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Expert Analysis

'Sole Discretion' Provisions and the Implied Covenant of Good Faith and Fair Dealing

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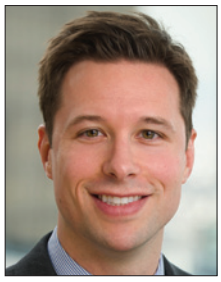

Civil plaintiffs frequently invoke the so-called "implied covenant of good faith and fair dealing" to allege that the defendant, while not breaching an express provision of the relevant agreement, nevertheless acted in a way that violated the parties' mutual expectations. Despite its regular appearance in briefs and opinions, however, the implied covenant of good faith and fair dealing has produced a significant amount of confusion among courts and litigants. Such confusion has been particularly acute in the context of agreements providing one party with sole discretion to act (or not act) in a particular manner.

As traditionally stated under New York law, the implied covenant "embraces a pledge that neither party shall do anything which will have the effect of destroying or injuring the right of the other party to receive the fruits of the contract." *511 W. 232nd Owners Corp. v. Jennifer Realty Co.*, 98 N.Y.2d 144, 153 (2002). Yet, significant questions arise from this premise: for example, what are the "fruits of the agreement" where one contracting party bargains for, and receives, the right to act in its "sole discretion"? Can that party breach the implied covenant by exercising its contractual discretion in bad faith?

Two decisions by the New York State Supreme Court, Appellate Division, have provided answers to these questions, and have helped to clarify the scope of the implied covenant in the face of a "sole discretion" provision agreed upon by sophisticated commercial parties: *ELBT Realty, LLC v. Mineola Garden City Co.*, 144 A.D.3d 1083 (2d Dep't 2016); and Transit Funding Associates LLC v. Capital One Taxi Medallion Finance, 149 A.D.3d 23 (1st Dep't 2017). As discussed below, each of these cases relied upon a New York Court of Appeals decision, *Moran v. Erk*, 11 N.Y.3d 452 (2008), to hold that the implied covenant cannot restrict a party's express right to exercise sole discretion under the contract.

ELBT Realty

First, in *ELBT Realty*, the parties entered into a contract for the sale of a commercial building that permitted the purchaser to terminate the agreement in "its sole discretion" and for "any reason whatsoever." When the purchaser exercised its termination right and demanded return of its down payment, the seller commenced an action alleging that the purchaser terminated in bad faith. The Appellate Division, Second Department, held that the implied covenant of good faith and fair dealing could not deprive the purchaser of its bargained-for right to terminate the contract for "any reason whatsoever during the specific time frame." The court reasoned:

[T]he plain language of the contract makes clear that termination of the contract was a possibility and the parties, who were sophisticated, counseled business entities negotiating at arm's length over a prolonged period of time, should have understood and expected that termination of the agreement could occur during that specified window of time, and that such a decision was the purchaser's alone and did not need to be accompanied by any specific justification.

144 A.D.3d at 1084 (citations omitted).

As the court emphasized, to impose a "good faith" limitation on the purchaser's discretion to terminate "would require adding terms to the contract and thereby make a new contract for the parties under the guise of interpreting the writing." *Id.*

In reaching its conclusion, the Second Department cited the Court of Appeals' decision in *Moran v. Erk*, 11 N.Y.3d 452 (2008). In *Moran*, the parties

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had negotiated a real estate purchase contract that included an "attorney approval contingency" clause. *Id.* at 454. After signing the agreement, the defendants "developed qualms about purchasing the [plaintiffs'] house" and "instructed their attorney to disapprove the contract." *Id.* at 454-55. The plaintiffs brought suit to recover damages, arguing that "the implied covenant of good faith and fair dealing implicitly limit[ed]" any discretion to disapprove the transaction in bad faith. *Id.* at 456.

The Court of Appeals rejected the argument, holding that it "misconstrues the implied covenant of good faith and fair dealing under New York law." *Id.* While recognizing that the implied covenant prevents a party from destroying the other party's right "to receive the fruits of the contract," the *Moran* court explained that "the plain language of the contract in this case makes clear that any 'fruits' of the contract were contingent on attorney approval, as any reasonable person in the [plaintiffs'] position should have understood." *Id.* at 456-57. Because "no further limitations on approval appear[ed] in the contract's language," the *Moran* court held that the purchasers were permitted to "disapprove the contract for any reason or for no stated reason." *Id.* at 459.

Prior to *ELBT*, the decision in *Moran* had been cited by a number of federal decisions applying New York law to dismiss claims for breach of the implied covenant of good faith and fair dealing based on express discretionary provisions. *See, e.g.*, *Overseas Private Inv. Corp. v. Gerwe*, No. 12-CV-5833(RA), 2016 WL 1259564, at *7 (S.D.N.Y. Mar. 28, 2016); *In Touch Concepts, Inc.*, 949 F. Supp. 2d 447, 471-72 (S.D.N.Y. 2013). Despite the previous lack of New York State appellate authority applying *Moran* in such a manner, at least one New York trial court opined that *Moran* represented a change in the law regarding the implied covenant and discretionary clauses. *See Valentini-Shamsky v. Deloitte, LLP*, 2015 WL 2127109, at *4 (Sup. Ct. N.Y. Cnty. May 5, 2015).

Transit Funding

Three months after the *ELBT* decision was issued, the Appellate Division, First Department, similarly addressed whether the implied covenant can limit a party's "sole and absolute" contractual discretion.

In *Transit Funding*, the parties entered into a revolving taxi loan agreement whereby the plaintiff could make periodic requests for loan advances and the defendant retained the right to deny "any" request "in its sole and absolute discretion." 149 A.D.3d at 25. In the face of a deteriorating taxi lending market, the defendant stopped approving the plaintiff's requests for loan advances and the plaintiff eventually brought suit, alleging, *inter alia*, that the defendant breached the implied covenant of good faith and fair dealing because its refusal to approve any further advances had destroyed the fruits of the contract and put the plaintiff out of business.

> Despite its regular appearance in briefs and opinions, the implied covenant of good faith and fair dealing has produced a significant amount of confusion among courts and litigants.

The defendant argued that the loan agreement specifically entitled the lender to deny any requests for loan advances for any reason, and thus the plaintiff could not plead a cognizable claim for breach of the implied covenant of good faith. The First Department agreed, holding that "the existence of the [implied covenant] cannot be relied on" in such circumstances. *Id.* at 29. Citing Moran v. Erk, the First Department emphasized that "[t]he covenant of good faith and fair dealing cannot negate express provisions of the agreement . . . nor is it violated where the contract terms unambiguously afford [the defendant] the right to exercise its absolute discretion to withhold the necessary approval."

Applying that principal, the *Transit Funding* court concluded that "[b]ecause [the defendant's] complained-of conduct consists entirely of acts it was authorized to do by the contract, its alleged motivation for doing so is irrelevant." *Id.* Accordingly, "even an intent to put [the plaintiff] out of business cannot justify a lawsuit for a claimed breach of the covenant where the express provisions of the agreement allowed [the defendant] to act as it did." *Id.* at 29-30. Significant to the court's decision (though not necessarily determinative) was the fact that other provisions of the same contract expressly conditioned one party's discretion on the exercise of "good faith," while the provision at issue lacked such language.

Recently, the First Department relied upon *Transit Funding* to again hold that the implied covenant could not be used to negate the defendant's bargained-for "sole and absolute discretion" under the contract. *See Veneto Hotel & Casino, S.A. v. German Am. Capital Corp.*, 160 A.D.3d 451 (1st Dep't 2018).

The *ELBT Realty* and *Transit Funding* decisions reaffirm the principle articulated in *Moran v. Erk* — *i.e.*, that the implied covenant of good faith and fair dealing should not be judicially imposed where it would modify or negate the express terms of the parties' agreement, including where the contract expressly permits one party to act in its "sole discretion." Contracting parties should bear them in mind when drafting agreements that expressly allow for one party's exercise of discretion.