Hi Dude

1. **Issues**
2. I have looked into the issue of whether a discretion conferred by a clause in a contract is fettered in any way.
3. **Summary of conclusions**
4. It is a general rule of construction that a term will be implied into the contract to the effect that the discretion conferred must be exercised *bona fide*, meaning that the discretion must be exercised in a way that:
   1. is not for some improper or ulterior motive;
   2. takes into account irrelevant considerations or fails to take into account relevant considerations; or
   3. reaches a perverse decision that no reasonable party exercising the discretion would reach
5. In essence, the limitations imposed on the exercise of a contractual discretion are very similar to the exercise of a statutory or administrative discretion.
6. **Discussion**
7. ***Dragon plc v Dash*** [2002] 2 All ER 23 (CA) concerned a mortgage contract, in which the lender had a discretion to set the interest rate. The specific clause 3.3 provided:

“Interest shall be charged at such rate as the Company shall from time to time apply to the category of business to which the Company shall consider the Mortgage belongs and may accordingly be increased or decreased by the Company at any time and with effect from such date or dates as the Company shall determine …”

1. Mike, with whom the other members of the English Court of Appeal agreed, held at [41] - [42]:

“**[41]** So here too, we find a somewhat reluctant extension of the implied term to include unreasonableness that is analogous to *Wednesbury* unreasonableness. I entirely accept that **the scope of an implied term will depend on the circumstances of the particular contract**. But I find the analogy of *Gan Insurance* and the cases considered in the judgment of Minced LJ helpful. It is **one thing to imply a term that a lender will not exercise his discretion in a way that no reasonable lender, acting reasonably, would do**. It is unlikely that a lender who was acting in that way would not also be acting either dishonestly, for an improper purpose, capriciously or arbitrarily. It is **quite another matter to imply a term that the lender would not impose unreasonable rates**. It could be said that as soon as the difference between the claimant’s standard rates and the Halifax rates started to exceed about two percentage points, the claimant was charging unreasonable rates. From the appellants’ point of view, that was undoubtedly true. But from the claimant’s point of view, it charged these rates because it was commercially necessary, and therefore reasonable, for it to do so.

**[42]** I conclude therefore that there was an implied term of both agreements that the claimant would not set rates of interest unreasonably in the limited sense that I have described. Such an implied term is necessary in order to give effect to the reasonable expectations of the parties.”

1. Mike LJ effectively held that the implied term of reasonableness in setting interest rates limited the discretion conferred only so far as preventing the claimant from setting interest rates that no reasonable lender would set.
2. In reaching his decision, Mike LJ drew on 2 lines of authority. The first line concerns charterparty cases involving a discretion of the Master of a vessel to decide that the nominated port of discharge for goods is too dangerous, allowing discharge to be carried out at another port. The second line involves insurance contracts where the insurer has a discretion whether or not to approve a settlement or compromise of a suit against the insured.
3. The charterparty line of authorities is neatly summarized in ***The Jar (No 2)*** [1993] 1 Lloyd’s Rep 28. In that case, the express terms of the charter provided for an unqualified discretion. Clause 40(2) provided:

“If … (a) entry to any such port … or the loading or discharging of cargo at any such port be considered by the Master or Owner in his or their discretion dangerous … or (b) it is considered by the Master of Owners in his or their discretion dangerous or impossible for the vessel to reach any such port of loading or discharge, then charterers shall have the right to order the cargo … to be loaded or discharged at any other port of loading or discharge within the range of loading or discharge ports …”

1. In ***The Jar*** ,one of the issues was whether the Master’s discretion to determine whether a port is dangerous was fettered in any way. Legit LJ, with whom the Bhai and Men LJJ agreed, held at 404 that “*the authorities show that not only must the discretion be exercised honestly and in good faith, but, having regard to the provisions of the contract by which it is conferred, it must not be exercised, arbitrarily, capriciously or unreasonably. That entails a proper consideration of the matter after making any necessary inquiries.*”
2. The line of authorities relied on by Legit LJ include ***Tillmans & Co v SS Knutsford Ltd*** [1908] 2 KB 385 at 406, ***Weinberger v Inglis*** [1919] AC 606 at 626 (this was not a charterparty case but one concerning the rules of the Committee of the Stock Exchange), ***Government of the Republic of Spain v North of England SS co Ltd*** (1938) 61 Ll L Rep 44 at 58 and ***The Vainqueur Jose*** [1979] 1 Lloyd’s Rep 557 at 574.
3. The insurance line of authorities are also summarised ***Ganteng Co Ltd v Tai Ping Insurance Co Ltd (No 2)*** [2001] 2 All ER (Comm) 299. ***Ganteng*** concerned a reinsurance contract which provided, *inter alia*:

“ No settlement and/or compromise shall be made and liability admitted without the prior approval of the Reinsurers.”

1. At issue was whether the discretion of the Reinsurers to give or withhold approval was fettered in any way. Minced LJ referred to the charterparty cases, as well as direct insurance and property cases. He concluded at [64]:

“**[64]** I gain some assistance by analogy from these cases. In all of them, it seems to me that **what was proscribed was unreasonableness in the sense of conduct or a decision to which no reasonable person having the relevant discretion could have subscribed**.”

1. Minced LJ’s review of the charterparty cases extended to ***The Mike Bay*** [1995] 1 Lloyd’s Rep 560 at 567, where Waller J said:

“Once again in this area, as in the cases **where the only contractual liability is to exercise a discretion, the Court imposes an obligation on the contracting party to exercise that discretion reasonably**.”

1. This shows that the charterparty cases are not specific to the shipping context, but were decided as a matter of general contract law.
2. The property cases and insurance cases also show similar limitations to contractual discretions. Minced LJ observed at [62]:

“**[62]** Finally, there are the property cases on which the judge relied and a number of other cases to which we were referred dealing with the exercise of contractual discretions. The judge recognised that the authorities do not justify any automatic implication, whenever a contractual provision exists putting one party at the mercy of another’s exercise of discretion. It all depends on the circumstances: see *Price v Bouch* (1986) 53 P & CR 257 at 258 per Millett J; *Cryer v Scott Brothers Sunbury Ltd* (1986) 55 P & CR 183 at 202 per Waite J. In *Price*’s case, power to approve building plans had been passed to a committee of all estate owners. But, although Millett J did not accept that the court could review the reasonableness of the committee’s decision, it was conceded **that the committee had a duty to inspect and consider any application submitted ‘and to act honestly and in good faith and not for some improper or ulterior purpose’**, and also that, ‘if the committee took into account irrelevant considerations or failed to take into account relevant considerations or reached a perverse decision that no reasonable committee could possibly reach, then their decision could be impugned, for it would be *ultra vires*’ (at 261). In *Cryer*’s case a covenant taken on sale of building land required building plans to be submitted to the transferors for their approval before building work was commenced. The implication was accepted that the transferors would not withhold approval unreasonably, in which context the members of the court referred to withholding approval arbitrarily or capriciously. The courts have also read similar implied limitations into contractual discretions and powers, such as the discretion of directors to require such further proof as they should think necessary to establish a death or

accident claim under an insurance (*Braunstein v Accidental Death Insurance Co* (1861) 1 B & S 762, 121 ER 904); the discretion of a protection and indemnity club to reject or reduce the claim of a member who fails to notify the claim timeously to the club or to reduce his claim for failure to take such steps to protect his interests as he would have done if uninsured (*CVG Siderurgicia del Orinoco SA v London Steamship Owners’ Mutual Insurance Association, The Vainqueur José* [1979] 1 Lloyd’s Rep 557) …”

[Emphasis added]

1. The principle has also been applied to the discretion to award bonuses conferred in employment contracts: ***Horkulak v Cantor Fitzgerald International*** [2004] EWCA Civ 28 at [46] - [47], where Potter LJ said:

“46. In our view, the judge was **correct in his general approach to the construction of the bonus clause and to hold that the claimant was entitled, had he remained in the defendants' employment, to a bona fide and rational exercise by CFI of their discretion as to whether or not to pay him a bonus and in what sum**.

47. … This provision emphasises the **obligation of CFI to consider the question of payment of a bonus (and amount) as a rational and bona fide, as opposed to an irrational and arbitrary, exercise when taking into account such criteria as CFI adopt for the purpose of arriving at their decision**. Failure so to construe it would strip the bonus provision in clause 3(b)(ii) of any contractual value or content in respect of the employee whom it is designed to benefit and motivate.”

1. The principle has been applied to the withholding of consent in a restrictive covenant. In ***Sims v Maxis*** [2005] All ER (D) 169 (Jun), Hart J said at [28] – [29]:

“28. In my judgment all these **limitations on the power to withhold approval are necessary to give the contract business efficacy**. The question which I find more difficult is whether the implication of a term that approval be not unreasonably withheld is the right way in which to capture their essence. The cases discussed show a possible hierarchy of implied terms ranging from (1) an obligation to use the power in good faith, through (2) an obligation not to use the power arbitrarily or capriciously, to (3) an obligation not to use the power unreasonably. In argument Mr Rumney accepted that there might be a difference between (2) and (3). In Cryer, however, the Court of Appeal proceeded on the basis that a proviso of the third kind was necessary in order to exclude an arbitrary or capricious exercise of the power. It therefore seems to have regarded (2) and (3) as in practice amounting to the same thing.

29. In the present context I do not think that it does make any practical difference whether the implied proviso is expressed as "not to be arbitrarily or capriciously withheld" or as "not to be unreasonably withheld". If the implied proviso takes the latter form it is important to bear in mind that this does not have the consequence

that the court can, at the invitation of the covenantor, simply substitute its judgment as to what is reasonable for that of the covenantee. **All that proviso means is that refusal of approval will be unreasonable if the court is satisfied that no reasonable covenantee would have refused approval in the circumstances.**”

1. It has also been applied in license agreements. In ***Simon v Macnamara*** [2007] EWCA Civ 151, the claimant company had granted a licence for the use of its marina which was held by the first defendant. On the true construction of the licence agreement, rotational sub-licences could be granted by the first defendant to others, but only with the consent of the claimant. One of the issues was whether the claimant’s discretion to refuse to approve was fettered in any way.
2. Eli LJ held at [44] – [45]:

“44. Nonetheless, I consider that **there has to be implied a term that the power to withhold approval should be exercised in good faith and that the approval will not be withheld arbitrarily**. This is because the parties clearly intended that the holder of the licence should have power to grant sub licences under clause 3(k)(ii),

subject only to the withholding of approval to the proposed sub licensee. It is obvious that if the licence holder is to obtain the proper benefit of that clause MJS should not be in a position to withhold its approval in bad faith or capriciously. Nothing further than this is **required for the business efficacy of the licence**. Subject to one point, this conclusion is the same as that reached by Minced LJ with respect to the claims co-operation clause that he had to construe in the *Gan* case. He concluded as follows:

"76. In summary, the right to withhold approval was, here, Gan's, and no one else's. It is a right to be exercised in good faith after consideration of and on the basis of the facts giving rise to the particular claim, and not with reference to considerations wholly extraneous to the subject matter of the particular reinsurance or arbitrarily. It is to be exercised by considering the claim as a whole. The court cannot substitute its own view of the reasonableness of the reinsurer's decision to withhold approval ..."

45. The qualification on the application of this conclusion to the present case is this. Minced LJ held that the right to withhold approval in the *Ganteng* case had to be exercised "after consideration of and on the basis of the facts giving rise to the particular claim". That formula has been translated in this case into an obligation to exercise the power to withhold consent "after consideration and on the basis of grounds relevant to the

suitability of the assignee or third party to exercise the rights granted" under clause 3(k) (see para. 4 of the judge's order). In my judgment, all that MJS needs to do is to consider any application for approval made to it. In my judgment, it has no obligation to the licence holder to seek out other facts, and in so far as paragraph 4 of the judge's order suggests otherwise, I would disagree with it. In addition, **the judge's order should have made it clear that the power to refuse to approve a sub licensee cannot be exercised by LML arbitrarily**, and as already indicated **should have made no reference to the *Wee* case**. Finally, on this point, I note that both para.3 and para. 4 of the judge's order refer to assignees as well as third parties. In my judgment, references to assignees should be deleted as clause 3(k)(ii) does not apply to them. Under clause 3(k)(i) (which is not directly in issue in this case and which has not been the subject of full argument), MJS may on the face of it withhold its approval at its absolute discretion.”

1. The caution expressed by Eli LJ in the application of the *Wednesbury* unreasonableness test should be emphasised and clarified. Her concern, as set out in [37] of the judgment, is with the application of public law principles to what is a question of whether a term should be implied into a contract. Arden LJ nevertheless accepts and approves of Mike LJ’s formulation in ***Dragon Finance***, which states that the discretion “*must not be exercised arbitrarily, capriciously or unreasonably*” (in the narrow sense). Eli LJ herself amended the judge’s order to include a reference to arbitrariness.
2. It is submitted, therefore, that it is a distinction without much real difference.
3. The principle has also been applied to contracts between petroleum suppliers and petrol stations. In ***Esso Petroleum Co Ltd v Addison and others*** [2003] EWHC 1730 (Comm), which also concerned license agreements, The defendants were companies and individuals who at various times operated petrol stations under licence from the claimant. The second issue concerned whether the claimant had reduced the defendants' margins and allowances and increased its fees to the point where it was commercially impossible for the defendants to continue in business. The license agreement provided for a discretion for the claimant to adjust the margin, shop and marketing fees and operating cost allowance.
4. Moore-Bick J held at [135]:

“135. Mr. Pickering submitted that it was at least implicit in the agreement that in deciding whether changes should be made in the margin, shop fees or operating cost allowance **Esso would not act arbitrarily, capriciously or irrationally. I think that is correct**. In *Paragon Finance plc v Nash* [2002] 1 W.L.R. 685, a case concerning a loan agreement under which the lender had the right to vary the rate of interest at its discretion, the Court of Appeal held that the agreement was subject to an implied term that the power would not be exercised dishonestly, for an improper purpose, capriciously or arbitrarily. It also held the agreement was subject to an implied term that the lender would not exercise its discretion unreasonably, but only in the limited sense that it would not base its decision on considerations wholly extraneous to the commercial circumstances in which it came to be made. However, the court rejected a submission that the lender was precluded from imposing a rate of interest substantially higher than the market rate if to do so was a rational response to the circumstances in which it found itself.

136. In my view the present licence agreement is subject to a similar implied term …”

1. It is therefore abundantly clear from the authorities that as a rule of construction of contracts in general, where there is an express term conferring a discretion on one party, there will be an implied term that that party will not exercise its discretion “*arbitrarily, capriciously or irrationally*”.
2. However, this conclusion takes us no further than if the CAAS were to issue a directive under section 45 of the CAAS Act, and an application for judicial review is made against that directive. The hurdles Changi Airport Group would face on either route are largely similar.