



COMMERCIAL DIVISION UPDATE

Limits on the Exercise Of 'Sole and Absolute' Discretion

Commercial contracts frequently give one party the right to determine in its sole and absolute discretion whether the performance of the other contracting party, or perhaps of a third party, satisfies the contractual requirements. For example, a contract may require party A to provide a letter of credit or some other document to party B that must in form and substance be satisfactory to party B in its sole and absolute discretion. But even where the contract places no express limits on the exercise of that discretion, does New York law do so?

Several Commercial Division justices recently have interpreted the exercise of such discretion in light of the implied duty of good faith and fair dealing, which the courts have found imposes an obligation to exercise such discretion in good faith. Where the application of this principle frequently diverges, however, is when dealing with contract termination issues and the right of one party, in its discretion, to terminate a contract.

Reflecting a fundamental difference between approving ongoing contractual performance and exercising the right to end a contract, some Commercial Division decisions appear less willing to allow any good faith obligation to interfere with a termination right, even going so far as to find that there is no enforceable expectation that a counter-party will exercise its discretion to terminate in good faith.¹ We address these decisions below.

Discretion and Good Faith

Judicial modulation of the exercise of sole and absolute discretion typically finds its roots in the implied covenant of good faith and fair dealing. For example, in *55 Eckford Realty LLC v. Bank of East Asia (U.S.A.) N.A.*, Justice Carolyn Demarest of the Kings County Commercial Division held that, despite a defendant's contractual right of "sole and absolute discretion," the implied covenant of good faith and fair dealing prevented



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defendant from imposing new requirements on the plaintiffs.²

In *55 Eckford*, the plaintiffs applied for a loan from the defendant bank to finance construction of a building.³ Subsequently, the bank issued a commitment letter obligating the plaintiffs to deliver 27 due diligence items in advance of closing, all of which were to be in form and substance satisfactory to the bank, and stating that the bank's obligation to close was "conditioned upon the completion by [the bank] and its counsel of such due diligence investigations...as [the bank] and its counsel shall deem appropriate."⁴ In addition, the commitment letter provided that any right given to the bank to approve or disapprove or to make any other decision or determination "shall be in the sole and absolute discretion of the bank."⁵

The commitment letter provided that the bank was to obtain an appraisal of the property.⁶ However, the bank allegedly put the completion of that appraisal on hold pending receipt from plaintiff of an approval from the Department of Health of the intended use of a portion of the premises as a day care center.⁷ The plaintiffs responded that the Department of Health issues day care center licenses only following completion of construction, that the use of the premises as a day care center was a permitted zoning use, and that, in any event, the bank's commitment was not contingent on the approval of a day care center.⁸ Relying on its right under the commitment letter to condition closing on the receipt of other information and documentation as it, in its sole and absolute discretion, deemed appropriate, the bank thereafter sent a letter informing the plaintiffs that the bank's loan commitment had expired, stating:

because [the bank] did not learn for some time after the commitment letter was signed and returned to it that the community facility

portion of the Project would be used as a day care center and because of regulatory and approval issues concerning such use, [the bank] was not able to complete the required due diligence and therefore was not able to close the loan before...the latest closing date as specified in [the commitment letter].⁹

The plaintiffs filed suit for specific performance and damages alleging breach of the loan commitment because plaintiffs had complied with all of their closing requirements, had requested a closing date from the bank for two weeks without a response, and the bank's appraiser had informed plaintiffs that the bank had "put everything on hold."¹⁰ The bank moved for summary judgment, arguing that the plaintiffs had failed to satisfy a closing condition of providing approved architectural plans for the building after determining to use the space for a day care center.¹¹

The court agreed with plaintiffs that approval by the health department of the day care center "could not have been obtained until after the building was constructed and a certificate of occupancy was issued."¹² The court rejected the bank's argument that it had the complete discretion to accept or approve plaintiffs' submissions and to demand additional information because "where a contract 'contemplates the exercise of discretion, this pledge includes a promise not to act arbitrarily or irrationally in exercising that discretion.'"¹³

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The court found that the covenant of good faith and fair dealing implied in the contract prevented the bank from using its discretion "to make any demand it wanted upon plaintiffs, even to the extent of effectively terminating its own obligation to loan the funds in spite of plaintiffs' attempts to comply."¹⁴ Thus, the bank did not have the right deliberately to "not obtain an appraisal of the property prior to the expiration of the commitment."¹⁵ As a result of the legal arguments and related factual issues raised, the

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court denied the bank's motion for summary judgment.¹⁶ Notably, the court found that the commitment letter was a contract of adhesion as the bank had drafted it, and therefore construed the language against the bank.¹⁷

Similarly, in *Legend Autorama, Ltd. v. Audi of America Inc.*, Justice Elizabeth Emerson of the Suffolk County Commercial Division denied summary judgment based on the existence of triable issues of fact "regarding whether [defendant] exercised its discretion in bad faith."¹⁸ The plaintiffs there were two Suffolk County Audi dealerships that had dealer agreements providing that Audi would assist the dealers "through such means as [Audi] considered appropriate."¹⁹ When Audi created a new dealership in the same county for the asserted purpose of assisting an underperforming market, plaintiffs brought an action including allegations that Audi breached the contract and the covenant of good faith and fair dealing.²⁰

In response to Audi's contention that it had "sole discretion" to decide how to assist its dealers based on the contracts "through such means as it considered appropriate," the court examined what obligations the implied covenant of good faith and fair dealing imposed on Audi.²¹ The court held that the covenant includes "any promises that a reasonable person in the position of the promisee would be justified in understanding were included" and "a pledge that neither shall do anything that will have the effect of destroying or injuring the right of the other party to receive the fruits of the contract."²² The court found the existence of issues of fact over whether Audi's conduct breached these obligations.²³

Right to Terminate

Conversely, where one party has the contractual right to exercise discretion to terminate a contract, other courts have placed little emphasis on the duty of good faith and fair dealing. For example, Westchester County Commercial Division Justice Alan Scheinkman held that a lender did not violate the covenant of good faith and fair dealing as defendants alleged in *Hudson Valley Bank, N.A. v. BanxCorp.*²⁴ The plaintiff lender brought an action against the defendant borrower and defendant guarantor for nonpayment of loans under a credit line agreement.²⁵ The credit line agreement at issue provided that the plaintiff "Bank may, at any time in its sole discretion, for any reason or for no reason whatsoever, terminate Borrower's ability to receive loans or advances," that the loans were payable on demand, and that the "Bank may make this demand at any time after the date hereof in its sole discretion...."²⁶ The court explained:

The concept that every contract carries with it a promise to use good faith and fair dealing in executing the contract does not extend so far as to permit the courts to re-write the agreements of the parties by deleting

provisions they made or adding provisions they did not make.²⁷

Therefore, since "the Agreement gave Plaintiff the right to terminate its financing at any time in its sole discretion, the Court cannot re-write the Agreement in order to create an obligation on the part of Plaintiff."²⁸ Moreover, "Defendants ha[d] no enforceable expectation that Plaintiff would use good faith in deciding whether to terminate financing."²⁹ Accordingly, the court granted the lender's motion for summary judgment in lieu of complaint.³⁰

Similarly, in *Better Homes Depot Inc. v. New York Community Bank*, the defendant bank allegedly wrongfully terminated a \$25 million line of credit in favor of the plaintiff, a business that acquired and re-sold residential properties.³¹ Pursuant to a loan agreement between the parties, "the decision to accept Additional Properties and make a new loan with respect thereto shall be made in the sole and absolute discretion" of defendant.³²

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Justice Timothy Driscoll in the Nassau County Commercial Division held that the defendant had the discretion under the loan agreement to terminate "its loans to [plaintiff] in light of factors including the declining real estate market and [its principal's] default under his personal line of credit."³³ Further, "the duty of good faith and fair dealing did not impose an obligation on the [defendant] to make additional loans" to plaintiff, and thus the court dismissed the complaint.³⁴

In *Wachovia Bank, N.A. v. Vesta 50 LLC*, Justice Orin Kitzes of the Queens County Commercial Division granted plaintiff's motion for summary judgment because the plaintiff lender had discretion to refuse extension of a loan maturity date after the defendant's default.³⁵ The loan note stated that the maturity date was "subject to the possible extension thereof pursuant to the terms and provisions of the Loan Agreement," which "gave [plaintiff] discretion in extending the due date of the loan."³⁶

The court found that while "a lender must act in good faith, or, stated otherwise, in a reasonable manner when exercising its discretion...defendant Vesta failed to raise an issue of fact concerning whether the plaintiff lender acted in good faith."³⁷ Further, the court found that the defendant's assertion of bad faith rested "on surmise, suspicion, and conjecture concerning the possible effect the banking crisis of 2008-2009 had on its relationship" with plaintiff, which did

not suffice to defeat a motion for summary judgment.³⁸

Conclusion

Although all of the decisions discussed above recognized that implicit in every contract is a duty of good faith and fair dealing, courts seem more willing to find that the exercise of discretion may violate the good faith covenant where the party with discretion overreaches and exercises it in a way not reasonably contemplated by the parties. Where a party has sole and absolute discretion to terminate a contract, however, the decisions appear less likely to find that the implied covenant of good faith and fair dealing may constrain the exercise of that right.

The courts thus seem generally to recognize the fundamentally different nature of a party exercising discretion to monitor or approve the other party's performance in an ongoing contractual relationship, and a party's contractual right to terminate that relationship in its discretion, the former invoking notions of good faith implicit in an ongoing contractual relationship, and the latter recognizing that the notions of termination and good faith may by definition not be fully compatible.

1. See *Hudson Valley Bank, N.A. v. BanxCorp.*, No. 6628/10, 28 Misc.3d 1232(A), 2010 WL 3516076, at *9 (Westchester Co. Sept. 7, 2010) (Scheinkman, J.).

2. No. 31923/08, 31 Misc. 3d 1229(A), 2011 WL 1944205, at *2, *9 (Kings Co. May 20, 2011) (Demarest, J.).

3. *Id.* at *1-2.

4. *Id.* at *2.

5. *Id.*

6. *Id.*

7. *Id.* at *3-4.

8. *Id.* at *4-6.

9. *Id.* at *5.

10. *Id.* at *6.

11. *Id.*

12. *Id.* at *7-8.

13. *Id.* at *9 (citing *Dalton v. Educ. Testing Serv.*, 87 N.Y.2d 384, 389, 639 N.Y.S.2d 977 (1995)).

14. *Id.*

15. *Id.* at *9.

16. *Id.* at *11.

17. *Id.* at *9.

18. No. 38667-08, 32 Misc.3d 1216(A), 2011 WL 2811461, at *4 (Suffolk Co. July 14, 2011) (Emerson, J.).

19. *Id.* at *1.

20. *Id.*

21. *Id.* at *4.

22. *Id.* (citing *Dalton v. Educ. Testing Serv.*, 87 N.Y.2d at 389).

23. *Id.*

24. 2010 WL 3516076, at *9.

25. *Id.* at *1.

26. *Id.* at *8.

27. *Id.* at *9.

28. *Id.*

29. *Id.*

30. *Id.* at *11.

31. No. 022670-10, 2011 WL 2110359 (Nassau Co. May 10, 2011) (Driscoll, J.).

32. *Id.*

33. *Id.*

34. *Id.*

35. No. 2820/10, 2011 WL 343252 (Queens Co. Jan. 11, 2011) (Kitzes, J.).

36. *Id.*

37. *Id.*

38. *Id.*