The Implied Obligation of Good Faith as a Limit on Contractual Discretion: The New York Approach to Contractual Good Faith Compared to *Bhasin*

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Introduction

Before 2014, the law in Canada "was that there was no general duty to perform contracts in good faith (except in narrow cases, for example in contracts of insurance)."[2] In 2014, however, the Supreme Court of Canada's decision in *Bhasin v. Hrynew* changed Canadian contract law by identifying good faith as an "organizing principle" of contract law that "manifests itself through the existing doctrines about the types of situations … in which the law requires, in certain respects, honest, candid, forthright or reasonable contract performance."[3] The Court identified these existing situations as including:

- Contracts expressly requiring cooperation of the parties to achieve their objects;
- Contracts involving the exercise of contractual discretion;
- Situations where a contractual power is used to evade a contractual duty;
- Contracts in the employment context in the narrow sense that the manner of termination must be done in good faith;
- Contracts in the insurance context; and
- Contracts in the tendering/procurement context.[[4]]

In addition, the Court held that the general organizing principle of good faith also applies to the parties' communications with each other concerning their contract performance. Specifically, the Court recognized a "duty of honest performance," under which "parties must not lie or otherwise knowingly mislead each other about matters directly linked to the performance of the contract." Per the Court, the "duty of honest performance is not an implied term, but rather 'a general doctrine of contract law that imposes as a contractual duty a minimum standard of honest contractual performance."[5] This doctrine "applies to all contracts, and parties are not free to exclude it from their contracts, though they can modify it to some extent depending on the circumstances."[6]

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[2] Ryan P. Krushelnitzky and Sandra L. Corbett, *Honest Performance and "Absolutely Everything" Else: Recent Developments in the Canadian Law of Contract*, For the Defense (DRI International), March 2015.

[3] *Id.* (quoting *Bhasin*).

[4] *Id.*

[5] Krushelnitzky and Corbett, *supra* (quoting *Bhasin*).

[6] *Id.*

Among the above situations identified in *Bhasin*, the Court listed "the exercise of contractual discretion" as just one of several discrete situations. By doing so the Court likely was referring to the specific situation where one party has the contractual discretion to bind another through its actions. But in a meaningful sense, all of the identified *Bhasin* situations deal with issues of discretion because they describe situations where some performance is to be taken, but the contract does not spell out specifically the form which that performance shall take. The performing party has at least some discretion to act as it sees fit, and *Bhasin* addresses the extent to which the law will proscribe the bounds of that discretion.

Similar to Canadian law, New York law recognizes a general obligation of good faith contract performance. The concept in New York, however, is narrower than the principles described in *Bhasin.* Whereas under *Bhasin*, the parties are not free to exclude the duty from their contracts, in New York the implied duty of good faith cannot be asserted in contravention of express contract terms. In addition, the duty of "honest" performance might imply, at least potentially, some subjective component for determining compliance with the implied obligation. In New York, however, the analysis will generally be objective: Regardless of motives or subjective intentions, is the performance objectively within the reasonable expectations of what the parties' bargained for? As discussed below, a number of New York decisions support this rule, including three decisions from the Court of Appeals, New York's highest court.

The Implied Obligation of Good Faith
Under New York Law

Under New York law, "all contracts imply a covenant of good faith and fair dealing in the course of performance."[7] And, this implied duty includes "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."[8]

As an implied term, the implied duty of good faith and fair dealing in New York must be construed in light of and in line with the contract's express provisions. The implied obligation of good faith cannot create additional "obligations inconsistent with other terms of the contractual relationship."[9] The implied duty "cannot be construed so broadly as to effectively nullify other express terms of the contract, or to create independent contractual rights."[10] As a result, New York courts will not hesitate to dismiss a claim for breach of the implied duty of good faith that is "merely a substitute for a nonviable breach of contract claim."[11]

With respect to the exercise of contractual discretion in particular, New York courts recognize that the implied duty of good faith cannot negate a "bargained-for clause that allows a party to exercise its discretion."[12] However, contractual discretion is not unlimited. Even the

[7] *511 W. 232nd Owners Corp. v. Jennifer Realty Co.*, 98 N.Y.2d 144, 153 (2002).
[8] *Id.* (citation omitted).
[9] *Id.* (citation and internal quotation omitted).
[10] *Nat'l Union Fire Ins. Co. of Pittsburgh, PA v. Xerox Corp.,* 25 A.D.3d 309, 310 (1st Dep't 2006).
[11] *Triton Partners LLC v. Prudential Sec. Inc.*, 301 A.D.2d 411, 411 (1st Dep't 2003).
[12] *Paxi, LLC v. Shiseido Americas Corp.*, 636 F. Supp. 2d 275, 286 (S.D.N.Y. 2009).

exercise of "an apparently unfettered discretionary contract right" may violate the implied covenant when it "frustrates the basic purpose of the agreement" and deprives the counterparty of the benefit of the bargain.[13] Nevertheless, courts are reluctant to interfere with a party's exercise of discretionary contract rights and will do so only in exceptional circumstances. A significant question that has long been the subject of debate in U.S. law is whether courts identify those circumstances under an objective or subjective test.[14]

The argument for an objective test turns on the rationale that the objective approach avoids "the well-known difficulties in proving subjective motivation ..." and "best accommodates the discretion-exercising party's interest in deference by judge and jury with the other party's interest in no arbitrary and expectable reasons for exercising discretion."[15] Courts following the objective standard hold that when "a party has a contractual right to take an action, the court may not inquire into that party's motive for exercising that right."[16] In other words, the implied duty of good faith and fair dealing is not "a mechanism to turn a dispute over the exercise of business judgment into a tort."[17] In a series of decisions discussed next, the New York Court of appeals seems to have confirmed that New York generally adopts the objective approach.

In a 1995 decision, *Dalton v. Educational Testing Service*,[18] the Court of Appeals held that when a "contract contemplates the exercise of discretion," the party with discretion is bound by the implied obligation of good faith and fair dealing, and that obligation includes a pledge "not to act arbitrarily or irrationally in exercising that discretion."[19] When a party exercises its contractually-granted discretion, that party – "not the courts – must be the final arbiter" of the propriety of decisions within the grant of discretion: A court "will not interfere with [the party's] discretionary determination unless it is performed arbitrarily or irrationally."[20] On that basis, the Court of Appeals in *Dalton* required a testing service to perform its contractual obligation to consider material submitted to validate a disputed score, but the Court declined to interfere with the service's discretion to make its own evaluation of that material.[21]

Thirteen years later, the Court of Appeals confirmed in *Moran v. Erk* that courts should tread very lightly when reading implied limitations into broad contractual grants of discretion: "We do not ordinarily read implied limitations into unambiguously worded contractual

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[13] *Hirsch v. Food Res., Inc.*, 24 A.D.3d 293, 296 (1st Dep't 2005).
[14] *See generally* Steven J. Burton, *Good Faith in Articles 1 and 2 of the U.C.C.: The Practice View*, 3 William & Mary Law Review 1533, 1562 (1994).
[15] *Id.* at 1563.
[16] *Kerns, Inc. v. Wella Corp.*, 114 F.3d 566, 570 (6th Cir. 1997) (applying New York law); *accord, e.g., Fitzpatrick v. Am. Int'l Grp., Inc.,* No. 10 CIV. 142 MHD, 2013 WL 709048, at *26 (S.D.N.Y. Feb. 26, 2013) (same).
[17] *CCM Rochester, Inc. v. Federated Inv'rs, Inc.,* No. 14-CV-3600 (VEC), 2017 WL 564063, at *6 (S.D.N.Y. Feb. 10, 2017).
[18] 87 N.Y.2d 384 (1995).
[19] *Id.* at 389.
[20] *Id.* at 392.
[21] *Id.*

provisions designed to protect contracting parties."[22] In *Moran*, a contract for the sale of a home was expressly contingent upon attorney review. After purchasing the home, the purchasers "developed qualms" about going through with the sale, and they instructed their attorney to disapprove the contract. The seller argued that the purchaser breached its implied obligation of good faith and fair dealing by instructing its attorney to cancel the contract for impermissible reasons. The seller argued that the cancellation had to be motivated by concerns arising out of the attorney's review, not simply by the purchasers' buyers' remorse. The trial court and the intermediate appellate court agreed with the seller that the buyer's motives were impermissible, and so they ordered the sale to go through. But the Court of Appeals reversed.

The Court of Appeals' holding applied specifically to the contractual discretion under attorney approval contingencies in real estate contracts, but its rationale would seem to extend more broadly to exercises of contractual discretion in general. Specifically, the Court detailed the dangers posed by intrusive factual inquiries into subjective good faith, particularly in areas of contract law where "[c]larity and predictability are particularly important ...."[23] It observed that disappointed sellers could bring a breach of contract action "any time" they were disappointed by the exercise of the contractual discretion to cancel the contract,[24] and that the outcome of those disputes would be "entirely dependent on the subjective equitable variations of different Judges and courts instead of the objective, reliable, predictable and relatively definitive rules of plain-text contractual language."[25] The Court of Appeals rejected the "chanciness inherent" in such a motive-focused contract regime.[26]

Finally, in 2013 the Court of Appeals addressed the issue of contractual discretion under the "follow the settlements" clause of a reinsurance contract. Reinsurance is commonly understood as insurance for insurance companies. An insurer (called the "ceding company" in the reinsurance relationship) buys reinsurance for losses under its policies. The reinsurance agreement typically grants the ceding company discretion to settle claims for coverage under the reinsured policy. Typically, the reinsurer must "follow" the cedent's settlements—*i.e.*, it must pay its reinsured share of the settlements without second-guessing the cedent's claim decisions. Courts have long recognized that the cedent's discretion was limited by an implied obligation of good faith. And reinsurers often argued that cedents breached this implied obligation when they made claims decisions that were motivated by a desire to maximize their reinsurance coverage. In *USF&G v. American Re-insurance Co.*, the Court of Appeals rejected this subjective approach.[27] The Court held that "objective reasonableness should ordinarily determine the validity" of the cedent's claim decisions."[28] It confirmed that "the cedent's motive should generally be unimportant."[29]

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[22] 11 N.Y.3d 452, 456 (2008),
[23] *Id.* at 458.
[24] *Id.*
[25] *Id.* (citation omitted).
[26] *Id.*
[27] 20 N.Y.3d 407 (2013).
[28] *Id.* at 420.
[29] *Id.* at 421.

The New York Court of Appeals has not stated a categorical rule that subjective motivations always are irrelevant to the analysis of good faith in the exercise of contractual discretion. Seemingly, the Court was careful in *USF&G* not to state such a categorical rule, as it held that "motive should *generally* be unimportant." Nevertheless, each time the Court has addressed the question of whether good faith should be determined objectively or subjectively, it has opted for an objective test. In general, therefore, New York requires that contract performance fit within the bounds of the bargain struck as an objective matter. The parties' subjective intentions and motives for their performance usually will be irrelevant for determining compliance of the implied obligation of good faith.