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Contractual determinations and commercial reasonableness

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Financial instruments frequently give one party (more often than not the lender) the right to make a 'decision' or to 'determine' a matter that will impact on the other (i.e. the borrower). Often that discretion or right to determine a point will be qualified to require the lender to act in a 'commercially reasonable' manner or to come to a 'commercially reasonable' outcome.

This article considers what standard of behaviour this phrase applies to a lender's obligations.

The meaning of Commercially reasonable

Mere rationality and no more

The meaning of the phrase, 'commercially reasonable' came before the Court of Appeal in *Barclays Bank Plc v Unicredit Bank AG [2014] EWCA Civ 302, [2014] 2 All ER (Comm) 115 ("Unicredit")*. Barclays had provided a guarantee facility Unicredit could terminate the facility with Barclays' consent. The guarantees required Barclays' consent to be "*determined ... in a commercially reasonable manner*".

Less than two years in, Unicredit sought to terminate, and Barclays refused its consent. Unicredit argued that Barclays had not acted in a commercially reasonable manner, submitting that the clause required Barclays to balance its own commercial interests against Unicredit's interests as the counterparty in order to achieve a mutual (or mutually satisfactory) outcome. This submission was rejected both by the Judge at first instance, and by the Court of Appeal.

The Court of Appeal rejected Unicredit's submission as unworkable in practice (see *Unicredit* [16]-[17]) The Court of Appeal also observed that if a clause was to require such a balancing act, then it would need to provide "*some method of discovering and assessing the counterparty's interests*." Finally, the Court of Appeal considered that if a balancing act really was the sort of exercise envisaged, one would not expect the parties to have conferred the decision on a contracting party at all but would expect a "*neutral third party*" to have been allotted the task instead (see [17]).

The Court of Appeal's reasoning suggested that the very choice to entrust a decision to a contractual party (who inevitably stands in a position where its interests are likely to conflict with those of the other) would compel a conclusion that the language of "*commercial reasonableness*" – whenever deployed – could mean no more than mere rationality (i.e. the absence of arbitrariness or capriciousness).

Something more than mere rationality?

Subsequent cases, however, considering the meaning of 'commercially reasonable' as a qualifier have confirmed that, depending on the context, the phrase may be construed as importing a more onerous threshold – an objective standard of reasonableness. Two examples are considered below: (1) *Arbuthnot* and (2) *Lehman Brothers*.

Discretion should be exercised for reasons connected to the purpose of the clause

In *Crowther v Arbuthnot Latham [2018] EWHC 504 (Comm)* ("*Arbuthnot*"), the claimants had brought claims for mis-selling in respect of loans secured by a charge over the claimants' French property against the defendant bank. These claims were settled in 2013. Under the settlement, the claimants owed a little over 5.9 million euros, the claimants were required to seek the bank's approval to a sale of the French property, and the bank was not to unreasonably withhold or delay its approval to sale. Upon any sale, the sale proceeds were to be paid to the bank for the sole purpose of part or full repayment of the outstanding amounts. In 2016, the claimants secured an offer on the French property for 4.5 million euros (less than the outstanding indebtedness). This offer was in line with market valuations, but the bank refused to approve the sale unless further security was provided to meet the shortfall.

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The bank argued that the Court of Appeal's decision in *Unicredit* supported their view that the standard of 'commercial reasonableness' did not prevent the bank from acting on its own commercial interests (see *Arbuthnot* [29]). However, HHJ Waksman KC distanced the case from the Court of Appeal's decision in *Unicredit* on the ground that "*just because a bank was involved in Unicredit and a bank is involved here does not really tell us very much*" (at [28]).

The key question as HHJ Waksman KC saw it was to identify the "*purpose*" of the clause (at [30]). The "*purpose*" was to be identified by reference to context and by reference to this context it was "*very hard to see why the scope of the clause should go any further than a concern which [sic.] the aim of permitting disposal of the property at a proper price*" (at [31]). This led HHJ Waksman KC to reject the bank's submission that the control mechanism included other aspects of the creditor / debtor relationship beyond the requirement to obtain a fair market value, and HHJ Waksman KC proceeded to hold that the bank's refusal to approve the sale was unreasonable because its reasons for refusing the sale had no connection with the aim of securing a sale at a proper value (at [32]).

The context may require objectively reasonable behaviour

Then in *Lehman Brothers Special Financing Inc v National Power Corporation [2018] EWHC 487 (Comm)* the court was required to construe the meaning of "*close out amount*" in the 2002 ISDA Master Agreement which required the determining party to "*act in good faith and use commercially reasonable procedures in order to produce a commercially reasonable result*". The equivalent provision in the 1992 ISDA Agreement had required "*an amount that party reasonably determines in good faith*". The case came before Knowles J who had (coincidentally) acted as counsel for the unsuccessful borrower (Unicredit) in *Unicredit*.

In construing the meaning of "*commercially reasonable*" in the 2002 ISDA Master Agreement, Robin Knowles J held that:

- The fact that the role of decision maker may place a contracting party in a position of conflict of interest does not mean that 'reasonableness' can only mean rationality and nothing more: "*It will depend on the wording and the context*" (at [68]). This marks a shift away from the Court of Appeal's reasoning in *Unicredit* at [17] (see above) that it would be impossible in practice for a commercially minded party to be required to have regard to the interests of the other party because a commercially minded party could not begin to assess what those interests were, still less to weigh them against their own.
- The change in the language between the 1992 and 2002 ISDA Master Agreement was "*material*" and designed to introduce "*(greater) objectivity*" (see [77]). Therefore, in the context of the 2002 ISDA Master Agreement, commercial reasonableness required an objective criteria of reasonableness rather than the lower standard rationality.
- The objective criteria of reasonableness allowed for a range of results – any of which might be commercially reasonable – but the fact that there was a range did not mean that the determining party could simply take the result which suited it best "*at one end of the range*" (see [60], [67]-[69], [73]-[82]).

Commercial reasonableness does not have a fixed meaning

This trio of judgments demonstrates that the phrase 'commercial reasonableness' does not have an independent or self-executing meaning in the law which the phrase will automatically import into any contract (see *Unicredit* [14], [21]; *Arbuthnot* [19], [29]; *Lehman Brothers* [68]). Instead, as with the construction of all contractual terms, 'commercial reasonableness; takes it meaning from the "*objective factual, commercial and contractual context*" of the clause in question (see *Arbuthnot* [35]).

The factors which form part of the context

- **Commercial context.** In *Unicredit*, the Court of Appeal considered that the objective commercial context was that "any commercial man whose consent to a course of action is required but to whom the determination ... is entrusted would think it commercially reasonable to have regard to his own commercial interests" (*Unicredit* [16]). Further, the Court of Appeal considered that in the banking industry in particular "*Bankers, as commercial men, have a keen instinct for where their own interests lie*" (at [17]). However, given the treatment of this decision by HHJ Waksman KC in Arbuthnot, the generality of this consideration must now be treated with caution.
- **Transaction context.** In *Arbuthnot*, the court identified three important factors as part of the "objective background fact": first that the property was security of the bank, second the nature of the Bank's security interest in the property and third that creditors do not usually object to the sale of security provided they are not undervalued and the sale proceeds go to discharging the indebtedness. Against this backdrop, HHJ Waksman KC held that it was hard to see why the clause should go further than a concern with the aim of permitting disposal of the property at a proper price with the result that the reasonableness of any refusal of consent fell to be determined only by reference to whether the proposed sale was at fair market value and at arm's length (see *Arbuthnot* [30]-[31], [35]).

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- **Documentary context.** In *Lehman Brothers*, the context included the material changes in language between the 1992 and 2002 ISDA Master Agreements. Those changes were deliberate and signalled a move to a tighter and more stringent threshold. Accompanying guidance explaining the changes had noted that the change was designed to achieve greater objectivity because it was felt that the 1992 Agreement was "*lacking*" (see *Lehman Brothers* [77]).

Conclusion

The courts' decisions in these cases illustrates that the nature of an obligation to act commercially reasonably depends on context and, therefore, as with the construction of any contractual term, there will be scope for argument as to what exactly the standard requires in the context of the contract in question.

Where the obligation is directed solely at matters of process the lender may only be required to act in a rational way (as in *Uncredit*). By contrast, where the discretion is instead directed at a specific purpose (as in *Arbuthnut*) or a textual comparison with related provisions points to a more stringent standard (as in *Lehman Brothers*) the obligation might have more substantive 'bite'.

Banks and finance providers would be well advised to specify what exactly want they want the standard to require. There is scope for argument about what commercial reasonableness means in different contexts especially now the courts have shown a willingness to move away from defining it as a simple test of rationality.

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