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New Possibilities for Implied Covenant Claims

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On May 28, the Court of Appeals issued *111 West 57th Investment LLC v. 111 W57 Mezz Investor LLC*. The opinion is notable for the split it produced and how it may change litigating claims for breach of the implied covenant of good faith and fair dealing. The issue presented was whether a party vested with sole discretion under a contract could breach the implied covenant if that party made a discretionary decision in bad faith.

Chief Judge Rowan Wilson, writing for the majority, and joined by Judges Rivera, Troutman and Ogden, held that it could. He cast the decision as little more than rote application of settled law.

The dissent was written by Judge Michael Garcia, and joined by Judges Madeline Singas and Anthony Cannataro. It framed *111 West 57th Investment* as a significant doctrinal shift that might lead contract drafters to abandon their reliance on New York law *en masse*.

For lawyers, the practical effect of *111 West 57th Investment* likely lies somewhere in between. It has not upended contract law, but it has changed how implied covenant claims will be litigated. Plaintiffs, particularly those facing sole discretion clauses, now have more ways to challenge discretionary decisions.

Defendants will need to ground their conduct in the purpose of the contract, rather than relying on text alone. Contract drafters, meanwhile, must be more deliberate about using these clauses, which are unlikely to provide the protection they once did.

111 West 57th Investment grew out of a project to develop a luxury residential tower. As alleged, the plaintiff invested $65 million. With it were two other investors, including a special purpose vehicle (“SPV”) that the project’s developers created. These entities then formed a joint venture, which secured $725 million in loans. Of that, $325 million came from a set of “Apollo” entities.

That $325 million loan went into technical default, so the parties entered into a forbearance agreement. This agreement restructured this loan into a $300 million senior loan and $25 million junior loan, both held by Apollo. Apollo could assign its interests in the junior mezzanine loan, subject to certain restrictions. The agreement also gave Apollo “sole discretion” to exercise any right assigned to it under the agreement.

Apollo assigned the junior loan to Spruce Capital Partners and others (“Spruce”) at a $25 million par value. Two days later, Spruce issued a notice of default on the junior loan. It then exercised a strict foreclosure remedy which wiped out the joint venture's equity, including the plaintiffs'.

The plaintiff claimed that this maneuver was the result of a "backroom deal" between Spruce, Apollo, and that SPV to wipe out its equity. In support, it asserted that Apollo showed Spruce projections that the equity it obtained could have a $600 million cash flow. This would make it worth far more than the $25 million Spruce would forgive in a strict foreclosure.

The plaintiff also noted that although the SPV's equity was wiped out too, it had negotiated a deal with Spruce to remain on the project as a developer. It would also receive "carry over equity."

Plaintiff sued, including a claim against Apollo for breach of the implied covenant of good faith and fair dealing. Apollo moved to dismiss but the Supreme Court found that the plaintiff pled a viable implied covenant claim.

The First Department reversed, explaining that "where a contract allows one party to exercise a contractual right in its sole discretion and for any reason whatsoever, the covenant of good faith and fair dealing cannot serve to negate that provision." 220 AD3d 435 (1st Dept. 2023) (alterations accepted).

The plaintiff appealed, and the Court of Appeals reversed, holding that the plaintiff had adequately pled a breach of the implied covenant.

The opinion and dissent paint opposite pictures of how *111 West 57th Investment* impacts existing contract law. The opinion states that it "in no way changes New York law. It applies well-settled principles to the allegations."

The dissent declares that the decision would "abandon th[e] institutional regard for stability and predictability" that made New York a preeminent commercial center and cause contract drafters to stop choosing New York law for their agreements.

Despite that alarm, *111 West 57th Investment* begins uncontroversially. It explains that every contract contains an implied covenant of good faith and fair dealing. That covenant prevents either party from doing anything that would destroy or injure the other party's rights to enjoy the fruits of the contract. It also requires the parties to perform the contract "in a reasonable way."

This retelling does little more than overrule a small set of First Department cases, including cases the First Department relied on below like *Transit Funding Assoc., LLC v. Capital One Equip. Fin. Co.*, 149 AD3d 23 (1st Dept. 2017). These cases found that a sole discretion clause could not support a breach of the implied covenant claim. Clearly, it can.

Where *111 West 57th Investment* goes beyond settled law is its inversion of how the covenant applies to discretion clauses. It provides—counterintuitively—that the greater the explicit delegation of discretion in a contract, the more carefully a court will police that discretion for breaches of the implied covenant. This is because the implied covenant "is even more important 'where a contract contemplates the exercise of discretion,' or in other words awards one party the freedom to act in ways the contract may not directly foresee."

Before, some First Department cases suggested that a sole discretion clause could never support an implied covenant claim. Now, parties can expect that when the implied covenant is used to challenge a sole discretion clause, courts will perform a more searching review not only of the contract's language, but of what the contract sought to achieve.

111 West 57th Investment shows how this more searching review may play out. The Court reviewed the contractual restrictions on how

Apollo could assign its loan, but explained that these restrictions could not be the final word: “the implied covenant’s very purpose is to cover that which is not anticipated and yet incompatible with the object of the contract.”

What drove the court’s analysis was that “the purpose” of the contract “was to facilitate the continued construction of the Project, and to safeguard the Joint Venture’s investment therein.” Because this was the contract’s purpose, “[e]ven if Apollo has the sole discretion to assign” the loan, it could not do so “as part of an alleged backdoor deal to appropriate the value of plaintiff’s equity.” Other plaintiffs faced with similar sole discretion clauses will now also have more ways to challenge how counterparties use that discretion.

This is a change to New York law, but not a wholesale revision. As Justice Benjamin Cardozo wrote in *Wood v. Duff-Gordon*, New York has long outgrown the “primitive stage of formalism when the precise word was the sovereign talisman.”

New York courts read contracts as a whole to interpret their purpose; discerning and effecting that purpose is the central objective of contract interpretation. By assessing the implied covenant’s operation in light of the contract’s purpose, *111 West 57th Investment* aligns with longstanding New York doctrine.

Given this, it is unlikely that, as the dissent suggests, “allegations that offend a court’s sensibilities” will be sufficient alone to support an implied covenant claim. And the dissent acknowledges that a sole discretion clause has never been an air-tight defense to an implied covenant claim.

Cases reviewed by the dissent like *Empresas Cablevision, S.A.B. de C.V. v JPMorgan Chase Bank, N.A.*, 680 F Supp 2d 625 (SD NY 2010) found breaches of the implied covenant when a counterparty’s actions clearly undercut the contract’s purpose. These cases were also “criticized for creat[ing] uncertainty in the market.” But 15 years later, there is little evidence that they caused contract drafters to abandon New York law.

It is possible that this case is the first step in advancing a more robust implied covenant doctrine. In a footnote, the court took the unusual step of specifically stating that it was not altering “the specific rule treating sole discretion to terminate a contract as a distinct right from the implied covenant.”

The decision to affirmatively state that a well-settled rule remains well settled is notable, particularly given that it is difficult to discern why the decision to terminate a contract should be any more exempt from the implied covenant than other contractual decisions, which now face a more searching review. For the moment though, the court has signaled that this branch of implied covenant doctrine stands unaltered.

So, while *111 West 57th Investment* does not open the door to contract anarchy, it does offer new possibilities for plaintiffs and new challenges for defendants—and drafters. Plaintiffs have more ways to challenge decisions under a sole discretion clause.

While such clauses should not have been a *per se* bar to implied covenant claims, there was at least a small body of First Department law suggesting otherwise. Those cases will be less of a barrier, and plaintiffs will no longer have to reach out for federal decisions for precedent challenging discretionary decisions.

Defendants facing implied covenant claims will also need to reorient their strategy towards telling a compelling, purpose-oriented narrative. Proffering a sole discretion clause as a *per se* bar will be unsuccessful. So will emphasizing the sophistication of the parties that drafted the contract.

An extended footnote expressly rejected applying the covenant differently based on the parties' sophistication. Rather a court must evaluate potential breaches of the covenant "from the viewpoint of a reasonable person in the position of the promisee."

Instead, defendants need to draw on the contract's language to show that the purpose of the contract was not undermined by how a party used its discretion.

Contract drafters, meanwhile, will have to re-evaluate how to employ sole discretion clauses. Vesting a party with sole discretion still offers flexibility and saves parties the transaction costs of negotiating and demarcating explicit obligations and guardrails. But these clauses are now more vulnerable to challenge. *111 West 57th Investment* invites courts to conduct a more searching review of how a party used its discretion.

111 West 57th Investment gives drafters a way to respond to this by more carefully crafting their contracts and discretion clauses. Contracts should be framed with an eye not just towards what discretion should be granted, but how, and to what end, that discretion should be used.

As the opinion explains, "the terms of a specific grant of sole contractual authority will, along with the terms of the contract as a whole, inform the determination of the scope of any implied duty."

Drafters can leverage this by using recitals to explain the purpose of the contract, and what the parties want to achieve. In sole discretion clauses, drafters can identify the purpose for which that discretion can be used. If a party foresees specific acts it may want to take under a sole discretion clause, it should build that guidepost into the contract. A term that authorizes a party to act at "its sole discretion, including, for the purpose of…" is more likely to survive court review than an unadorned clause.

This strategy has limits. A party cannot give itself the right to act in bad faith (and one doubts a counterparty would agree to it). Also, adding qualifiers and examples to a discretion clause may reduce the risk of an implied covenant claim but increases the risk that these clauses will give rise to a normal breach of contract claim. Balancing the risks of a broad or cabined discretion clause will be a key challenge for contract drafters going forward.

111 West 57th Investment has not bulldozed contract doctrine. But it has created new opportunities and challenges. Plaintiffs will have new opportunities to challenge sole discretion clauses, forcing defendants to develop new strategies in response. Contract drafters should reevaluate how they frame parties' discretion with this vulnerability in mind.

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