In that context Blair J did not think that Braganza required the kind of analysis of the decision-making process that would be appropriate in the public law context. In his view Braganza had expressly left open the question of the extent to which procedural judicial review objections could arise in commercial contracts. Scrutiny of the decision making process itself was not appropriate in a situation where both parties were commercial parties, the decision was one which could be and might need to be taken without delay and in which the non-defaulting party was entitled to have regard to its own commercial interests.

In Watson and Others v Watchfinder.co.uk [2017] EWHC 1275 (Comm) however, Waksman J concluded that a Braganza duty did arise in a commercial context. That case concerned a claim for specific performance of a share option agreement. Waksman J found that a clause which stipulated that the option could only be exercised with the consent of a majority of the board of directors was subject to a qualification that it be exercised in a way that was not arbitrary, capricious or irrational. Whilst noting that such a conclusion was not inevitable in every case, he concluded that it was “clearly” appropriate there. There was an obvious conflict of interest as far as the existing shareholders in the company were concerned since “the grant of further shares would dilute their own holdings and/or restrict at least to some extent their availability for other investors who may have to pay much more”.

He therefore ruled that the decision maker was subject to a Braganza duty. That meant that there had to be a proper process for the decision in question which took into account material points and did not take into account irrelevant ones. It also meant that the outcome could not be outside what any reasonable decision maker could decide, regardless of the process adopted.

The evidence showed that there had been hardly any real exercise of discretion at all. The issue of board consent was dealt with extremely quickly and casually at the end of a board meeting, there was no real discussion such that the decision seemed to be based on a mistaken view that the board had an absolute right of veto rather than an obligation to
consider whether the claimants had made a real or significant contribution to the progress or growth of Watchfinder. Watchfinder had failed to comply with its Braganza duty and the claimants were entitled to an order for specific performance of the option agreement.

Hot on the heels of Watchfinder came another Waksman J decision in BHL v Leumi ABL Limited [2017] EWHC 1871 (QB). This concerned the exercise of a discretion in the context of a receivables finance agreement. The discretion granted the finance provider the right to recover fees of "up to 15%" of the receivables recovered.

Waksman J considered the intended "target" of this provision. He concluded that it allowed Leumi ABL Limited (Leumi) to charge a fee which was meant to "represent or capture or estimate in some way" Leumi’s future costs and expenses in respect of the collection of receivables. It afforded Leumi some flexibility since it could not know in advance precisely what those costs would be but it did not give Leumi an "untrammelled discretionary power". It had to be subject to some "qualification" otherwise it could be exercised oppressively or abusively.

When Leumi decided to charge the full 15% without making any attempt to calculate its likely costs recovery it breached its Braganza duty. It failed to take into account a number of relevant factors, including how long the collect out would take, how the process of the collection would change over time, who would do the collect out and what Leumi’s own internal costs would be. It simply charged the maximum 15% without giving any proper consideration to the issue.

On the evidence the judge concluded that a fee of 4% was the absolute maximum Leumi could have charged in order to remain compliant with its Braganza duty.

Comment

These decisions help shed light on how and when the Braganza duty might apply but are very fact specific. As discretionary provisions are commonplace in finance agreements there is potential for a Braganza duty to apply in many different situations. Whilst binary decisions, such as when to make a demand or appoint administrators for example, may not be subject to challenge, other discretions, such as an ability to vary interest rates, might be. Further case law seems inevitable.

In the meantime the following practical points should be noted:

- Be aware that decisions made pursuant to the exercise of a contractual discretion may be subject to challenge and review. Bear this in mind both at the drafting stage and when exercising a discretion.
- If you have a discretion to exercise, think about what the "target" of that discretion is, in other words consider what issue it allows you to determine and what considerations you should bear in mind.
- Keep a paper trail which demonstrates that a proper decision making process has taken place. Show that your decision was reached rationally, taking relevant factors into account but disregarding anything irrelevant. Make specific reference to any relevant evidence which you relied on in reaching your decision.

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