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Briefing note November 2015

Addressing Abuse of Contractual Powers

The courts are willing to prevent misuse of contract powers by implying terms to act honestly and on proper grounds and not in a manner that is arbitrary, irrational or capricious.

Where service management regimes in contracts give customers a discretion as to the penalties that can be awarded against the service provider for service failures, the courts will imply a term limiting the exercise of the customer's discretion to acting honestly and on proper grounds and not in a manner that is arbitrary, irrational or capricious: *Portsmouth City Council v Ensign Highways Ltd* [2015] EWHC 1969 (TCC). The Supreme Court has endorsed a similar implied rationality term in which both limbs of the Wednesbury test should be considered: the first limb focussing on the decision-making process and whether the right matters have been taken into account and the second focussing on the outcome of the decision and whether it was so outrageous that no reasonable decision-maker could have reached the decision: *Braganza v BP Shipping Ltd & Anor* [2015] UKSC 17. These decisions demonstrate the willingness of the courts to prevent the misuse of contractual powers but increase uncertainty as to the extent to which contractual powers and remedies can be exercised.

Portsmouth City Council and its unaffordable 20 year contract.

In July 2004, Portsmouth City Council ("**PCC**") entered into a long term PFI contract with Ensign Highways Ltd ("**Ensign**") for the rehabilitation, maintenance and operation of PCC's highway network. The contract contained a regime for awarding service points for breaches by Ensign of its obligations, including a table setting out a number of default events for which points could be awarded, and the number of points that could be awarded for each event, listed in a column headed "Maximum Event Value". The awarding of service points under the contract carried a number of penalties for Ensign, culminating in the right of PCC to terminate the contract with immediate effect in the event that 250 or more service points were awarded against Ensign in a 12 month period.

Initially, PCC viewed the value in the column headed "Maximum Event Value" as the upper limit, and would therefore award service points in a range between 1 and that value, depending on PCC's view of the gravity of the breach. PCC would assess and award these penalties on a monthly basis. However, following cuts in funding to local authorities in 2012, PCC realised that the agreement with Ensign, which still had twenty years to run, had become unaffordable. However, to terminate the contract for convenience it would have had to pay £140 million to Ensign under the relevant contractual provisions.

The advice of an external consultant

On the advice of an external consultant, PCC began a strategy of awarding the maximum number of service points for every breach. PCC also ceased communicating with Ensign about the service points on a monthly basis, and instead stored up points apparently with a view to surprising Ensign with them. Ensign was unhappy with these developments and referred PCC's approach to the awarding of service points to expert determination in accordance with the contract. The Expert determined that PCC had acted in bad faith, without co-operation and unfairly.

Seeking court declarations as to its rights

PCC then sought declarations from the court in relation to what its obligations were when awarding service points. Was PCC permitted to award the number of service points described in the contract as the "Maximum Event Value" for every breach event, or was PCC subject to obligations to Ensign when determining the number of service points it awarded, and if so what were those obligations?

Despite PCC's arguments to the contrary, it was decided that the Maximum Event Values were indeed maximums,

and not fixed tariffs to be applied irrespective of the circumstances. The contract therefore required PCC to exercise discretion when determining how many service points it awarded (up to the specified maximum number).

No good faith obligation

Ensign argued, unsuccessfully, that in exercising that discretion PCC was subject to a general obligation to act in good faith said to be contained in a clause of the agreement which provided that the parties "shall deal fairly, in good faith and in mutual co-operation with one another…" but this concerned the obligations of the parties with respect to PCC's specific Best Value Duty within the context of a Best Value Review process involving the consideration and possible variation of the Agreement which was not directly related to the service management regime. The court concluded that where a contract contains clauses which specifically provided for a duty of good faith, care must be taken not to construe a general obligation outside the terms of those contractual requirements. Clause 44 did not apply to the rest of the agreement, or to the service management regime, and there were no grounds for making the service management provisions subject to it.

The Court took the orthodox approach that there is no general duty of good faith in English contract law. Notwithstanding the much publicised *Yam Seng* case (which suggested that longer term "relational" contracts require higher degrees of communication, trust and predictable performance, and were therefore more likely to include implicit duties of good faith), the Court considered that a duty of good faith was not normally implied into commercial contracts, and as such it was necessary for contracts to contain an express clause importing a relevant duty of good faith before the court would find one.

The implied 'rationality' test

Ensign was more successful in arguing that the clause entitling PCC to award service points must be subject to an implied term covering the manner in which service points could be awarded. The Court considered that, to make sense of the contract's service management regime, PCC's discretion as to the number of service points that may be awarded must have been intended to be subject to an implied term that: "*When assessing the number of Service Points to be awarded…PCC's Representative is to act honestly and on proper grounds and not in a manner that is arbitrary, irrational or capricious.*"

Applying a Maximum Value to all default events did not satisfy this test.

This approach is not peculiar to the Technology and Construction Court. The Supreme Court recently endorsed the principle that such a power cannot be abused or exercised on the basis of an uninhibited whim: see *Braganza v BP Shipping Ltd & Anor.* The Supreme Court more fully developed the rationality test explaining it should be applied using both limbs of the Wednesbury test, the first limb focussing on the decision-making process and whether the right matters had been taken into account and the second focussing on the outcome of the decision, ie: whether, even though the right things had been taken into account, the result was so outrageous that no reasonable decision-maker could have reached the decision. The context of the particular contract was important. It was held that the information relied on in that case could not be regarded as sufficiently cogent evidence to justify the contractual decision-maker making the decision it did. No one had suggested that the decision was arbitrary, capricious or perverse, but it was unreasonable in the first limb sense, having been formed without taking relevant matters into account.

The implied rationality test does not amount to a requirement of reasonableness or good faith but it can be applied in practice in such a way that it amounts to much the same thing.

The distinction between whether to exercise a contractual right and how to exercise it

When it comes to implying terms in relation to service management regimes, the case applied the distinction made in the earlier *Mid Essex* case between a discretion (1) whether to exercise a contractual right under a service management regime; and (2) how to exercise such a contractual right. The former should not be subject to an implied term, since whether a contractual right can be exercised is something that should be seen as within the gift of the owner of that right. On the other hand, if the service management regime works in a way which allows the customer discretion as to how the regime should be operated (such as by leaving to the customer a discretion as to how many service points may be awarded, i.e. a certifying function, as in this case), the court may decide (as it did in this case) that it is necessary to imply a term into the contract governing how such discretion must be exercised by the customer, in order to make sense of what the contract requires and to give effect to the parties' agreement. The Court considered that PCC was required

to take into account the circumstances of the breach, and perhaps even wider considerations going beyond the mere circumstances of the breach.

The resulting uncertainties

The willingness of the court to imply a term in such circumstances, underscores the importance to providers and customers alike of providing comprehensively for what their rights and obligations are with respect to penalties for service failures. Otherwise, the courts see themselves as willing and able to fill the gaps.

The uncertainty that this gives rise to could rob some service management regimes of some of their teeth. Uncertainty can arise as to whether customers can safely rely on failures notified under such regimes in order to exercise remedies such as termination of the contract, or other remedies which depend on the number of service penalties accumulated. Not every contract party is willing, like Portsmouth City Council, to seek declarations from the courts as to their rights.

It may be more difficult for customers to rely on service penalties, particularly where rights as important as the right to terminate are at stake. The courts are generally reluctant to allow a party to terminate early, unless there are good reasons to support and justify such action and this is likely to limit the scope for awarding service penalties.

These decisions will be of interest for contracting parties generally, wherever a discretion is allowed to one party. In particular this can often arise in contracts for IT or other outsourcing projects that include service management regimes. It is not unusual to find accumulated service penalties giving rise to a right to terminate.

Service management regimes

A party may seek to rely on alleged breaches of a service management regime as conferring upon it a right to terminate. However, if the service management provisions of the contract had not been updated to reflect changes in the scope of the project, as can often be the case, and the technical implications of those changes render the definitions of the key service levels in the contract meaningless, as can often be the case, then those key service levels may become incapable of being breached by the provider. As a consequence, the service provider may not be in breach to an extent that could confer a termination right on the customer.

If there are contractual requirements only to exercise a termination right where it is reasonable and proportionate in the circumstances to do so, reliance on past service breaches of this nature may not satisfy the reasonable or proportionate test. A customer's reliance on the service management regime in the contract to terminate the contract can therefore be misplaced and, if so, expose it to a damages claim by the provider for wrongful termination of the contract.

Benchmarking

Many IT and outsourcing contacts also allow for the customer to exercise a discretion in calling for benchmarking of the contract price. The exercise of a discretion in calling for the benchmark may be a mere exercise of a contractual right and so not subject to an implied duty but conducting that benchmarking will likely be subject to the implied rationality tests. As a result, the benchmarking expert may be subject to a duty to act honestly and on proper grounds and not in a manner that is arbitrary, irrational or capricious. In so far as the benchmarking expert appointed is invited by the customer to consider failed tenderers as potential constituents of the benchmark, this may be argued to be irrational in that the failed tenderer may not be considered a valid or relevant comparator with those that were successful. Of course, every contract needs to be considered and read by reference to its own context and language.

Asset Registers

In a similar context, a party may seek to argue that exit obligations to provide an asset register and related information about assets (including therefore choses in action) entitle them to detailed information about the rights and process of an outsourcer, including details of know-how. Such provisions depend on the construction of the contract and must normally be exercised consistently with their contractual purpose, such as to enable an effective handover on exit but no more.

In this way the principles about purposive construction can work with the rationality test to limit the scope of obligations and prevent any potential abuse.

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