

Implied Duty of Rationality in Commercial Contracts

by Joseph Lewin

On 30 November 2020, the UK High Court handed down judgment in the relief phase of the case of *Otello Corporation ASA v. Moore Freres & Company LLC and Last Lion Holdings Limited* (BL-2018-000840).

Dorsey & Whitney advised the successful Claimant, Otello.

The case arose as a result of a breach by the board of directors of the Second Defendant, Last Lion, of the implied duty to act rationally when exercising an apparently unfettered contractual discretion.

This implied duty is rarely found to be breached, and this case is therefore notable for setting out the types of conduct that might lead a Court to find that there had been a breach in practice.

Implied Duty of Rationality

Although English law typically allows for freedom of contract between business entities, implied terms do exist.

One of these is a duty to act rationally and in good faith, which is implied into contractual terms that provide for one party to have a discretion to make a decision over the other, which will impact the rights of that other party.

This duty is sometimes referred to as the “*Braganza duty*” or “*Socimer duty*”, following the leading cases on the matter: *Braganza v BP Shipping Ltd* [2015] UKSC 17 and *Socimer International Bank v Standard Bank London Ltd* [2008] EWCA Civ 116.

This duty was defined by the Court of Appeal in the Socimer case, which held 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

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arbitrariness, capriciousness, perversity and irrationality."

This duty to act rationally is likely to be implied where:

1. one party, acting as decision-maker, has discretion to make a decision;
2. the manner in which the discretion is exercised will impact rights held by both parties;
and
3. there is a potential for a conflict of interest for the decision maker.

Most commentary on this implied duty and its effect on the exercise of contractual discretionary rights has stressed that the standard that is required of the party with the discretion is not an onerous one. It should be rare in a commercial context that a party would act so arbitrarily, capriciously or perversely that it would breach this implied duty.

The *Otello* case constitutes a rare exception to that view.

Otello v. MFC

Otello is a minority shareholder in a company called Last Lion Holdings Limited ("**Last Lion**"), the Second Defendant.

MFC, the First Defendant, is the majority shareholder of Last Lion. MFC owns roughly 70% of voting rights, and has a power to control the board of Last Lion by appointing three out of four of its directors.

Last Lion's Articles of Association permit the transfer of shares if such transfer is "*approved by a majority of the Board*" of Last Lion, with "*such approval not to be unreasonably withheld or delayed*".

When Otello wanted to sell its minority shareholding to a third party, Mercury Software Partners LLC ("**Mercury**"), it therefore needed the consent of Last Lion's board to proceed.

However, when Otello sought this approval from the board of Last Lion, the board's response was to institute an extended approval process, headed by an apparently independent subcommittee made up of two of the directors appointed by the majority shareholder. After numerous rounds of questioning regarding the identity of Mercury and its management and ownership, lasting more than two months, the subcommittee advised that the transfer be refused. This decision was based to a large extent on a decision of the Quebec court that was critical of the conduct of Mercury's principal, which Mercury had failed to provide voluntarily, but which the subcommittee held out as reason to refuse approval.

Prior to this final decision, Otello petitioned the Court for an order that Last Lion's affairs were being conducted in a manner that unfairly prejudiced Otello's interests as a shareholder, under section 994 of the Companies Act 2006.

At trial in the liability stage, the Court held that there had been unfairly prejudicial

conduct.

Among other things, the Court found that the manner in which the board's discretion as to whether to give approval had been exercised was in breach of the implied duties of rationality and good faith in *Braganza* and *Socimer*.

The factual basis for this decision was the judge's finding that the independent subcommittee process was not in fact constituted in good faith, and was instead a sham, designed as a mechanism to refuse approval:

- Far from seeking information on the identity of Mercury to assess whether Mercury was an acceptable transferee, the board was in fact already aware of Mercury's identity.
- In fact, prior to Mercury's approach to Otello, MFC had been in negotiations with Mercury in a bid to sell Otello's shares at a substantial mark up without Otello's knowledge. This fact was known to at least two of the directors on the board, including one on the subcommittee.
- During the course of those negotiations between MFC and Mercury, of which Otello was entirely unaware, MFC had sought to obtain Otello's agreement to the sale of its shares (at a price substantially lower than the price that Mercury was offering to MFC). When that agreement was not obtained, MFC had made statements that could indicate a threat to use the approval process in the Articles of Association to trap Otello into its investment.
- Against that background, the "independent" subcommittee was no more than a sham. Disclosure showed that the questions that were to be raised by the committee were already being prepared by the lawyers acting for MFC before the subcommittee had even been constituted, and it was clear that the directors on the subcommittee had taken no active role in the process that they were supposedly controlling.
- In those circumstances, the judgment of the Quebec court was not relevant to the manner in which the discretion of the board had been exercised, despite its findings which might in other circumstances have been determinative.

As a result, despite the substantive paper trail created by the board and its legal counsel, the Court found that there had been a breach and found in favour of Otello on liability.

The matter proceeded to the quantum stage, which was finally determined on 30 November 2020, with the Court ordering (among other things) that MFC purchase Otello's minority shareholding for \$48 million.

Concluding thoughts

Although cases where a party is found to have breached the implied duty of rationality are uncommon, they do exist, as the *Otello* case demonstrates.

To avoid being in breach of an implied duty of rationality by not exercising reasonable discretion in decision-making, it is prudent to ensure that any relevant commercial decision maker(s) do go through a proper decision-making process; by identifying factors that were taken into account in evaluating and concluding decisions, and recording them in an appropriate manner, perhaps with legal support if required.

However, such decision-making does still need to be *bona fide*: the Otello case is a good example of how merely creating a paper trail with the appearance of acting rationally does not absolve a decision maker of its obligations. Its decisions must still be genuinely rational.

Copies of the liability stage judgment of Mr. M H Rosen QC dated 14 September 2018, with citation [2018] EWHC 2347 (Ch), and the relief stage judgment of Edwin Johnson QC dated 30 November 2020, with citation [2020] EWHC 3261 (Ch), are available to the public.

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