



Reasonableness and the Implied Covenant of Good Faith and Fair Dealing in Commercial Leases

by **Lawrence I. Rothstein**

Where a party's discretionary consent in a commercial lease is subject to a reasonableness standard, whether express or implied, the covenant of good faith and fair dealing may create an obligation to act in a way that was not foreseen by the party. Consequently, New Jersey courts may imply a good faith commercial reasonableness standard in evaluating a party's refusal to grant consent. Determining what is reasonable may not be as simple as it appears because the term "reasonable" is relative and not readily discernable; it connotes action according to the dictates of reason, such as what is just, fair and suitable under the circumstances.¹ Moreover, a claim of unreasonableness may also allege a violation of the implied covenant of good faith and fair dealing, since the parties' expectations of

the disputed action may not be set forth in the lease and the aggrieved party may maintain that the withholding of the requested consent deprived it of enjoying the expectations and benefits it bargained for in the lease.

Implied Covenant of Good Faith and Fair Dealing Generally

Every contract in New Jersey contains an implied covenant of good faith and fair dealing.² Accordingly, it is implied that neither party to a contract will do anything that will have the effect of destroying or injuring the other party's right to receive the benefits of the contract.³ The implied covenant of good faith and fair dealing may be breached even where the contract's express terms are not breached.⁴

The concept of 'good faith' defies precise definition. The Restatement (Second) of Contracts provides that good faith in the "performance or enforcement of a contract emphasizes

faithfulness to an agreed common purpose and consistency with the justified expectations of the other party; it excludes a variety of types of conduct characterized as involving 'bad faith' because they violate community standards of decency, fairness or reasonableness."⁵ Proof of "bad motive or intention" is required for an action for breach of the implied covenant of good faith and fair dealing.⁶ Acknowledging that a "complete catalogue of the types of bad faith is impossible," the restatement lists "evasion of the spirit of the bargain, lack of diligence and slacking off, willful rendering of imperfect performance, abuse of a power to specify terms, and interference with or a failure to cooperate in the other party's performance" as examples of bad faith that have been recognized in judicial decisions.⁷ A covenant may be breached if the aggrieved party demonstrates the other party destroyed its reasonable expectations by acting with ill motives and without any legitimate purpose.⁸

The New Jersey Supreme Court found that a landlord breached the implied covenant of good faith and fair dealing where a tenant improperly sought to exercise an option under its lease 19 months in advance of the deadline, and the landlord, despite a series of communications between the parties over many months, waited until the option deadline expired before advising the tenant that its exercise of the option was defective.⁹ In explaining why the implied covenant of good faith and fair dealing was breached, the Court emphasized that the breach was not a landlord's failure to cure a tenant's lapse, but rather was a "demonstrable course of conduct, a series of evasions and delays, that lulled [tenant] into believing that it had exercised the option properly."¹⁰

Discretionary Consent

A commercial lease often contains provisions that provide for the exercise

of discretion by both the landlord and the tenant. Instances where a landlord's discretion may be required include: a proposed change of use of the premises, a proposed assignment of the lease, a proposed subleasing of the premises, or a proposed structural alteration of the premises. A tenant may have discretion to terminate the lease in the event of a violation of a co-tenancy provision or an exclusive provision, or where a specified event such as a casualty, change in the common areas, or a partial taking adversely impacts its operations. Regardless of the instance and the specific language used, each party will likely expect the other to act reasonably when determining whether to exercise discretion.

Although a commercial lease is a hybrid of property and contractual rights, when interpreting a lease the principals of contract law will be applied. In interpreting a contract provision, a court generally turns first to a contract's plain language.¹¹ Unless the contract uses specialized language peculiar to a particular trade, profession or industry, courts will afford the contractual terms their plain and ordinary meaning.¹² The contract should be considered as a whole, without isolating certain provisions from others that pertain to the same subject.¹³ A contract provision will be enforced when its terms are clear and unambiguous.¹⁴ A court will not rewrite a contract for the parties.¹⁵

In commercial leases, the implied covenant of good faith and fair dealing is applicable to a party's exercise of discretion as set forth in the lease. Conversely, in the absence of discretion (*e.g.*, where a particular action or event is specifically prohibited) the covenant should be inapplicable.¹⁶ Suppose a tenant desires to sublease its premises, but the lease provides for an absolute prohibition against subleasing. The implied covenant of good faith and fair dealing should be inapplicable to such a request by the tenant since the requested event

(the proposed subletting) is prohibited under the plain language of the lease and the exercise of discretion is not required by the landlord.

The implied covenant of good faith cannot contradict the express terms of a lease.¹⁷ In most instances, however, landlords and tenants will not agree to an outright prohibition on topics that are of particular importance to the parties, such as a change of the initial use of the premises, continuous operation, alterations, assignment and subletting, or signage rights.

As a compromise, if a party cannot obtain an unfettered right to take a particular action, the parties may agree that the particular action will require the reasonable consent of the non-requesting party. For instance, if the lease provides the tenant may not sublease its premises without the landlord's reasonable consent, the landlord presumably would be required to demonstrate a reasonable basis for withholding consent for a proposed sublease. In order to ascertain what the parties would deem reasonable, the lease could contain objective criteria to provide a foundation of the subleasing criteria. For example: no more than one subtenant in the premises, the tenant will not advertise the rate of the subtenancy, the proposed subtenant will utilize the premises for the specific use set forth in the lease, the proposed subtenant is not an occupant of the building in which the premises is located (or any other building owned by the landlord), and/or the proposed subtenant has not been in negotiations with the landlord for the leasing of space for an agreed upon time period (*e.g.*, six months prior to the requested subleasing). Absent objective criteria in the lease to create a baseline of what is reasonable, the landlord's withholding of consent to a proposed sublease may result in an allegation that the landlord's denial was made in bad faith and deprived the tenant of a benefit (*i.e.*,

subleasing) the tenant bargained for in the lease.

It is important to note that the element of bad faith is essential to demonstrating a breach of the implied covenant of good faith and fair dealing. While a party may act unreasonably in withholding its consent, a finding that the party acted unreasonably does not automatically equate to a finding of bad faith; conversely, a finding of bad faith will always be deemed an unreasonable action.¹⁸

Likewise, a covenant of good faith and fair dealing may be implied even in the absence of a reasonableness standard within a lease. For instance, using the aforementioned subleasing hypothetical, suppose the lease states that any proposed subleasing of the premises requires the landlord's consent (without any reference to reasonableness or that

such consent may be denied in the landlord's sole discretion). Although it may appear that such language permits a landlord to arbitrarily withhold its consent, a tenant may argue that since the landlord agreed in the lease to consider the tenant's request (as opposed to an outright prohibition) such consideration requires that the landlord be reasonable in order for the tenant to receive the benefit of what it bargained for in the lease. In such a case, the implied covenant of good faith and fair dealing may apply to the landlord's decision to withhold its consent.

Conclusion

In exercising discretion in a commercial lease, the parties may agree upon a reasonableness standard without defining what 'reasonableness' means. Where reasonableness is undefined and the expectations of the parties are not described in the lease, the parties may have differing views on what constitutes reasonableness. In such circumstances, a denial of consent may leave a party open to a charge that it breached the implied covenant of good faith and fair dealing, as its unreasonable denial prevented the other party from enjoying a benefit bargained for in the lease.

Although it may not be realistic or feasible to include objective criteria for every instance in a lease where consent for a particular action is based on reasonableness, including such objective criteria benefits both parties. The parties may include mutually acceptable objective standards that aid decision-making and provide a measure of predictability. Additionally, the inclusion of such standards may preclude a finding of bad faith in the event the requested consent is denied. ⚖

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ENDNOTES

1. *Broad & Branford Place Corp. v. J. J. Hockenjos Co.*, 132 N.J.L. 229, 232 (1944).
2. *Sons of Thunder, Inc. v. Borden, Inc.*, 148 N.J. 396, 420 (1997).
3. *Id.*
4. *Id.* at 422 – 23.
5. Restatement (Second) of Contracts, § 205 cmt. a (1981); see also N.J.S.A. 12A:2-103(b) (“‘good faith’ in the case of a merchant means honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade.”).
6. *Wilson v. Amerada Hess Corp.*, 168 N.J. 236, 251 (2001).
7. Restatement (Second) of Contracts, § 205 cmt. d (1981).
8. *Wilson*, 168 N.J. at 251.
9. *Brunswick v. Route 18 Shop. Center*, 182 N.J. 210 (2005).
10. *Id.* at 230–31.
11. *Kieffer v. Best Buy*, 205 N.J. 213 (2011).
12. *Id.* at 223.
13. *Newark Publishers Ass’n v. Newark Typographical Union*, 22 N.J. 419 (1956).
14. *Stone v. Royal Ins. Co.*, 211 N.J. Super. 246, 248 (App. Div. 1986).
15. *Zacarias v. Allstate Ins. Co.*, 168 N.J. (2001).
16. Mark A. Senn, *Commercial Real Estate Leases: Preparation, Negotiation, and Forms* § 11.08 (5th ed. 2016).
17. *Id.*
18. Joel R. Hall, *Assignment: The Tenant’s Perspective*, in *Commercial Real Estate Leases: Selected Issues in Drafting and Negotiating in Current Markets* (ALI-CLE Course of Study, May 5-6, 2016), available at Westlaw, SX024 ALI-CLE 531.

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