PHILADELPHIA, MONDAY, APRIL 18, 2005

The Legal Intelligencer

THE OLDEST LAW JOURNAL IN THE UNITED STATES

ALM

REAL ESTATE

N.J. Reiterates Good Faith Requirement in Commercial Contracts

BY MARTIN DOYLE AND DAVID FELDER
Special to the Legal

It may not rise to the level of the Golden Rule, but the New Jersey Supreme Court recently reiterated its position that business transactions in New Jersey are subject to a requirement of "fair dealing," which in some cases may require parties to perform actions extending beyond the four corners of the contract.

The case was *Brunswick Hills Racquet Club Inc. v. Route 18 Shopping Center Associates*, decided in January. In that case, one party to a contract engaged in a protracted pattern of "subterfuge and foot-dragging," which was clearly intended to mislead its counterpart in order to deny it the benefit of a lease option. Even though it neither lied nor actually breached any express provision of the contract at hand, this party's conduct was nonetheless, the court held, a violation of the common law duty of "good faith and fair dealing" recognized in the state of New Jersey.

In 1976, the landlord's predecessor-in-interest entered into a 25-year lease with the tenant's predecessor-in-interest. The lease permitted the tenant to construct a tennis center on the property, which it did at great cost, and provided for an automatic 25-year renewal unless tenant gave advance notice that it wished to terminate upon expiration of the original term. Rent during the 25-year renewal period would be triple the rent payable during the original term.

Alternatively, the tenant had the option, at the end of the original term, to either purchase the property or enter into a 99-year lease, in either event upon much more attractive economic terms than the automatic 25-year renewal. In order to exercise the long-term lease option, the tenant was required to provide written notice to the landlord, accompanied by a $150,000 payment (representing prepaid rent), not less than six months prior to expiration of the original lease term.

In February 2000, the tenant's attorney gave the landlord notice that tenant wanted to exercise its option for the 99-year lease. This notice was delivered 19 months prior to expiration of the lease term and 13 months prior to the deadline for exercise of the option. The letter confirmed that the payment obligation would be $150,000, indicated that the tenant was performing a title search, and asked whether the landlord would be preparing the lease document. The tenant, however, had misread the lease and believed that the $150,000 payment would be due at the time of commencement of the 99-year term, which was incorrect. Consequently, the tenant did not pay the $150,000, either at the time of the giving of notice or at any time prior to the option exercise deadline, when it was actually due under the terms of the lease.

Following receipt of tenant's notice letter, the landlord embarked upon a course of conduct which was clearly intended to mark time, in the hopes that the tenant would fail to recognize its error and thus miss the deadline for making the option payment. During the period from February through December 2000, the tenant's attorney apparently sent no less than five letters requesting that the landlord deliver a draft lease document for review, indicating that he wanted to finalize all terms well in advance of commencement of the new lease term. Most of these went unanswered, and those responses that were sent were generally either mere acknowledgments or were disingenuous promises to move the matter forward.

In December 2000, the landlord approached the tenant with a demand that it execute an estoppel certificate in connection with landlord's application for a bank loan. This form of estoppel offered stated that the tenant had no option to purchase the property. The tenant crossed this

DOYLE

FELDER

MARTIN DOYLE *and* **DAVID FELDER** *are members of Saul Ewing's real estate department in the firm's Philadelphia office. Both have worked on a number of major real estate transactions and have been involved in all aspects of real estate development, sales, finance and leasing. Doyle received a law degree, cum laude, from the University of Pennsylvania Law School. Felder received his J.D. degree, cum laude, from Harvard Law School.*

statement out and inserted, in two locations, contrary statements indicating that it had exercised the long-term lease option.

In January and September 2001 (before the option expired), the tenant's counsel wrote two more letters requesting the draft lease. In December, another letter was sent, and in January 2002 the attorneys for the parties had a telephone call, during which it was discussed whether or not a new document was necessary, as the original lease contained all the relevant terms. The parties did discuss the need to record a memorandum of lease. The tenant's counsel confirmed the substance of the call in a letter.

Finally, in February 2002, in the words of the state Supreme Court, "two years after Spector first communicated plaintiff's intent to exercise the option, defendant's attorney dropped the hammer. In a letter to [tenant's counsel], the [landlord's] lawyer, for the first time, took the position that plaintiff had not properly executed the option and that defendant would not honor plaintiff's attempt to do so."

Tenant's counsel expressed shock at this notice and noted in a response that discussions shortly before had focused exclusively on logistical issues pertaining to the execution of the lease, and that the landlord had never before asserted a failure to exercise the option. The tenant then attempted to pay the $150,000, which tender was rejected, and litigation ensued.

The trial court found in favor of the landlord, holding that the contract clearly required the tenant to pay the $150,000 six months prior to expiration of the lease term and that the written notice alone was insufficient to exercise the option. Moreover, the court held, the landlord was under no duty to inform the tenant of its failure to properly exercise the option and had not misrepresented any facts to the tenant, thereby causing it harm. The appeals court affirmed, agreeing that the tenant did not perform in strict accordance with the requirements of the lease in exercising the option and that the landlord had no affirmative duty to notify the tenant of its error.

In New Jersey, as in most jurisdictions, options agreements are strictly construed and courts are extremely reluctant to grant equitable relief to a tenant, purchaser or franchisee who misses an exercise deadline. It is accepted that since an option grants to one party a unilateral right to cause a transaction to occur, the parties are entitled to negotiate the terms under which that right may be exercised.

In *Brick Plaza Inc. v Humble Oil*, the New Jersey Superior Court had previously noted that a tenant that misses an option exercise deadline may be entitled to relief only where the delay in exercise is slight, the landlord is not prejudiced, and the failure to grant relief would impose an unconscionable hardship on the tenant. That court, moreover, cited the New Jersey Supreme Court case *Dunkin Donuts of America v. Middletown Donut Corp.*, which had stated, "If parties choose to contract for a forfeiture [when an option deadline is missed], a court of equity will not interfere with that contract term in the absence of fraud, accident, surprise or improper practice."

In *New Brunswick*, the Supreme Court reiterated that option holders must act in "strict accordance" with option terms and that ordinarily a tenant missing a deadline is not entitled to relief, even when its error works an extreme hardship. In this case, the tenant had clearly missed the deadline through its own fault and thus, under most circumstances, would be out of luck.

That said, however, the court went on, "Every party to a contract, including one with an option provision, is bound by a duty of good faith and fair dealing in both the performance and enforcement of the contract." This duty is implied in every contact and need not be expressly stated. The court noted the difficulty in defining such a concept, citing, variously, the New Jersey UCC ("honesty in fact and observance of reasonable commercial standards of fair dealing"), the Restatement 2nd of Contracts ("conduct that does not violate community standards of decency, fairness or reasonableness"), and its own prior decisions ("refrain[ing] from doing anything that will have the effect of destroying or injuring the right of the other party to receive the benefits of the contract."). Proof of bad motive or intention, it noted, is a vital element of a bad faith claim.

The court stated that rather than enumerate a set definition of "good faith and fair dealing," each case must be judged on its own facts. However, it did acknowledge that its prior decisions had made clear that a defendant may breach the covenant of good faith and fair dealing even when it does not violate the express contract terms; and a plaintiff may be entitled to relief if "its reasonable expectations are destroyed when a defendant acts with ill motives and without any legitimate purpose."

These principles are facially quite expansive and stand in contrast, for example, with the position taken by the courts of Pennsylvania. Pennsylvania, while accepting in principle the Restatement 2nd of Contracts, has generally limited its application to certain narrow situations (e.g. franchise, insurance or employment relationships) and, more importantly, has generally confined its application through a doctrine known as "necessary implication."

As described in the Superior Court case of *Conomos Inc. v Sun Company*, "necessary implication" allows the court to infer a requirement "necessitated by reason and justice without which the intent of the parties is frustrated." Such implied duties will not, however, trump express provisions of a contract, and will not be read to imply a term not explicitly contemplated by the contract. The parties, the Superior Court noted, will not be held beyond their undertakings, and these may be as narrow as they like. Applying this test, it seems possible that a Pennsylvania court might have denied relief to the tenant in *New Brunswick*, finding that notice from the landlord to the tenant of its omission is never required, at least under the covenant of good faith (though it might be that another cause of action — waiver or estoppel, perhaps — might also have saved the tenant).

The New Jersey Supreme Court, however, clearly found the conduct of the *New Brunswick* landlord and its attorney to be outrageous and legally impermissible. In the court's view, this landlord engaged in a 19-month pattern of evasion, subterfuge and gamesmanship with the express purpose of denying the tenant the benefit of its option.

The landlord did not respond to repeated requests by the tenant to discuss the option, never requested the lease payment and did not respond in any way to the tenant's revisions of the landlord's requested estoppel. The landlord knew that the tenant wanted to exercise the option, and purposely

acted to foster that belief until the deadline for exercise had passed. In summary, the court held, the tenant's repeated letters and telephone calls concerning the option obliged the landlord to respond and to do so truthfully.

The court easily distinguished *Brick Plaza*, where it had refused to give relief to a tenant that missed an extension deadline, asserting that in that case, the tenant had slept on its rights where here the tenant had gone to great lengths in its efforts to enforce its rights. In light of such efforts and the landlord's knowledge and intentions, the court held that the tenant was entitled to the relief sought, extension of the lease under the terms of the option.

The court did attempt to put the brakes on extension of the good faith covenant somewhat, reiterating that bad faith can only be found where improper motives exist, and emphasizing that contracts will not be interpreted to require altruistic behavior between parties. Thus parties are not expected to act as each other's keepers. Even so, it is clear that the parties to a contract are expected to behave at least equitably toward each other.

Hmm, maybe that's not so far off the Golden Rule (business-style) after all. •