At your discretion

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COMMERCIAL CONTRACTS MAY CONFER on one contracting party the discretion to take decisions that have an impact on the interests of the other party to the contract. This can give rise to questions of whether the decision maker owes any duties to the other contracting party and the extent to which the decision maker is entitled to prefer their own interests. This issue arose in the recent case of *Euroption Strategic Fund Ltd v Skandinaviska Enskilda Banken AB* [2012], where the court had to consider, among other things, whether the defendant (a clearing broker) owed the claimant (an investment fund) a duty to conduct a close out liquidation of the claimant's portfolio of assets with reasonable skill and care, following a failure by the claimant to comply with its contractual obligation to make margin payments.

THE CLAIM

The claimant, Euroption Strategic Fund Ltd (Euroption), was an investment fund that traded mainly in European equity options. The defendant, Skandinaviska Enskilda Banken AB (SEB), acted as Euroption's clearing broker between May and October 2008 pursuant to an exchange traded futures and options mandate entered into on 12 May 2008 (the mandate).

In the financial turmoil of October 2008, Euroption (whose trading strategy left it exposed in a volatile market) failed to meet margin calls made by SEB and SEB exercised its contractual right to close out Euroption's portfolio. While Euroption did not dispute SEB's right to do this, it alleged that SEB had (in broad terms):

i) delayed in the close out of the portfolio generally or (alternatively) in relation to a number of specific positions; and

ii) opened new 'combination' positions without contractual or other authority.

It therefore issued proceedings against SEB, claiming damages for breach of contract, negligence and/or breach of fiduciary duty (although by the end of trial the breach of fiduciary claim had been withdrawn).

SEB'S RIGHTS AND OBLIGATIONS UNDER THE MANDATE

Clause 11 of the mandate obliged Euroption to pay margin when asked to do so by SEB to support the exposure on Euroption's portfolio. Where Euroption failed at any time to provide sufficient margin or other payment due in respect of any transaction as required, SEB was entitled 'to close out [Euroption's] open contracts at any time without reference to [Euroption]'. SEB was also entitled, at its discretion, to close out Euroption's positions, having made reasonable efforts to contact Euroption, *inter alia*, 'at any time SEB deem[ed] it necessary for its own protection'.

Both parties agreed that, in exercising its rights under clause 11 of the mandate, SEB was under a duty to conduct the close out in good faith, and in a manner that was not arbitrary, capricious, perverse and/or irrational. However, Euroption alleged (and SEB denied) that SEB had a contractual and/or tortious duty of care to conduct the close out exercise competently and with reasonable care. There was also a dispute about the degree of discretion afforded to SEB under clause 11 of the mandate. Euroption alleged that this was a narrow provision conferring no discretion upon SEB and requiring SEB to complete the liquidation of the portfolio without delay and without opening any new positions. SEB, on the other hand, argued that the mandate conferred a wide and unfettered discretion in relation to the conduct of the close out.

DUTY TO ACT RATIONALLY VERSUS DUTY TO ACT WITH REASONABLE SKILL AND CARE

In essence, therefore, the key legal issue in dispute, and the one on which this article focuses, was whether:

i) as SEB argued, the only limit on SEB's close out right was the obligation to act honestly, in good faith and not arbitrarily, capriciously, perversely or irrationally; or

ii) whether, as Euroption argued, the right was a much more limited one, conferring little or no discretion over the conduct and timing of the close out and requiring SEB to conduct the close out with reasonable skill and care.

In considering this issue, Gloster J referred in some detail to the case of *Socimer International Bank Ltd (in Liquidation) v Standard Bank London Ltd (No 2)* [2008] (in which Barry Donnelly, acted for the successful defendant/appellant). In that

case, the Court of Appeal had to consider, in the context of trading between banks in forward sales of emerging markets securities, a provision in the forward sales agreement that gave the defendant, Standard Bank, an absolute discretion, following a default by the claimant, Socimer, whether to liquidate or retain the portfolio to satisfy the amount due to it, but obliged it to carry out an immediate valuation of the portfolio and to credit the resultant amount to the claimant. The question for the Court of Appeal was whether the defendant's contractual obligation was to conduct an honest but otherwise subjective valuation of the portfolio of assets, or whether, as a matter of contractual implication, the defendant was under a duty to take reasonable care to determine their true market value.

The Court of Appeal found that there was no obligation to take reasonable care to arrive at the true market value of the assets. The decision maker's discretion was limited, as a matter of necessary implication, only by concepts of honesty, good faith, and genuineness, and the need for the absence of arbitrariness, capriciousness, perversity and irrationality. Subject to those limitations, the decision maker was entitled to act in accordance with its own best interests.

Rix LJ, with whom the other members of the Court of Appeal agreed, described this as a duty to act rationally. When considering whether a party has acted rationally, the court does not replace the view of the decision maker as to what was reasonable in the circumstances, with the court's own view, provided that the decision maker does not step outside the bounds of its duty of acting honestly, in good faith and not arbitrarily, capriciously, perversely or irrationally. The concept of 'reasonableness' is relevant but only in the *Wednesbury* unreasonableness public law sense (where the test is whether the decision taken is so unreasonable that no reasonable person, in the position of the person taking the decision, could have taken it). When considering a duty to act with reasonable skill and care, however, the court will deploy a set of objective criteria and reach its own decision as to what is reasonable.

DUTY TO EXERCISE REASONABLE SKILL AND CARE?

Notwithstanding the decision in *Socimer*, Euroption sought to persuade Gloster J to take a different approach and argued that the language used in the mandate should be read as being subject to an implied term that any close out should be conducted competently and with reasonable care either pursuant to s13 of the Supply of Goods and Services Act 1982 (the 1982 Act) or in accordance with the usual common law rules on implied terms. Euroption also argued that SEB owed it a tortious duty of care when conducting the close out.

> ***'When considering a duty to act with reasonable skill and care, the court will deploy a set of objective criteria and reach its own decision as to what is reasonable.'***

STATUTORY IMPLIED TERM?

Section 13 of the 1982 Act provides that:

> 'In a contract for the supply of a service where the supplier is acting in the course of a business, there is an implied term that the supplier will carry out the service with reasonable care and skill.'

Euroption argued that this provision applied to clause 11 of the mandate. However, Gloster J rejected this argument on the basis that the implied term only applied to the services agreed to be provided under a contract and not to all rights and obligations under such a contract. Under the mandate, SEB had agreed to provide two types of service to Euroption, namely advisory services and settlement and exchange services. Section 13 of the 1982 Act would apply to the provision of these services. The right to close out Euroption's positions, by contrast, was a discretion conferred on SEB for the purposes of protecting its own position; it could not be characterised as a service supplied by SEB to Euroption and so s13 of the 1982 Act did not apply.

COMMON LAW IMPLIED TERM?

Gloster J also rejected Euroption's argument that a term that SEB would conduct the close out using reasonable skill and care and to a suitably professional standard could be implied into the mandate. The judge stated that such a term was not necessary to give business efficacy to the mandate nor was it so obvious that it 'goes without saying' that such a term should be applied.

Furthermore, it was uncertain how such a duty could be defined or how, in the extremely volatile trading conditions of 10-14 October 2008, objective criteria could be retrospectively applied by the court to determine whether the closing broker had satisfied the relevant standard. In terms of risk allocation, there was no reason why a broker providing clearing services for a modest commission per trade (and not holding itself out as an expert options trader) would put itself at risk of having its trading decisions second guessed in this way, when faced with an unwanted portfolio as a result of a customer's default.

TORTIOUS DUTY OF CARE

Euroption also relied upon the three tests that can be applied by the court when considering whether a duty of care arises in the context of pure economic loss, namely:

a) The 'assumption of responsibility test', which asks whether the defendant has undertaken a responsibility towards the claimant to exercise reasonable care and skill (see *Henderson v Merrett Syndicates Ltd* [1995]).

b) The 'threefold test', which asks whether:

- **i)** the damage that has occurred was foreseeable;
- **ii)** there was a sufficiently proximate relationship between the parties; and
- **iii)** it is fair, just and reasonable in all the circumstances to impose a duty of care (see *Caparo Industries v Dickman* [1990]).

c) The 'incremental test' whereby the law recognises categories of cases in which duties are owed by analogy with

existing cases where it has already been established that duties of care are owed (see *Murphy v Brentwood DC* [1991]).

As for the incremental test, Gloster J accepted SEB's submission that the imposition of a duty of care in the present case would involve expanding the law into a new context, namely that of a clearing broker conducting a close out and that this was not an appropriate relationship in which to impose a duty of care.

The judge dealt with the assumption of responsibility and threefold tests together and found that they had not been satisfied. She gave a list of reasons for this but, in broad terms, her decision was based on the fact that Euroption was a specialist option trader, whose business it was to take and manage risks, and who did not, in the usual course of events rely on SEB; whereas SEB was in a position not of its own making and there was no reason why it should be held responsible to Euroption for the careful management of the portfolio when the purpose of clause 11 of the mandate was to enable SEB to protect its own position.

More generally, Gloster J said that once Euroption's case on implied statutory or contractual terms had failed, there was no room for the imposition of a tortious duty of care, which was more extensive than that which was provided for under the mandate. In support of this finding, she referred to the following statement of Lord Templeman, in *Downsview Nominees Ltd v First City Corporation Ltd* [1993]:

> 'The House of Lords has warned against the danger of extending the ambit of negligence so as to supplant or supplement other torts, contractual obligations, statutory duties or equitable rules in relation to every kind of damage including economic loss... There will always be expert witnesses ready to testify with the benefit of hindsight that they would have acted differently and fared better.'

OUTCOME

For the reasons given above, therefore, Gloster J held that SEB did not owe Euroption a duty to conduct the close out with reasonable skill and care. Nevertheless, in case she was wrong about this, the judge considered whether, on the facts, SEB would have been in breach of such a duty if it existed and also whether it had been in breach of its admitted duty to conduct the close out rationally. A detailed analysis of the judge's factual findings is outside the scope of this article. The judge found in favour of SEB and dismissed Euroption's claims, but it is worth briefly considering the way in which the judge dealt with some of Euroption's arguments because her findings include some further points of general interest.

THE COMBINATION TRADES

Euroption complained that, while conducting the close out, SEB had executed two combination trades that involved opening new positions in circumstances where the relevant positions could and should have been closed 'naked' (ie without opening a new trade). This, Euroption argued, was done in excess of SEB's authority conferred by the mandate. However, Gloster J found that SEB's right to 'close out' the portfolio included a right to enter into the combination trades because, as the expert evidence showed, this was a recognised market method of closing out an open position as part of a forced liquidation process.

Gloster J also considered whether executing the combination trades was a breach of SEB's duty of care (if one existed) or its admitted duty to act rationally. She found that it was not, saying, among other things, that a clearing member conducting a close out in its own interests in circumstances such as those prevailing on 10 October 2008 was under no obligation to consider every possible alternative trade at every moment on that day. The fact that it might have been possible to structure a group of trades that included options and futures, that might have been even more beneficial from a risk reduction perspective than the trades that were executed, did not mean that the trades that were executed did not themselves have very substantial benefits or that it was anything other than reasonable to execute such trades.

THE DELAY CLAIMS

One of Euroption's claims was based on the premise that the close out started on 9 October 2008. It argued that, having started on that date, SEB could and should have completed the close out by close of business on the same day. This claim failed because, on the facts, the judge found that the close out was not started until 10 October 2008.

As a fall-back argument, Euroption complained that, on the assumption that the close out began on 10 October 2008, SEB delayed in the buying back of certain short call positions. Gloster J noted that she received a 'meticulous and micro analysis' of the strategy that Euroption contended that SEB should have adopted in relation to closing out these short call positions and commented that Euroption was effectively inviting the court, by reference to suggested alternative trading strategies, to re-run the entire close out from 10-14 October. She thought that this was the wrong approach. In her view the issue for the court was not the relative strengths and weaknesses of another strategy compared with the strategy in fact adopted but whether the decisions actually taken were within the bounds of reasonableness and flexibility that brokers have when put in this position. On the facts, the judge found that Euroption had not shown any breach by SEB of its duty to exercise reasonable skill and care (if one existed), let alone any breach of its duty to act rationally and that the decisions taken by SEB were well within the discretion of a clearing member closing out a client's position after default in the provision of margin.

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Associated Provincial Picture Houses Ltd. v Wednesbury Corporation [1947] 1 KB 223

Caparo Industries v Dickman [1990] 1 All ER 568

Downsview Nominees Ltd v First City Corporation Ltd [1993] 1 AC 295

Euroption Strategic Fund Ltd v Skandinaviska Enskilda Banken AB [2012] EWHC 584 (Comm)

Henderson v Merrett Syndicates Ltd [1995] 2 AC 145

Murphy v Brentwood DC [1991] 1 AC 398

Socimer International Bank Ltd (in Liquidation) v Standard Bank London Ltd (No 2) [2008] 1 Lloyd's Rep 558