7

Discretion Risks

ADVERSE-PARTY DISCRETION HAZARDS

Adverse-Party Discretion

Discretionary acts "involv[e] an exercise of judgment and choice, not an implementation of a hard-and-fast rule exercisable at one's own will or judgment."[1] A decision guided by a rule for which there is but a single outcome is not discretionary; however, if more than one outcome is possible and must be accepted by others, then the authority to make the decision is committed to judgment or discretion. We are here concerned with the hazard such discretion creates, whatever the reason for its grant.

As described in chapter 5, discretion allows a party, alone or together with other parties, either

(1) to decide a matter, such as a benefit, task, commitment, or responsibility for a condition or a contingency for itself or the other party or
(2) to veto the decision of such party, often by requiring a party's consent to such a decision.

Following are cases that illustrate the types of discretion previously described:

- *Computronics, Inc. v. Apple Computer, Inc.*:[2] In its contract with its dealers, Apple, a computer manufacturer, reserved "the right to appoint other authorized dealers and resellers, and to make direct sales to anyone at any time without notice or liability to Dealer." Apple sold computers to a university at a discount and allowed the university to sell them to staff and students. The dealer objected to Apple's decision. The case illustrates the first type of discretion: Apple could choose to seek the benefits of direct sales to universities, even at a discount and even though such sales competed with the dealer, eroding the dealer's benefits.[3]
- *Pacesetter Motors, Inc. v. Nissan Motors Corp. U.S.A.*:[4] An auto dealer agreed to sell its auto dealership for approximately $500,000 to a buyer who wanted to move the location. To complete the sale, the seller had to obtain the manufacturer's consent, such consent not to be unreasonably withheld. The manufacturer refused its consent because the site at which the transferee intended to operate was too close to another dealer. The dealer sold the dealership to another buyer for $250,000. The case illustrates the second type of discretion: the manufacturer could veto the dealer's decision to sell, subject to having reasons for doing so.[5]

One party's discretion is the other party's hazard: the former's decision has the potential to diminish the latter's interests in the transaction, contrary to the latter's expectations about how such discretion was to be exercised. As we have seen, the allocation of potential benefits in a transaction can be a zero-sum game: one party's benefit comes at the other party's loss of economic opportunity or value, apart from any tasks such other party must complete. In such transactions, one party's anticipated benefits are at the mercy of the other party's decisions to the extent of such discretion.

Such hazards are divisible by the party having discretion and the matters its discretion it can affect.

(a) The party, alone or together with other parties, may decide
  (i) the benefits it will realize,
  (ii) the tasks it will perform,
  (iii) the commitments it will have to complete such tasks, and
  (iv) how it will respond to contingencies; or
(b) the party may, alone or together with other parties, decide
  (i) the benefits the other party will realize,
  (ii) the tasks the other party will perform,
  (iii) the commitments the other party will have to complete such tasks, and
  (iv) how the other party will respond to contingencies.

Computronics, Inc. illustrates the combination of the facts in scenario (1)(a)(i) (party decides what benefits it will realize), and *Pacesetter Motors, Inc.* illustrates (2)(b)(i) (party decides whether to veto other party's decision about benefits that the other party hopes to realize). When combined with (1) (party decides) and (2) (party vetoes by refusing consent), the decisions in (a) and (b) yield sixteen scenarios or hazards created by adverse parties having discretion.

Following are cases that illustrate five of these sixteen scenarios:

- *Lenape Resources Corp. v. Tennessee Gas Pipeline Corp.*[6]: A pipeline company agreed to take, or pay for if not taken, a portion of gas produced by producers from gas reserves committed under a gas sale agreement. The contract permitted the producers

  > "[t]o operate its property free from any control by [the pipeline company] Buyer in such a manner as [the producers] Seller, in its sole discretion, may deem advisable, including without limitation, the right, but never the obligation, to drill new wells, to repair and rework old wells, and to plug any well or surrender any lease or portion thereof when no longer deemed by Seller to be capable of producing gas in paying quantities under normal methods of operation."[7]

  Some 10 years later, the producers increased production from two wells, one of which was low producing, to five wells, significantly boosting production. Whereas before the production increase the pipeline company never paid more than $300,000 for gas produced in any single year, after the increase, it paid $89,000,000 for gas produced in one year.[8] The case illustrates scenarios (1)(a)(ii) (producers decide how much gas they will sell) and (1)(b)(ii) (producers decide how much gas the pipeline company will buy or for which it will pay a take-or-pay payment).
- *Anderson v. Automatic Sprinkler Corp.*[9]: An employment contract included the following clause relative to the award of bonuses:[10]

  > The award of any direct incentive is entirely within the discretion of the corporation and nothing contained herein will be construed to the contrary. . . . With respect to those representatives whose employment with the corporation is terminated [for reasons other than their disability or retirement], the payment or nonpayment of all or any direct incentive installments previously set aside but unpaid to them at the time of their termination, will rest completely in the absolute and final discretion of the Compensation Committee of the Board of Directors."

  A sales representative terminated his employment. The compensation committee decided not to award any incentive compensation, giving no reasons. The case illustrates scenario (1)(a)(ii): the employer had discretion to decide how much, if any, bonus compensation it would be obligated to pay a former employee.[11]
- *Ehredt Underground, Inc. v. Commonwealth Edison Co.*[12]: A contract under which a utility agreed to pay a contractor a fixed price for work required the contractor to use employees who belonged to a union acceptable to the utility. To mollify the union that represented its employees, the utility advised the contractor that the union must belong to the AFL-CIO. As a result, the contractor had to choose a union whose members received wage rates 90 percent more than the rates for the union the contractor proposed but was not affiliated with the AFL-CIO.[13] The case illustrates scenario (2) (b)(ii) (the utility had to approve the contractor's choice of the union the members of which would perform the contract).
- *Flight Concepts Limited Partnership*[14]: This case is summarized in chapter 3.[15] The case illustrates scenario (1)(a)(iii): the licensee had discretion to decide, when if at all, it would be committed to use the licensed intellectual property.
- *Cabriolet Porsche Audi, Inc. v. American Honda Motor Co., Inc.*[16]: The agreement between a car dealer and the exclusive importer and distributor of Honda cars in the United States allowed the importer to allocate cars to dealers according to a mathematical formula. The contract stated that when cars were in short supply, "Dealer gives Distributor the right to allocate such supply in any reasonable manner Distributor deems fit in any geographical market area." Demand for Honda cars increased during an Arab oil embargo. The distributor continued to use the same formula for allocating cars to dealers. The case illustrates scenario (1)(a)(iv): the importer had discretion to decide how to complete a task it had to complete—allocation of available cars to the dealers—in the event of a contingency, the shortage of cars.[17]

Two further subdivisions of two groups of the scenarios previously described are useful. The first group constitutes the scenarios wherein a party decides its or the other party's tasks: scenarios (1)(a)(ii), (1) (b)(ii), (2)(a)(ii), and (2)(b)(ii)). This group can be divided into decisions about

(A) the tasks that must be completed and
(B) whether the tasks have been completed (or a breach or a default has occurred).

Lenape Resources Corp. and *Ehredt Underground, Inc.* illustrate the discretion described in (A) or scenarios (1)(a)(ii)(A), (1)(b)(ii)(A), (2) (a)(ii)(A), and (2)(b)(ii)(A).

Following are cases that illustrate three scenarios:

- *Random House, Inc. v. Curry*[18]: A contract between three authors and a publisher obligated the authors to deliver a manuscript about Jesse Jackson of approximately 100,000 words in length, "satisfactory to the [p]ublisher," not later than an agreed date. The authors delivered a manuscript. The publisher decided the manuscript was unsatisfactory, terminated the contract, and demanded repayment of the royalty advance.[19] Because, at contract formation, neither party could detail the content and style it expected in the manuscript, the authors' task was highly uncertain. That uncertainty was mitigated, if not eliminated, for the publisher by the wide latitude given it, the obligee, to decide if the manuscript prepared by the authors, the obligors, was satisfactory. The authors traded uncertainty risk for the risk the publisher would unfavorably exercise that discretion. The case illustrates scenario (1)(b)(ii) (B): the publisher had discretion to decide if the other party, the authors, had fulfilled their commitments. That discretion was also a hazard to the authors, as their investment in and anticipated royalties from the book would be lost.

- *General Electric Capital Corp. v. Direct TV, Inc.*[20]: General Electric Capital Corp. (GECC) purchased and serviced Direct TV's accounts receivable payable by its customers. The agreement provided accounts would be "characterized as written off when deemed uncollectible in GECC's sole discretion, or, if not sooner, when the account is 180 days delinquent." In response to complaints about dealer fraud and breaches, GECC wrote off $16 million of Direct TV's accounts and terminated the agreement. The case illustrates scenario (1)(a) (ii)(B): GECC had discretion to decide when its obligation to service an account had been completed, by "deeming uncollectible" and writing off accounts.[21] That discretion mitigated GECC's information and uncertainty risks—that the accounts might be subject to claims not disclosed and difficult or impractical to collect. That discretion was a hazard for Direct TV as it stood to lose the value in its receivables it expected to realize from their sale to GECC.
- *Capital Options Investments, Inc. v. Goldberg Brothers Commodities, Inc.*[22]: Linnco acted as a clearing broker for certain commodity trades and guaranteed payment for losses on trades by the commodity exchange. It cleared commodity option trades initiated by customers of introducing brokers, such as Capital Options, whose customers traded on the margin. The contracts between the clearing and introducing brokers and between the introducing brokers and their customers required the latter to "maintain such margins or collateral for [c]ustomer's accounts as requested from time to time by [the clearing broker] . . . in its sole discretion (which requests may be greater than exchange and clearing house requirements)." When, in 1987, the stock market crashed, Linnco demanded that Capital's customers double their margin requirements within five days, from $1300 to $2600 per option, even though their positions were not due until later that year and early the following year. The following month, Linnco demanded that the broker's customers further increase their margin requirements on certain options to $15,000 per option and gave them one hour to satisfy the demand.[23] Because at contract formation, Linnco could not predict changes in the commodity prices, it could not then decide the margin requirements at any time in the future. They were uncertain. That uncertainty was mitigated, if not eliminated, for Linnco, the obligee, by the discretion given it to decide the customers' or obligors' margin requirements at any time. The introducing brokers and customers traded uncertainty risk for the risk Linnco would exercise its discretion adversely to their interests. The case illustrates scenario (1)(b)(ii)(A): Linnco had discretion to decide the margin or collateral the trader was required to provide at any time.
- *CIBC Bank and Trust Co. (Cayman) Ltd. v. Banco Central do Brasil*[24]: A facility agreement permitted the agent to accelerate outstanding Brazilian sovereign debt following a default if creditors holding more than 50 percent of the outstanding debt voted to instruct the agent to do so. More than 50 percent of such debt was held by a Brazilian bank that was owned more than 50 percent by the Brazilian government, also an obligor under the facility. One bank, acting on behalf of the remaining debt holders, demanded that the agent accelerate the outstanding debt.[25] This scenario is a variation on scenario (2)(a)(ii)(B): the Brazilian government through its ownership of the bank that controlled the voting rights under the facility agreement had discretion to decide when a default warranted acceleration of its debt. The discretion did not permit the Brazilian bank to declare that the Brazilian government had satisfied its obligations or was not in default, but did allow it to block acceleration, a key remedy. The hazard for the other banks was the debtor's ability to gain control over the decision to declare a default.

The second group, which includes scenarios wherein a party decides its or the other party's commitments in scenarios (1)(a)(iii), (1)(b)(iii), (2)(a)(iii), and (2)(b)(iii)), can be divided by whether the decision is about:

(X) when a commitment exists and
(Y) when that commitment is terminated.

Flight Concepts Limited Partnership[26] illustrates scenario (1)(a)(iii)(X): Boeing had discretion to decide when it would be committed to use the licensed intellectual property.

The following cases illustrate scenario (1)(a)(iii)(Y):

- *Mirax Chemical Prod. Corp. v. First Interstate Commercial Corp.*[27]: A borrower promised to pay its lender "on demand, all or any part of the debit balance at any time." The loan agreement could be "terminated at any time by the [the lender] by written notice to the [borrower]." When the borrower incurred financial losses, the lender demanded repayment of the loan. The case illustrates scenarios (1)(a)(iii)(Y) and (1)(b)(ii)(A): the lender had discretion to terminate its commitment and to determine when the borrower had to perform by accelerating its obligation to repay outstanding loans.[28] That discretion mitigated, if not eliminated, a hazard to the lender: the uncertainty about when the borrower might be unable or unwilling to pay. The hazard for the borrower was the lender's discretion to accelerate the loans' maturity without reason at any time.
- *Boat & Motor Mart v. Sea Ray Boats, Inc.*[29]: A boat dealer sold a manufacturer's boats for more than 20 years under a dealership agreement that allowed either party to terminate upon 30 days' notice to the other party and provided that neither party was to be liable for any loss arising out of the agreement. Dissatisfied with the dealer's performance, the manufacturer notified the dealer the dealership agreement would not be renewed following expiration of its annual period. During the last year of the dealership, the dealer spent $90,000 on promotion and incurred costs of $85 per hour for warranty repairs while being reimbursed $20 per hour from the manufacturer. The case illustrates scenario 1(a)(iii)(Y): the manufacturer had discretion to terminate its commitment upon 30 days' notice notwithstanding any investments by the dealer.[30] That discretion mitigated, if not eliminated, the benefit, task, condition, and contingency oversight, remorse, and other risks to both parties, as discussed in chapters 3 to 5. That discretion was a hazard for the dealer, whose losses could be and were its investment in and anticipated profits from the dealership.

Changes in Decision Maker

A decision maker may undergo changes that have the potential to materially alter its use of its discretion when

- the party to the contract is changed,

- another party controlling the decisions made by a party is changed, or
- the personnel of the party responsible for making such decisions or performing or receiving performance are changed or their managers are changed.

The decision maker changes when it assigns or transfers the contract, often as an asset with its own value or as one of the assets or liabilities that are part of a business being transferred. The contract might also pass by operation of law to the decision maker's heirs or legatees or, if it is an entity, to its successor or owner in a liquidating distribution[31] or merger. The result is a decision maker different from that with which the other party contracted. A change of control of a decision maker occurs when its ownership interests are transferred, effecting a transfer or change of control of it without having to transfer the assets it owns; technically, the parties to the contract remain unchanged, while the owner of the decision maker has changed. A change of control can also occur without all the ownership interests in the decision maker being transferred; those responsible for its governance or management may change. When a transfer of ownership interests effects a change of control is outside the scope of this text. When there is more than one tier of entity ownership, a change of control may be effected by the transfer of the ownership interests at a higher tier level: the ultimate parent entity may transfer the ownership interests in a lower tier entity that owns the ownership interests in a still lower tier entity that owns the decision maker, or the ownership interests in the ultimate parent might be transferred.[32] A merger may or may not result in a change of party or control: if the decision maker is the surviving entity, no change in party occurs, though a change of control may or may not occur; and if it is not the surviving party, a change in party occurs, as the contract becomes a binding obligation of the surviving entity. A change in management occurs when a decision maker changes the individuals responsible for deciding whether to continue with a transaction and the resources to be allocated to its implementation. A change in personnel occurs when individuals not initially responsible for implementing the transaction are given such responsibility.[33]

While a change in decision maker or its owners, management, or personnel does not itself result in the decision maker's exercising discretion more adversely to the other party than it otherwise would, the possibility of such a change creates uncertainty about how that discretion will be so exercised. A changed decision maker may desire to extract more value from a transaction than its predecessor and will thus exercise whatever discretion it has to realize such value.

Following are cases that illustrate the adverse effect of changes in decision makers:

- *Lenape Resources Corp.*: This case is previously summarized.[34] During the first ten years of the term of the gas sale agreement, the producers drilled only two wells on the committed acreage, one of which was a low-producing stripper well. The mineral lessors who leased mineral rights to the producers, impatient with the low production, sued the producers for, inter alia, failing to develop the leases underlying the committed acreage. The mineral lessors and producers settled the lawsuit, agreeing that part of the committed acreage would be unitized with an adjacent property. After unitization, the producers entered into a farmout agreement with two other gas producers. As a result of the farmout, these two other producers became the "sellers" under the gas sale agreement. The new producers drilled three wells, one bottomed on the committed acreage and two inside the units on acreage outside the acreage originally committed to the gas purchase agreement. The two new wells on the units were highly successful.[35] Through the farmout agreement, the producers transferred a portion of their interests in and control of development of the mineral leases to the new producers, who more aggressively developed the committed and adjacent acreage. As previously discussed, the first hazard for the pipeline company was the producers' discretion to increase production. The second was the producers' ability to transfer their interests to more aggressive producers. The buyer assumed responsibility for the risk it might have to deal with producers who would increase production.
- *Liebowitz v. Elsevier Science, Ltd.*:[36] Liebowitz "conceived of a scientific journal and persuaded the late media tycoon, Robert Maxwell, who then owned Pergamon Press, to back the idea. Publication began. Over the years, Liebowitz's ideas spawned a number of highly successful journals, all published by Pergamon under Liebowitz's direct or indirect editorship."[37] The contract was between Pergamon and Advanced Engineering Research and Development Corp. (AERDCO), an entity formed and controlled by Liebowitz, reflected "mutual confidence shared by Liebowitz and Maxwell, [and] did not contemplate the possibility that the parties would part ways."[38] "In time, however, Pergamon was sold [after Maxwell died]. Relations between Liebowitz and Pergamon's new owners soured."[39] AERDCO had "responsibility and authority for appointing and removing" editors and appointees of any of the journals but had to consult with Pergamon regarding any such appointments. An editor of one of the journals resigned. AERDCO appointed Liebowitz and his son as successors. Pergamon appointed a competing candidate, opposing Liebowitz's self-interested appointments, even though Liebowitz previously served as an editor. Where Maxwell would have deferred to Liebowitz concerning the appointment of editors, the new management of Pergamon more aggressively asserted its right to participate in the appointments by seeking to block Liebowitz's.[40] The relatively insignificant hazard for AERDCO was Pergamon's limited participation in decisions to appoint new editors. Pergamon could not block but could influence those appointments. That hazard was acerbated by the potential for a change in Pergamon's ownership and management, which could, as it did, result in an unwillingness to accept AERDCO's choices.

ADVERSE-PARTY DISCRETION RISK MANAGEMENT

Adverse-Party Discretion

We observed how discretionary decision-making by one party mitigates the uncertainty risk to that party. That discretion, in turn, creates a different risk for the other party: that the decisions of the decision maker will be self-interested, in some instances, at the expense of the other party. That risk is mitigated by reintroducing uncertainty back into the transaction, by curbing the decision maker's discretion. The devices that mitigate such risk (described briefly in chapter 5) are

- processes for determining how discretion should be exercised,
- guidelines that set boundaries for the exercise of discretion, and
- requirements that the decision makers pay compensation for their exercise of discretion.

Decision-Making Process. The strongest mitigation of the risk that the adverse party will exercise its discretion in a manner unacceptable to the other party is to require that the decision maker obtain the other party's consent. The counterparty continues to have discretion to propose actions it or the other party may take without its decisions binding the other party unless that other party agrees to such proposal. The result is that both parties have discretion: the counterparty to propose actions and the other party to approve or veto them. As we have seen, an agreement to agree results in uncertainty about whether the parties will agree on matters as to which agreement is necessary.

As previously discussed, that uncertainty risk can be mitigated by prescribing a detailed procedure that states when and how each party may exercise its discretion or achieve specific milestones. Each party has a commitment to complete its milestone in the process of endeavoring to reach agreement while continuing to have its discretion to refuse its consent.

Following are cases that illustrate how a detailed process mitigates the uncertainty risk created by wide discretion:

- *In the Matter of the Arbitration between De Laurentiis*[41]: A producer, an author, and a distributor agreed to produce and distribute a motion picture about the South American patriot Simon Bolivar. The producer was to engage a writer or writers of the first rank to prepare a story outline, a "screen treatment," and thereafter a final scenario. The author and distributor were to consult during the preparation of the story outline and scenario. The producer was to complete a scenario in final form within three months from the date of the agreement. If the distributor did not approve the script, then the producer was to revise it. The producer undertook to make all necessary arrangements for financing, for the hiring of actors and a director, and for world distribution of the completed picture, all this to be subject to the prior approval of the distributor that promised not to withhold such approval unreasonably. The final scenario had to be accepted to all three parties.[42] The producer never hired a writer. The case illustrates scenario (2)(a) (ii)(B): the distributor and writer had to approve the final scenario prepared by the producer, thus agreeing with the producer when it had completed its tasks. It also illustrates how the consultation requirement mitigated the wide latitude given the producer to perform and all three parties to approve the final scenario.[43]
- *Local 3-7 International Woodworkers v. DAW Forest Products*[44]: A buyer of a forest products business and the union representing the logging operations employees agreed upon a procedure the union and buyer were to follow when negotiating a new collective bargaining contract. The agreement allowed the union to submit within two weeks of signing the agreement a plan to keep the logging operations competitive; the buyer had to respond within an agreed period of time, indicating if the proposal had "merit;" and further procedures were to be followed, depending whether the proposal had merit. The buyer also agreed to continue logging operations unless "in the opinion of the [buyer] Company, the logging equipment is determined to be inoperative, unsafe or uneconomical to operate, [in which case] it shall be retired." Before submitting a plan, the union asked the buyer for information it said it must have to prepare a plan, but that information was not provided. The buyer purchased the business and discontinued logging operations, terminating 62 of 68 logging employees. The union demanded that the buyer continue to negotiate the collective bargaining contract. Uncertainty at contract formation about what, if any, terms on which the logging employees would continue to be employed was mitigated by a combination of procedures: one, which required the buyer and the union to follow a procedure for negotiating a collective bargaining agreement, and another, which allowed the buyer to discontinue logging operations if the logging equipment was determined by it to be inoperative, unsafe, or uneconomical to operate. Those procedures created new risks to the employees: that no agreement on the new contract would be reached, in effect a decision adverse to them, or the buyer would decide the logging operations were uneconomic, another decision adverse to them. Both of those risks were, in turn, mitigated by the enforceability of the agreement to negotiate, which enforceability limited the buyer's discretion to refuse to agree.[45] The case illustrates scenario (1)(a)(iii)(X): the buyer had discretion to determine when it would be committed to agree to a collective bargaining contract. The case also illustrates how the detailed consultation and other procedures helped to mitigate the buyer's discretion to stop negotiating with the union.

We are not here concerned with the enforceability of the agreement to agree in the first case or the agreement to negotiate in the second, though enforceability was the issue in both cases. A putative agreement that is void for vagueness is one that fails to comply with the legal formalities that create a binding commitment. Whether an agreement to negotiate or agree creates such a commitment is a question about compliance with such formalities. The question here is how that discretion to refuse to agree or to negotiate can be mitigated using consultation and other procedures. The enforceability of such an agreement is a useful indicator that the mitigation of discretion is meaningful.

Decision-Making Guidelines. Substantive standards for the exercise of discretion set boundaries by which the validity thereof is determined. The most common of such standards are good faith and reasonableness. Good faith is defined as "[a] state of mind consisting in (1) honesty in belief or purpose, (2) faithfulness to one's duty or obligation, (3) observance of reasonable commercial standards of fair dealing in a given trade or business, or (4) absence of intent to defraud or seek unconscionable advantage."[46] Reasonable is defined, in part, as "[f]air, proper, or moderate under the circumstances; sensible."[47] Reasonableness includes good faith: a party acting reasonably is also acting in good faith.

Following are cases that illustrate how these standards limit discretion:

- *Local 3-7 International Woodworkers*[48]: This case is previously discussed.[49] The discretion to stop logging operations was also subject to the implied duty to act in good faith. The company had to consider the union's proposals in good faith and determine whether they had merit. That might also have included a duty to provide the data requested by the union.[50] Similarly, the company's discretion to cease logging was limited to instances when its logging equipment was inoperative, unsafe, or uneconomical to operate.[51] The case illustrates how a good faith limitation set boundaries on the company's discretion by obligating it to entertain and evaluate the union's proposals and continue to negotiate as long as the negotiations were fruitful. Note the contract did not expressly state that either party had to act in good faith; the limitation was implied. A party that does not want its discretion thus limited may have to exclude the implied duty.
- *Banc of America Securities LLC v. Solow Bldg. Co., LLC*[52]: A lease required the prior consent of a landlord to tenant improvements. The landlord was "not to unreasonably withhold its consent" to proposed, nonstructural changes required to render the space amenable to the lessee's business purposes. The lease also required that the landlord approve or disapprove proposed alteration plans within ten business

days and that, upon substantial completion of the work, the landlord could recover its actual out-of-pocket expenses reasonably incurred in connection with such alterations. The landlord demanded a $6 million fee for its consent to alterations, an amount equal to 3 percent of the overall cost of the improvements, and sent demands to the tenant to pay the fee and notice it would not further review plans until paid. The reasonableness limitation obligated the landlord to review the proposed improvements and denied him the right to demand a fee for approving them.[53] The case illustrates scenario (2)(b)(ii) while its consent was required, the landlord could not unreasonably refuse to approve the tasks the tenant proposed to complete in order to realize some of benefits of the lease. It also illustrates how the reasonableness requirement confined the landlord's exercise of discretion: it could not extract a fee when none was stated in the contract.

Decision-Making Compensation. The exercise of discretion may be conditioned upon a payment by the decision maker to the other party as compensation for some or all of its losses that result from its decision. The fee in *Banc of America Securities LLC* was not an example because the landlord was not seeking compensation for any service or reimbursement for any loss on its part. Also, because the payment was not contingent upon a breach or default by the decision maker, it was not liquidated damages or a penalty. Compensation may be nominal or substantial, and the greater the compensation that must be paid to exercise discretion one way rather than another, the more significant the deterrent on its exercise unfavorable to the party receiving such compensation.

The following are illustrations of such conditions:

- *Piantes v. Pepperidge Farm, Inc.*[54]: This case is summarized in chapter 3.[55] The franchisor was allowed to terminate a franchise upon payment of 125 percent of the fair market value of the franchise as determined by a panel of arbitrators. The case illustrates scenarios (1)(a)(i)(Y) and (1)(b)(i)(Y): the franchisor had discretion to decide when its and the franchisee's commitments could be terminated. The price of exercising the discretion was the value of the franchisee's business plus a premium.
- *Metered Appliances, Inc. v. Lafayette Court Apartment Corp. and Service Directions, Inc.*[56]: Lafayette leased a laundry room to Metered under a lease that gave Metered a right, upon termination of the lease, to match the terms of any new lease Lafayette proposed to enter into with a third party. Lafayette negotiated a one-year lease with a third party that gave either party the right to terminate at any time, with the lessor responsible to pay the costs of removal of the equipment and improvements. It offered this lease to Metered, who rejected it.[57] The case also illustrates scenarios (1)(a)(iii)(Y) and (1)(b) (iii)(Y): the landlord had discretion to decide when its and the tenant's commitments were terminated. The price in this instance was modest, the tenant's cost of removing its equipment.

Changes in Counterparty

Changes in a counterparty can acerbate two hazards: the adverse party's exercise of its discretion, as described in this chapter, and an obligor's or putative obligor's completion of the tasks it is expected to complete, as described in the next chapter. Changes in a party may result in its being less able or willing to perform such tasks. Measures that mitigate the risks created by changes in an obligor include all those that mitigate the risks created by changes in an adverse discretionary decision maker. For that reason, such measures are explained in the next chapter.

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1 BLACK'S LAW DICTIONARY 565 (10th ed. 2014).

2 600 F. Supp. 809 (W.D. Wis. 1985).

3 When the dealer sued for breach of contract, the court held the quoted language "reserved to [the manufacturer] itself the broadest possible latitude to sell to whomever it pleased under whatever terms it chose." *Id*. at 813.

4 913 F. Supp. 174 (W.D. N.Y. 1996).

5 The dealer sued the manufacturer for wrongfully withholding its approval, claiming proximity to an incumbent was not a valid reason for denying consent. The manufacturer moved for summary judgment, which the court granted. "[The manufacturer] Nissan clearly possessed the right to evaluate any proposed sale in accordance with what Nissan deemed to be its best interests. 'Location' was expressly stated as being a criterion relevant to Nissan's determination that a prospective buyer could meet its obligations under a franchise agreement." *Id*. at 179.

6 870 S.W.2d 286; rev'd 925 S.W.2d 565; 1996 Tex. LEXIS 40; 39 Tex. Sup. J. 496; 29 U.C.C. Rep. Serv. 2d (Callaghan) 759; 137 Oil & Gas Rep. 630 (Tex. 1990).

7 925 S.W.2d at 576.

8 The pipeline sued for declaratory relief that, inter alia, it was not obligated to take gas or pay for gas not taken in the quantities produced by the sellers. The trial court granted a partial summary judgment for the sellers. The court of appeals reversed the trial court's summary judgment on the Uniform Commercial Code issue, holding that the contract was an output contract subject to the good faith and proportionality restrictions in the UCC. The Texas Supreme Court reversed, holding the contract was not an output contract because the take or pay payment was "for the exclusive dedication of reserves for a fixed period of time." *Id*. at 578. The court held that the contract "anticipates that the Sellers may drill new wells in new depths and horizons and increase production and delivery capacity in discovering new reserves." *Id*. at 571.

9 147 Ga. App. 236, 248 S.E.2d 507 (Ga. App. 1978), sub. nom. Automatic Sprinkler Corp. v. Anderson, 243 Ga. 867, 257 S.E.2d 283 (Ga. 1979).

10 *Id*. at 867.

11 The employee sued for breach of contract, claiming the employer failed to make an honest judgment and thus abused its discretion. The employer moved for summary judgment, and the trial court granted the motion; the appeal court reversed, and the Georgia Supreme Court reversed, holding "There can be no breach of an implied covenant of good faith where a party to a contract has done what the provisions of the contract expressly give him the right to do." *Id*. at 868.

12 848 F. Supp. 797 (N.D. Ill. 1994).

13 The contractor claimed the utility's refusal to accept its proposed union violated the covenant of good faith and fair dealing. The court granted the utility's motion for summary judgment, finding the utility's desire to avoid difficulty with its own union consistent with acting in good faith.

14 819 F. Supp. 1535 (D. Kan. 1993).

15 *See* text accompanying ch. 3, notes 94–96.

16 773 F.2d 1193 (11th Cir. 1985).

17 The dealer sued the distributor for breach of contract when its orders went unfilled. The district court found the allocation system unreasonable and awarded judgment in favor of the dealer; the distributor appealed. The appeal court reversed, finding the allocation system and its application to the shortage reasonable. "American Honda's allocation system is a competitive one. Dealers in each zone are competing with each other for the limited number of cars sent from Japan. That an automobile distributor, naturally interested in selling as many cars as possible and encouraging its dealers to do so, should adopt such a competitive system is not unreasonable. Nor is it unreasonable that, under this competitive system, dealers that undertake to sell a maximum number of cars during a soft period are rewarded with more cars during the hot period than are dealers, like Cabriolet, that for their own reasons do not undertake to sell many cars." *Id*. at 1204.

18 747 F. Supp. 191 (S.D.N.Y. 1990).

19 The publisher sued to recover the advance and moved for summary judgment. Denying the motion, the court held that while the satisfaction clause was enforceable, the publisher's decision had to be made in good faith, and the question of whether that was the case was one of fact to be determined by the trial court.

20 94 F. Supp.2d 190 (D. Conn. 1999).

21 When GECC sued Direct TV, the latter claimed the write off breached GECC's duty of good faith and fair dealing which should be implied in the agreement. The court granted GECC summary judgment on the claim, holding such duty could not be implied where it would override the express contractual terms. *Id*. at 197. Thus while GECC had an obligation to service the accounts it purchased, it also had sole discretion to decide when those accounts were written off and no longer to be serviced.

22 958 F.2d 186 (7th Cir. 1992).

23 The demand was not met, Linnco liquidated the customers' positions, and Capital sued the clearing brokers for breach of contract. The district court granted the clearing brokers' motion for summary judgment and the appeal court affirmed.

24 886 F. Supp. 1105 (S.D.N.Y. 1995).

25 When the debt was not accelerated, the bank demanding acceleration filed suit against the agent and the Brazilian bank for breach of contract. The agent and the Brazilian bank moved for summary judgment, which was granted. The bank argued that the implied duty of good faith and fair dealing prohibited the Brazilian bank from using the outstanding debt it held to block acceleration. The court held the implied duty could not override the express provisions of the agreement, which clearly defined the Brazilian bank as a bank and required banks holding more than 50 percent of the outstanding debt to vote in favor of acceleration. The Brazilian bank had discretion as to how to vote the debt it held.

26 *See* text accompanying notes 14 and 15.

27 950 F.2d 566 (8th Cir. 1991).

28 The borrower claimed breach of contract, bad faith, economic duress, and intentional infliction of mental distress. The district court granted summary judgment in favor of the lender and the appeal court affirmed, finding the contract was terminable at will by the lender.

29 825 F.2d 1285 (9th Cir. 1987).

30 The dealer unsuccessfully claimed such terms were unconscionable.

31 *E.g*., Trubowitch v. Riverbank Canning Co., 30 Cal.2d 335 (Cal. 1947), where an antiassignment clause in a contract for the sale of tomato paste was held inapplicable to a transfer of the contract by operation of law that occurred following dissolution of the corporation that was party to such contract.

32 *E.g*., Torrey Delivery, Inc. v. Chautauqua Truck Sales and Service, Inc., 47 A.D.2d 279 (N.Y. App. 1975), where a lease granted the lessee a right of first refusal to purchase the leased property. When the sole shareholder of the landlord died, the shares in the landlord were sold to the defendant; the landlord was merged into the defendant, which registered the title to the property in its name. The lessee claimed it was entitled to exercise its right of first refusal and purchase the property, as the purchase of the stock effected a change in the ownership of the property. The defendant's motion for dismissal was granted on appeal; the court held, "Ownership of capital stock being distinct from ownership of corporate property, it follows that the sale of such stock is not a sale of corporate property." *Id*. at 282–83.

33 *E.g*., Mindel v. Image Point Productions, Inc., 725 F. Supp. 189 (S.D.N.Y. 1989).

34 *See* text accompanying notes 6 and 7.

35 This summary is extracted from the report of the case at 925 S.W.2d 565, 568.

36 927 F. Supp. 688 (S.D.N.Y. 1996).

37 *Id*. at 692.

38 *Id*.

39 *Id*.

40 Liebowitz sued Pergamon, claiming, inter alia, his entity had the right to appoint him and his son as editors; the publisher responded that the appointments by the entity were bad faith. Both parties moved for summary judgment on the issue of who had authority to appoint the editors. The court granted Liebowitz's motion, noting, "Conceivably, if plaintiffs' (sic.) appointed a manifestly unqualified editor, such an action might be regarded as bad faith and, consequently, as a breach of contract." *Id*. at 701, n.22. Because Liebowitz served as editor-in-chief and his son had previously been on the editorial board, their appointments could not be said to be a bad faith exercise of discretion. Liebowitz was allowed to exercise his discretion, even where it clearly favored his interests. 927 F. Supp. 688, 692 (S.D.N.Y. 1996).

41 9 N.Y.2d 503, 215 N.Y.S.2d 60, 174 N.E.2d 736 (N.Y. 1961).

42 This summary is extracted from the report of the case 9 N.Y.2d at 507.

43 The distributor initiated arbitration proceedings pursuant to the contract. The producer applied to the court to stay the arbitration and to have the contract declared unenforceable as illusory. The court held the contract was enforceable because the parties "expressly promised each other to consult at reasonable times and places during the preparation of the outline and of the scenario 'to the end that both [the producer] De Laurentiis and [author] Campos may make every effort in good faith to cause to be created, within the period specified herein, a story outline, screen treatment and final scenario acceptable to both.'" *Id*. at 509.

44 833 F.2d 789 (9th Cir. 1987).

45 The union sued for specific performance of the memorandum of agreement; the buyer claimed the agreement was too indefinite to be enforceable; the district court agreed, dismissing the suit; and the appeal court reversed. Although the court summarized the negotiation procedure outlined in the memorandum of agreement, the appeal court focused on the implied duty of good faith, holding, the "district court could determine breach of the duty of good faith consideration by examining whether the Company had exercised its 'honest judgment' or whether it had met the reasonable person standard in rejecting the Union's proposal." *Id*. at 793–94.

46 BLACK'S LAW DICTIONARY, *supra* note 1, 808.

47 BLACK'S LAW DICTIONARY, *supra* note 1, 1456.

48 833 F.2d 789 (9th Cir. 1987).

49 *See* text accompanying notes 44–46.

50 833 F.2d at 794–95.

51 *Id*. at 796.

52 47 A.D.3d 239, 847 N.Y.S.2d 49, 2007 N.Y. Slip Op. 09545 (N.Y. App. 2007).

53 The tenant sued for an injunction to prevent termination of the lease and for damages. The trial court found that the fee was unjustified since the landlord's cost did not approach 3% of the tenant's costs; the withholding of the consent until the fee was paid was an unjustified refusal of the consent. The appeal court agreed, stating, "It is evident that the [New York] Court of Appeals did not intend economic self-interest to be applied as an expansive principle to excuse all manner of misconduct." 47 A.D.3d at 247.

54 875 F. Supp. 929 (D. Mass. 1995).

55 *See* text accompanying ch. 3, notes 110–111.

56 35 Misc.3d 1238(A), 954 N.Y.S.2d 760 (Table), 2012 WL 2122368, 2012 NY Slip Op 51038(U) (N.Y. Sup. Ct. 2012).

57 Metered claimed it was not a bona fide offer and was designed to defeat its first refusal right. The third party testified that it accepted the lease because it was confident Lafayette would be satisfied with its service and not exercise the termination right. The court granted the motion for summary judgment on the breach of contract claims, holding Metered had not proven the one-year lease was not bona fide. The short term and termination right enabled the landlord to decide at any time if the benefits of the lease with the selected lessee were worthwhile, relative to the benefits it might realize from other laundry service providers.