LENDER NOT SUBJECT TO BROAD GOOD FAITH DUTY WHEN EXERCISING DISCRETIONS UNDER LOAN AGREEMENT (HIGH COURT)

In *Morley (t/a Morley Estates) v Royal Bank of Scotland Plc [2020] EWHC 88 (Ch)*, the High Court held that a loan agreement was not a "relational" contract and so the bank's exercise of contractual discretions under that agreement was only subject to a duty to exercise them for a legitimate commercial aim and not so as to vex the borrower maliciously. It was also held that while compliance with regulatory standards was relevant to whether the bank had satisfied the duty to provide banking services with reasonable skill and care, whether it had complied with its internal policies and procedures would not be taken into account.

Richard Hornshaw, partner, *Sheena Buddhdev*, senior counsel and *Srishti Kalro*, associate in the Finance Litigation team at *Akin Gump LLP, London* have commented on the decision for Practical Law.

by *Practical Law Finance*

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The High Court (Kerr J) has dismissed a borrower's claims against a bank in respect of actions taken by the bank's restructuring group following events of default under a secured loan agreement.

It was held that:

- The loan agreement was not a "relational" contract and so it was not appropriate to imply a "Braganza duty" of good faith into the loan agreement. This meant that the bank's exercise of various contractual discretions under the loan agreement was not limited by "concepts of honesty, good faith, and genuineness, and the need for the absence of arbitrariness, capriciousness, perversity and irrationality". The bank merely had to exercise its discretional powers so as not to vex the borrower maliciously and for a purpose connected with its commercial interests.
- While compliance with regulatory standards was relevant to whether the bank had satisfied the duty to provide banking services with reasonable skill and care, whether it had complied with its internal policies and procedures would not be taken into account.
- The bank did not intimidate the borrower nor subject him to economic duress.

Lenders will be relieved that Kerr J found that an ordinary loan facility agreement is not a relational contract. Therefore, if a borrower has defaulted, it is unlikely that a court will imply a broad duty of good faith into the loan agreement in respect of the lender's exercise of contractual discretions. The lender can act relatively unfettered in its own commercial interests. (*Morley (t/a Morley Estates) v Royal Bank of Scotland Plc [2020] EWHC 88 (Ch) (27 January 2020)*).

Richard Hornshaw, partner, *Sheena Buddhdev*, senior counsel and *Srishti Kalro*, associate in the Finance Litigation team at *Akin Gump LLP, London* have commented on the decision for Practical Law.

BACKGROUND

"Relational" contacts and good faith

While the courts have firmly rejected a general doctrine of good faith, this might be implied by a court in a specific class of long-term contracts, known as "relational" contracts (that is, contracts requiring a high degree of co-operation, communication and confidence between the parties) (*Yam Seng Pte Ltd v International Trade Corporation Ltd [2013] EWHC 111 (QB)* and *Al Nehayan v Kent [2018] EWHC 333 (Comm)*). For more information, see *Practice note, Contracts: good faith: Implied obligations requiring good faith.*

Duty of rationality

One aspect of good faith is the duty of rationality. This is an implied obligation, in the absence of clear language to the contrary, to exercise a contractual discretion in good faith and not arbitrarily or capriciously (*British Telecommunications plc v Telefónica O2 UK Ltd [2014] UKSC 42*). This is often referred to as the "Braganza duty" after the leading case, *Braganza v BP Shipping Ltd [2015] UKSC 17*.

There have been several decisions where the court has considered whether to imply a Braganza duty in relation to finance transactions (see below).

Socimer International

In *Socimer International Bank Ltd v Standard Bank London Ltd [2008] EWCA Civ 116*, the Court of Appeal considered what, if any, limitations there are on a decision-maker's freedom of decision when a contract allocates to one party only a power to make decisions under the contract that may affect both parties (see Legal update, Contract: implied limits on exercise of contractual discretion). It was stated that:

> " ... a decision-maker's discretion will be limited, as a matter of necessary implication, by concepts of honesty, good faith, and genuineness, and the need for the absence of arbitrariness, capriciousness, perversity and irrationality. The concern is that the discretion should not be abused."

Paragon Finance

Similarly, in *Paragon Finance plc v Nash [2001] EWCA Civ 1466*, which considered a lender's contractual power to set the interest rate applicable to mortgages, it was held that there was an implied term that the rates of interest would not be set dishonestly, for an improper purpose, capriciously or arbitrarily. Such an implied term was necessary to give effect to the parties' expectations.

Property Alliance

However, more recently in Property Alliance Group Ltd v Royal Bank of Scotland plc [2018] EWCA Civ 355 a narrower constraint was implied in relation to a lender's power to request a valuation to be prepared at any time. The borrower's argument that the lender's power was subject to an implied requirement that it must be exercised in good faith and not arbitrarily or capriciously was rejected. The court was not swayed by the argument that without such a limitation, there would have been nothing to stop the lender requiring a valuation every week or even every day (albeit that the borrower was only obliged to pay for one valuation per year or if there was a default).

It was held, however, that the lender did not have an absolute right to call for valuations even though the clause must have been inserted for its benefit. It could be inferred that the parties intended the power granted by the valuation clause to be exercised by the lender in pursuit of legitimate commercial aims rather than, say, to vex the borrower maliciously. The lender could not commission a valuation for a purpose unrelated to its legitimate commercial interests or, if doing so, could not rationally be thought to advance them.

For more information, see *Article, PAG v RBS: Court of Appeal dismisses IRHP misselling and LIBOR manipulation claim: Valuation claim*.

FACTS

The borrower, a property developer, entered into a three-year loan agreement with a bank (RBS). The loan was non-recourse to the borrower but was secured on a portfolio of properties.

In early 2009, the bank obtained an updated valuation, which evidenced a breach of the loan to value covenant. The bank started charging interest at an increased default rate. Negotiations to restructure the loan failed.

Eventually, the borrower entered into agreements with the bank that enabled him to salvage some of the portfolio, but the rest of the portfolio was transferred to the bank's subsidiary. The borrower subsequently claimed rescission of those agreements or damages in lieu of rescission. He asserted that:

- He had only entered into the agreements because the bank had intimidated him and subjected him to economic duress by threatening to appoint a receiver who would arrange for the entire portfolio of mortgaged properties to be transferred in a "pre-pack" sale to the bank's subsidiary.
- The bank had breached its duty to exercise reasonable skill and care in providing banking services.
- The bank had an implied duty in contract to act in good faith. He claimed four breaches of the bank's implied duty to act in good faith, including obtaining a new valuation of the mortgaged property portfolio "forcing" a breach of the loan to value covenant.

In relation to the implied duty of good faith, the borrower argued that the loan agreement was a relational contract as it was non-recourse to him and, therefore, trust was reposed in him. Other relevant factors indicative of a relational contract were that it was intended that further properties would be developed using advances under the loan agreement (to both the bank's and borrower's financial advantage) and hedging was required to protect both parties against the adverse impact of interest rate changes.

DECISION

Loan agreement not a relational contract

The loan agreement was not a relational contract; it was an ordinary loan facility agreement.

The bank's contractual discretions under the loan agreement (the power to obtain a revaluation of the mortgaged properties and to charge default interest) had to be exercised in the manner set out in the *Property Alliance* case. That is, they should be exercised so as not to vex the borrower maliciously and for a purpose connected to the bank's commercial interests. However, as the loan agreement was not a relational contract, the bank's right to exercise these discretions was not further limited by a broader concept of honesty and good faith (as, for example, seen in the *Socimer International* and *Paragon Finance* cases).

On the facts, all the bank's actions were rationally connected to its commercial interests.

Kerr J also confirmed that a distinction should be made between a discretion and a decision whether to exercise an absolute contractual right (such as calling in of a loan). In the case of the latter, there is no question of implying a duty of good faith (*UBS AG v Rose Capital Ventures Ltd [2018] EWHC 3137 (Ch)*).

Compliance with internal policies not relevant to whether banking services provided with reasonable skill and care

It was accepted that the bank had a duty to provide banking services with reasonable skill and care (based on section 13 of the Supply of Goods and Services Act 1982 and *Hedley Byrne & Co v Heller & Partners Ltd [1964] AC 465*). On the facts, the bank's provision of lending services did not fall below the standard required.

The court agreed that non-compliance with applicable regulatory standards was relevant to whether the bank had breached the duty. However, the bank's internal policies and procedures were not relevant to the required standard of care. Regulatory standards are evidence of what reasonable people in the trade or profession would expect of its members and, therefore, evidence of what the public should be entitled to expect. The standards that an organisation sets itself, by means of written policies and procedures, may or may not have much probative value in indicating the required standard of care and whether it was met. They may accurately replicate industry wide professional standards but may merely be strategies adopted for internal purposes, having little to do with the standard of care required.

No intimidation or economic duress

On the facts, the bank did not intimidate the borrower nor subject him to economic duress.

COMMENT

Lenders will be relieved that Kerr J found that an ordinary loan facility agreement is not a relational contract. Therefore, if a borrower has defaulted, it is unlikely that a court will imply a broad duty of good faith into the loan agreement in respect of the lender's exercise of contractual discretions. The lender can act relatively unfettered in its own commercial interests.

AKIN GUMP'S COMMENT

This case represents a good outcome for RBS: it won on all points and the court did not consider that a breach of the bank's internal policies and procedures could be used as evidence of a breach of the duty to exercise reasonable skill and care. Had the court done so, financial institutions could have been exposed to a significantly increased risk of liability to third parties.

However, this is unlikely to be the end of the story.

In finding that the bank's conduct did not amount to intimidation or economic duress, Kerr J relied heavily on *Times Travel (UK) Ltd v Pakistan International Airlines Corp [2019] EWCA Civ 828* in which it was held that an element of bad faith was required in order to establish "lawful act" duress. However, Kerr J has granted the borrower permission to appeal a part of his judgment in light of the fact that, after he had handed down judgment, the Times Travel case was given leave to appeal by the Supreme Court.

In light of the above, the law as to what constitutes illegitimate conduct in order to establish intimidation or duress may be further developed. If the Supreme Court approves the standard prescribed in *CTN Cash and Carry Ltd v Gallaher Ltd [1994] 4 All ER 714* (in which it was said that illegitimate conduct could include behaviour which is lawful but socially or morally unacceptable) we could see more cases such as Morley coming to the courts. Financial institutions may also need to rethink their policies and procedures as courts may be less inclined to view any aggressive restructuring practices as being part of the "rough and tumble" nature of modern business. These issues are all the more relevant now as the number of restructurings is expected to gather pace in the wake of the business interruption caused by the COVID-19 crisis.

Further, although the loan agreement in this case was not found to be a relational contract on the facts, the judgment leaves open the possibility that a loan agreement with different features (where, for example, parties are required to collaborate in relation to their obligations or where parties jointly participate in profits), could be treated as a relational contract. Financial institutions will, therefore, have to contend with the possibility of a duty of good faith being implied in other cases.

Finally, it is worth making mention of the recent proposals for the setting up of a separate Financial Services Tribunal (FST) to hear disputes between SMEs and financial institutions. SMEs have long been wary of pursuing their cases through the courts system fearing high costs (in particular, the risk of adverse costs) and an adversary

with deep pockets and a large legal team. This case represents another loss for SMEs at first instance. The judgment in this case comes at a time when SMEs are faced with an increasingly difficult macroeconomic environment. Many of the issues that arose between banks and their SME clients during the financial crisis of 2008 are likely to resurface. Against this background, it is quite possible that the All-Party Parliamentary Group on Fair Business Banking will increase the frequency and volume of its calls for establishing the FST. This could have a dramatic effect on the dynamic inherent in disputes between SMEs and large financial institutions, echoing the transformation in employer/employee relationships brought about by the introduction of employment tribunals.

CASE

Morley (t/a Morley Estates) v Royal Bank of Scotland Plc [2020] EWHC 88 (Ch) (27 January 2020) (Kerr J).