

FUND FINANCE FRIDAY

In the Discretion of the Holder

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A search of the term “discretion” in virtually any credit agreement will yield numerous results. It is the word or words preceding that result that often is a point of much consternation. Many borrowers prefer the use of “reasonable,” which connotes the idea that an objective standard must be utilized in making a determination and such standard would be applied in a manner that is consistent with the standard a lender employs in exercising rights and remedies with other borrowers and loans of similar structure, size and complexity. Most lenders, on the other hand, favor the use of “sole” or “sole and absolute,” which implies that the lender has the ability to exercise a greater degree of preferential discretion in deciding whether to approve an action (or inaction). Preferences aside, what does this distinction really mean when a contract vests the right to make a determination in a party to that contract? That answer lies in a small body of case law that varies by jurisdiction.

Many credit agreements are governed by New York law. As such, the manner in which the New York courts have adjudicated the issue seems particularly pertinent. The phrases “sole discretion” and “in its sole discretion” are often used in contracts to refer to an instance when a person or entity is given the right to make a decision or take certain actions based on its own independent assessment and determination. It has been argued that these phrases grant a party complete latitude in making decisions or exercising rights, and the use of these terms relieves a party vested with such discretion from exercising it in good faith.

The court in *Southern Telecom Inc. v. ThreeSixty Brands Group, LLC*, 520 F.Supp.3d 497 (S.D.N.Y. 2021) reiterated that exercising discretion in good faith is an underlying principal of contract law. According to *Southern Telecom* court, a determination as to whether a particular standard of conduct has been met and whether a party has performed its contractual obligations requires that such determination be made honestly, with due consideration of the applicable facts and not on some dubious, insignificant basis. In other words, the exercise of discretionary decision making (even when qualified by such terms as “sole discretion” and “sole and absolute discretion”) by a party “mandates that an action authorized to be taken for a particular reason actually be taken for that reason.”

However, the benefit of the words “sole discretion” and “in its sole discretion” are not without importance. The *Southern Telecom* court stated: “Where a contract allows one party to terminate the contract in ‘its sole discretion’ for ‘any reason whatsoever,’ the covenant of good faith and fair dealing cannot serve to negate that provision.” This statement stands for the proposition that as long as the party vested with a “sole discretion” standard of decision making authority considers the applicable facts, a resulting decision based upon the consideration of those facts may not be challenged by the affected party based upon whether the resulting decision was fair or reasonable in the view of the affected party. Instead, the party vested with sole discretion authority is simply prohibited from basing its decision on a predetermined reason unrelated to an actual consideration of the facts. In other words, a determination must be based on something other than simply “I don’t want to” and must be made after giving consideration to facts and standards that dictate that the decision is not being made on a preplanned basis. If the deciding party proves that there is no standard against which its exercise of discretion is being measured (*i.e.*, there are no facts or reasons to believe a course of dealing dictates how the party should act), the covenant of good faith and fair dealing would not deprive the party holding the discretion from utilizing that discretion in whatever manner it desires.

In summary, many states have case law indicating that a covenant of good faith and fair dealing is implied in every contract, and that standard prevents one party from engaging in conduct that would deny the other party the benefits of the contract. The determination of whether a party acted in good faith and the applicability of that principle hinges on an analysis of facts. However, the courts have held that the implied covenant of good faith and fair dealing cannot be used to trump a grant of discretionary power if the *express purpose* of a contract is to grant unfettered discretion to a party and the exercise of that discretion is rooted in some analysis of the facts and consequences applicable to making a determination.