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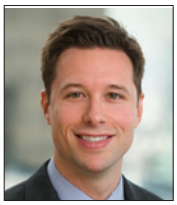
"Sole Discretion" Provisions, Implied Covenants and Fiduciary Duties



By **Alexander Drylewski**

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Our previous article discussed ways in which New York courts treat causes of action for breach of the implied covenant of good faith and fair dealing in the face of contractual provisions permitting the defendant to act in its "sole discretion." (See Alexander Drylewski, "'Sole Discretion' Provisions and the Implied Covenant of Good Faith and Fair Dealing," New York Law Journal (June 18, 2018), available at: https://www.law.com/newyorklawjournal/2018/06/19/062018ny_drylewski/). Specifically, we addressed three Appellate Division decisions holding that the implied covenant "cannot negate express provisions of the agreement, nor is it violated where the contract terms unambiguously afford [a party] the right to exercise its absolute discretion." Transit Funding Assoc., *LLC v. Cap. One Equip. Fin. Corp.*, 149 A.D.3d 23, 29 (1st Dept. 2017); see also Veneto Hotel & Casino, *S.A. v. Ger. Am. Cap. Corp.*, 160 A.D.3d 451, 452 (1st Dept. 2018); ELBT Realty, *LLC v. Mineola Garden City Co.*, 144 A.D.3d 1083, 1084 (2d Dept. 2016). These decisions follow the Court of Appeals' reasoning in *Moran v. Erk*, 11 N.Y.3d 452 (2008), which held that a party's contractual right to act with sole discretion cannot be limited by the implied covenant, even where the party is alleged to have exercised its right in bad faith.

'Shatz' and 'Richbell'

The First Department's recent decision in *Shatz v. Chertok*, 180 A.D.3d 609 (1st Dept. 2020), suggests that application of the above principle is less straightforward in cases where the parties owe fiduciary duties. In *Shatz*, an entrepreneur brought suit against an investment firm, alleging that the firm's officers failed to pursue a previously-agreed upon investment opportunity and secretly diverted that opportunity to another entity in which they had an interest. The plaintiff asserted causes of action for breach of fiduciary duty and breach of the implied covenant of good faith and fair dealing (among others).

The defendants sought dismissal of the good faith and fair dealing claim on the ground that the corporation's operating agreement gave the investment company "'sole and absolute discretion' over investment decisions." *Shatz*, 180 A.D. at 609. The First

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Department rejected this argument, reasoning that although the defendants were permitted sole discretion over investment decisions, the complaint sufficiently alleged that defendants exercised that discretion in bad faith and to self-deal.

In doing so, the *Shatz* court relied on the First Department's earlier decision in *Richbell Info. Servs., Inc. v. Jupiter Partners, L.P.*, 309 A.D.2d 288 (1st Dept. 2003). In *Richbell* (a decision predating *Moran*), the parties formed a privately held corporation and entered into an agreement that required both of them to consent to a public offering of the company's stock, in effect giving each party the right to veto any such offering by withholding their consent. The defendant vetoed a contemplated public offering and the plaintiffs brought suit, alleging that the defendant invoked its veto power in bad faith and for the purpose of increasing its own profits while depriving the plaintiffs of the benefit of the joint venture.

The plaintiffs asserted causes of action for, among other things, breach of the implied covenant of good faith and fair dealing and breach of fiduciary duty. In denying the defendant's motion to dismiss these causes of action, the First Department concluded that even where a contract gives one party an unlimited right to take a particular action (in that case, the right to give or withhold consent to conduct a public offering), that right may not be exercised solely for personal gain in a manner that deprives the other party of the fruits of the contract.

The court stated "that this limitation on an apparently unfettered contractual right may be grounded" in either "the construction of the parties' fiduciary obligations" or "on the purely contractual rule that even an explicitly discretionary contract right may not be exercised in bad faith so as to frustrate the other party's right to the benefit under the agreement." *Richbell*, 309 A.D.2d at 302.

> Parties engaged in commercial transactions would do well to remember these issues when drafting sole discretion provisions or assessing their rights and obligations thereunder.

The *Richbell* court recognized that its holding created some "tension" between "the imposition of a good faith limitation on the exercise of a contract right and…the avoidance of using the implied covenant of good faith to create new duties that negate explicit rights under a contract." Id. The court concluded, however, that the plaintiffs' allegations did not create "new duties" in that case but only sought "imposition of an entirely proper duty to eschew this type of bad-faith targeted malevolence in the guise of business dealings." Id.

Good Faith and Fair Dealing Jurisprudence

In light of the decisions highlighted above, it might seem as though New York courts have developed inconsistent lines of authority regarding whether the implied covenant of good faith and fair dealing can apply where a party is permitted to exercise sole discretion under the contract. A closer analysis, however, reveals potential grounds for reconciling the case law.

First, New York law recognizes that the implied covenant of good faith and fair dealing encompasses only those obligations that "a reasonable person in the position of the promisee would be justified in understanding were included." *Moran,* 11 N.Y.3d at 457. In Shatz and Richbell, the plaintiffs alleged a fiduciary relationship between the parties coupled with allegations of egregious misconduct. Although the *Shatz* court did not expressly distinguish between cases involving fiduciary duties and those that do not, *Shatz* may be harmonized with *Moran* on the ground that a party's fiduciary

duties inform what a "reasonable" promisee would be "justified" in understanding was encompassed by the parties' agreement, including what promises may be implied therein.

To the extent the *Richbell* decision can be read to suggest that the implied covenant will trump a sole discretion provision even in the absence of a fiduciary relationship, it bears noting that *Richbell* pre-dates *Moran* and the many recent decisions applying Moran to dismiss good faith and fair dealing claims where the defendant was permitted discretion under the contract. See, e.g., *Seeking Valhalla Tr. v. Deane*, 182 A.D.3d 457 (1st Dep't 2020); *United Nat. Foods, Inc. v. Goldman Sachs Grp., Inc.*, 2020 WL 2135803, at *13 (N.Y. Sup. Ct. May 5, 2020); *Revlon Consumer Prods. Corp. v. Pac. World Corp.*, 2020 WL 3451880, at *3 (N.Y. Sup. Ct. June 24, 2020).

Second, *Richbell* and *Shatz* involved claims of fraudulent conduct that was inconsistent with the parties' fiduciary relationship. Recent decisions have sidestepped *Richbell* on this ground. For example, in *Seeking Valhalla*, a decision that post-dates *Shatz*, the plaintiff alleged that the defendant violated her fiduciary duties, the operating agreement and the implied covenant of good faith and fair dealing by reducing plaintiff's sharing ratio even though the operating agreement explicitly provided that she could reallocate sharing ratios in her "sole discretion." The motion court dismissed the complaint on the ground that the implied covenant "cannot negate express provisions of the agreement." *Seeking Valhalla Trust v. Deane*, 2019 WL 1491660, at *10 (N.Y. Sup. Ct. Apr. 04, 2019).

New York courts may be more inclined to sustain claims for breach of the implied covenant of good faith and fair dealing where the plaintiff alleges egregious misconduct, bad faith and self-interest in the context of a fiduciary relationship.

In so doing, the court expressly distinguished *Richbell* on the ground that it involved allegations of "fraud, collusion and illegality," while the defendant's alleged conduct in *Valhalla* fell within the terms of the parties' agreement. Id. at *11. The First Department agreed, concluding that the agreement at issue was "unambiguous" and the defendant merely utilized the very rights given to her in the operating agreement by exercising "her express sole discretion to reallocate sharing ratios, even down to zero, at any time." 182 A.D.3d at 458.

Conclusion

In sum, it appears that New York courts may be more inclined to sustain claims for breach of the implied covenant of good faith and fair dealing where the plaintiff alleges egregious misconduct, bad faith and self-interest in the context of a fiduciary relationship. Courts examining an arm's length transaction between sophisticated parties, on the other hand, tend to be less willing to impose implied duties in the face of contractual provisions providing one party with the ability to act with sole discretion. Ultimately, parties engaged in commercial transactions would do well to remember these issues when drafting sole discretion provisions or assessing their rights and obligations thereunder.