CLIENT UPDATE

UK COURT OF APPEAL DECIDES ON "COMMERCIAL REASONABLENESS" IN THE CONTEXT OF DETERMINATIONS MADE BY PARTIES TO FINANCIAL INSTRUMENTS

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On 20 March 2014, the UK Court of Appeal handed down its decision in *Barclays Bank Plc v Unicredit Bank AG* [2014] EWCA Civ 302. The appeal concerned the construction of a clause requiring a party to make a determination in a "commercially reasonable manner" in deciding whether to consent to optional early termination.

The case concerned a "synthetic securitisation" and is particularly relevant to financial institutions, but it also has broader application to the interpretation of commercial contracts. The case is a useful reminder that, unless exceptional circumstances apply, the courts will give effect to the ordinary meaning of the words of contractual provisions, especially where the parties in question can "look after their own interests and contract on different terms if they wish to do so".

In this update we pick out some of the key issues.

KEY POINTS

- It was the "manner" of the determination which must be commercially reasonable; it did not follow that the outcome had to be commercially reasonable. But commercially unreasonable outcomes would cause the manner of the determination to be subjected to greater scrutiny.

- A party required to make a determination in a "commercially reasonable manner" is entitled to take account of its own

commercial interests in preference to the interests of the counterparty.

- A "commercially reasonable" determination is a control on the deciding party. A party will not be acting in a commercially reasonable manner if it makes demands which are way above what it could otherwise reasonably anticipate.

- The entire agreement clause did not operate to exclude evidence about the way in which parties exercised contractual rights.

THE FACTS

The case concerned a "synthetic securitisation" entered into by Unicredit and Barclays in 2008 whereby Unicredit transferred the credit risk in a pool of assets to Barclays who would make quarterly payments to Unicredit in respect of relevant portfolio losses and in return Unicredit paid quarterly premiums to Barclays. There were three such guarantees given by Barclays as Guarantor to Unicredit. The purpose of the transaction was to enable Unicredit to transfer the credit risk without removing the portfolio of assets from its balance sheet. The transfer would, however, enable its capital requirements (under the Basel Accords) to be reduced.

The lifetimes of the guarantees were 11 years and 19 years, but the Optional Early Termination clause gave Unicredit the option to terminate if "a Regulatory Change occurs in respect of the Bank, provided that the Bank has obtained the prior consent from the Guarantor, such consent to be determined by the Guarantor in a commercially reasonable manner". At the outset of the transaction, Barclays understood that it could expect to earn at least five years of premium and fees and accordingly it booked five years' worth of profit.

In 2010, however, Unicredit sought to terminate the guarantees early as a result of a regulatory change which resulted in the bank no longer receiving capital relief by virtue of the guarantees. Unicredit ceased paying premiums and contended that the guarantees ended on the date the notice was given. Barclays maintained that the guarantees had not been terminated and remained in force.

FIRST INSTANCE DECISION

Barclays brought proceedings against Unicredit for the unpaid premiums due to it and the first instance judge found in its favour. The judge held in broad terms that Barclays had withheld its consent to early termination in a commercially reasonable manner and that Unicredit's purported early termination in 2010 was invalid and of no effect. The judge

held importantly that Barclays was entitled to take primary account of its own interests in determining whether to consent to termination.

THE APPEAL

Unicredit appealed on three grounds, saying that the judge was wrong:

- to hold that Barclays was entitled to give precedence to its own commercial interests and thereby to exclude the interests of Unicredit in refusing to consent to early termination;
- to hold that Barclays was entitled to demand a sum equal to the entire (discounted present value of the) fees that it would have received if the guarantees had continued for five years; and
- in failing to give effect to an Entire Agreement clause.

The appeal failed on all the issues.

CONSTRUCTION OF THE EARLY TERMINATION CLAUSE

The Court noted that there was considerable debate on how the clause was to be categorised by reference to the relevant authorities. For example, was the clause analogous to landlord and tenant cases in which there is a covenant against assignment without the consent of the landlord "such consent not to be unreasonably withheld"? The Court considered this debate "not helpful" since the meaning of the clause has to be determined as a matter of construction of this particular contract in its particular context.

- *Issue 1: was Barclays entitled to prioritise its own commercial interests?* It was submitted by Unicredit that the clause required Barclays to have regard to the interests of Unicredit in order that a mutual (or a mutually satisfactory) outcome could be achieved. This was rejected by the Court which noted that it was impossible to see how such a proposition could work in practice as it would require some method of discovering and assessing the counterparty's interests. Such a requirement was likely to be unsatisfactory and could lead to an unfair result.

  It was held that Barclays was entitled to take account of its own interest in preference to the interests of Unicredit. The basis of this finding was that, on its proper construction, it was the manner of the determination which had to be commercially reasonable: it did not follow that the outcome had to be commercially reasonable. In other words, Barclays was not required to make a determination which had a commercially satisfactory outcome for Unicredit.

- *Issue 2: was Barclays' demand "commercialy reasonable"?* The Court noted that the clause was intended to be a "control exercise of some kind". If, therefore, Barclays had said that they would not consent at any price or if it had said that they wanted 11 years' (or 19 years' as the case might be) fees as being the full term of the guarantees, that might well not have been "commercially reasonable". But that was not the case. Barclays did not refuse consent outright: it was conditional on payment of five years of fees. The Court held that, in light of the relevant background, this was not an unreasonable expectation and the determination had been made in a commercially reasonable manner.

  It is notable that, in reaching this decision, the Court's analysis appeared to be more focused on the reasonableness of the outcome of the determination as opposed to the manner in which the determination had been made by Barclays. It might have been expected that the Court's focus should have been on Barclays' decision making process: for example, on whether the issue went before the Bank's credit committee or appropriately senior employees made the decision to make consent conditional upon payment of 5 years of fees. However, it is assumed that because the determination was so manifestly commercially reasonable, the Court considered that the manner of Barclays' determination had not warranted greater scrutiny.

ENTIRE AGREEMENT CLAUSE

- *Issue 3: the effect of the Entire Agreement clause*. Unicredit submitted that evidence and argument regarding Barclays' understanding that the contract would last for 5 years was inconsistent with the entire agreement clause of the guarantees. The Court disagreed that this was the purpose or effect of the entire agreement clause. It was necessary for the Court to construe the entire agreement clauses strictly. It was not intended to exclude admissible evidence or argument about the way in which parties considered the exercise of rights given to them by the terms of the contract.

COMMENT

The Court of Appeal's decision will undoubtedly be welcomed by financial institutions, particularly as the Court was unwilling to interfere in a commercial contract where the parties can "look after their own interests and contract on different terms if they wish to do so".

It is apparent that the Court of Appeal had no difficulty in construing the meaning of the words in the Optional Early Termination clause. Given that there was no ambiguity in the meaning of the words, the Court of Appeal did not consider that the use of the term

"commercially reasonable" in other contractual contexts (e.g. the 2002 version of the ISDA Master Agreement) made any difference to the question of construction of the term in the present case.

The Court noted, however, that it was difficult to express a test for commercial reasonableness for the purpose of this (let alone any other) contract. Notwithstanding that difficulty, the Court tentatively expressed the test as the party who has to make the relevant determination will not be acting in a commercially reasonable manner if he demands a price which is substantially above what he can reasonably anticipate would have been a reasonable return from the contract into which he has entered and which it is sought to terminate at an early date.

The lesson from this decision is that, whilst a party it is entitled to prefer its own commercial interests in circumstances where it is required to act in a "commercially reasonable manner", the situation should not be treated as an opportunity to make unrealistic commercial demands in return for giving consent.

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Please do not hesitate to contact us with any questions.

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