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Gamesmanship Taken Too Far

Commercial landlord breached covenant of good faith and fair dealing by dodging tenant's inexact attempt to renew lease

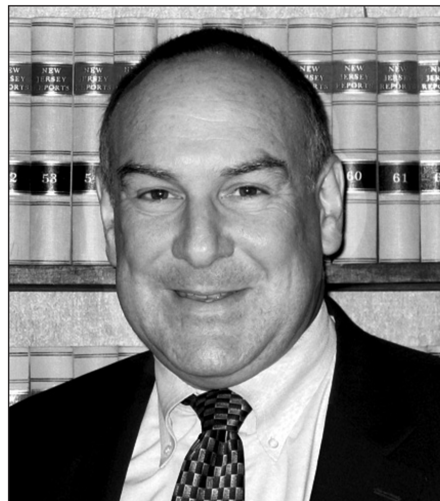
By Arthur L. Raynes

The most important commercial law case of the past term dealt with the Court's utilization of the concept of a covenant of good faith and fair dealing to avoid a harsh result that otherwise would have resulted from enforcement of a commercial contract between two sophisticated parties, each represented by counsel.

Good Faith and Fair Dealing

Brunswick Hills Racquet Club v. Route 18 Shopping Center Associates, 182 N.J. 210 (2005), dealt with the familiar issue of whether a commercial tenant's failure to comply strictly with the lease's renewal terms would allow a landlord to terminate the lease, which turned out to be unfavorable to the landlord.

There, a commercial tenant entered into a 25-year lease with its landlord. That lease contained an option either to purchase the property or to enter into a 99-year lease with very favorable financial terms to the tenant. To exercise the 99-year option, the tenant had to give notice at least six months prior to the expiration date of the original lease and pay to the landlord an option price of $150,000. Nineteen months before the option deadline, the plaintiff/tenant's attorney advised the defendant/landlord in writing of the tenant's desire to exercise the 99-year option, but no monies were paid. Over the next two years, the plaintiff's attorney sent numerous letters regarding this issue. Most letters went unanswered, but at no time did the landlord voice any objection to the option or demand payment of the option price. Then, after the deadline passed, the landlord advised the tenant that because it had not paid the option price, the right to exercise the option had lapsed.



Following a bench trial, the trial judge entered a verdict in favor of the landlord, which was affirmed by the Appellate Division, due to the tenant's failure to comply strictly with the terms of the lease, i.e., its failure to pay the option price. The Appellate Division noted that the parties were sophisticated business entities represented by counsel and declined to write a more favorable contract for the plaintiff than the one it had signed. See *Brunswick Hills,* 182 N.J. at 222. While there was no question that the plaintiff had not properly exercised the option, the Supreme Court analyzed the covenant of good faith and fair dealing, a term implicit in every contract, and reversed the lower courts.

In determining whether the covenant had been breached, the Court noted that proof of bad faith or intention is necessary to sustain the cause of action. Because the landlord had "dodged" the plaintiff's attempts to exercise the option, the Court found the requisite bad motive. Notably, the defendant acknowledged at oral argument that it did not want to accept the option price because it was not in its financial interests to do so. This alone, however, could hardly have met any test of bad faith; wanting to avoid an unfavorable renewal is a common element in every failure to renew case. Instead, the bad faith really seems to have related to the "gamesmanship" that the Court found to have occurred, in the landlord's "playing possum" before it "dropped the hammer." Citing to the *Restatement (Second) of Contracts*, the Court noted:

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> As a general rule, 'subterfuges and evasions' in the performance of a contract violate the covenant of good faith and fair dealing 'even though the actor believes his conduct to be justified.' *Brunswick Hills*, 182 N.J. at 225, citing, *Restatement (Second) of Contracts* §205 cmt. d (1981).

An important aspect of this opinion was the Court's distinction of the case that had been controlling law in the field, *Brick Plaza, Inc. v. Humble Oil & Refining Co.*, 218 N.J. Super. 101 (App. Div. 1987). In that case, the tenant failed to exercise an option to purchase the premises until five months after the deadline had passed. The Appellate Division determined that the tenant had slept on its rights, despite its assertions that its failure to exercise its rights was due to "an honest mistake," namely its reliance on an incorrect prior draft of the lease.

The *Brunswick Hills* court declared that the defendant "withheld vital information from plaintiff with the purpose of exploiting the terms of the contract without regard to the harm caused to plaintiff." Id. at 227.

In comparing and distinguishing *Brick Plaza*, the Court wrote:

> In both cases, the tenants made capital improvements to the premises and faced financial hardship if not permitted to exercise the lease option. However, unlike the tenant in *Brick Plaza*, supra, plaintiff here did not sleep on its rights and gave notice of its intent to renew nineteen months in advance of the option deadline. Unlike the landlord in *Brick Plaza*, supra, defendant here knew of plaintiff's intent to exercise the option and yet engaged in subterfuge and foot-dragging, thus delaying plaintiff's efforts to close timely on the option. Those are not trivial distinctions. Id. at 228.

Finally, while the Court stressed that it was not seeking to impose moral standards on the marketplace, or convert landlords into calendar clerks, it did want to make clear that gamesmanship could be taken too far, and when it was, a defendant could be required to account for its actions. The Court stated:

> The breach of the covenant of good faith and fair dealing in this case was not a landlord's failure to cure a tenant's lapse. Instead, the breach was a demonstrable course of conduct, a series of evasions and delays, that lulled plaintiff into believing it had exercised the lease option properly. Id. at 230-231.

Physicians' Restrictive Covenants

Community Hospital Group v. More, 183 N.J. 36 (2005), and *Pierson v. Medical Health Centers*, 183 N.J. 65 (2005), are companion cases that address the enforceability of restrictive covenants among doctors. Justice John Wallace Jr. delivered both opinions.

In the landmark case of *Karlin v. Weinberg*, 77 N.J. 408 (1978), the Supreme Court refused to declare that restrictive covenants among doctors were per se unenforceable. Since 1978, a mainstay of New Jersey chancery practice has been litigation among physicians about their restrictive covenants. The new cases marked the most recent attempt to have the Court overrule *Karlin* and find that such restrictive covenants are per se unenforceable. Instead, the Court reaffirmed the 1978 ruling in *Karlin*, and analyzed the circumstances under the reasonableness test, with a particular emphasis on the covenant's impact on the public.

The defendant in *Community Hospital Group* was a neurosurgeon who entered into a series of employment contracts with the hospital. Each contract included a post-employment restrictive covenant that prohibited the doctor from engaging in certain medical practices within a 30-mile radius for two years after employment was terminated. In the controlling contract, the doctor agreed the restrictions were reasonable and that in the event of a breach the hospital would suffer irreparable damages and have a right to relief through an injunction.

The doctor gave his notice and left his employment with the hospital in accordance with the contract. When he left the hospital, the doctor took with him documents containing patient and referral source information. Although the doctor was offered positions outside the 30-mile radius, he instead opted to join the practice of another neurosurgeon and receive medical staff privileges at Somerset Hospital, which was only 13.5 miles from Community Hospital Group. The neurosurgeon who hired the doctor certified that until the defendant became available, the neurosurgeon had been unable to fill the position due to a lack of qualified candidates.

The Appellate Division had applied *Karlin's* three-prong test, which requires that a restrictive covenant not inflict undue hardship on the employee, protect a legitimate interest of the employer, and not be detrimental to the public. In applying the test, that court found that the plaintiff had a legitimate interest in protecting referrals and patient relationships, that the doctor would not suffer undue hardship because he could find work outside of the 30-mile area, and that the period of restriction was reasonable. In assessing the reasonableness of the area covered, the Appellate Division noted that patients traveled more than that distance for specialized care, such as neurosurgery. That court also found that the public interest would not be damaged because five hospitals in the area provided neurosurgery and the doctor's patients were not restricted from continuing their relationship with the doctor. The Supreme Court granted leave to appeal.

The doctor argued to the Court that the neurosurgeon who hired him was the only on-call neurosurgeon for Somerset Hospital and that to restrict

the doctor from practicing would be detrimental to the public.

The doctor also argued that the Court should adopt a per se ban on restrictive comments for physicians. In making this argument, the doctor asked the Court to turn to its own backyard, in which ethical standards make lawyers' restrictive covenants per se unenforceable. As further support of this argument, the doctor noted the American Medical Association's view that restrictive covenants are unethical if the covenant restricts the patient's right to choose a physician.

The hospital argued that any hardship to the doctor would merely be financial in nature and that the doctor was only restricted from treating patients within the area, not from treating patients that commuted to his practice outside the area.

The Court found that there was not enough justification to overrule *Karlin*, and noted that the medical profession has dealt with the *Karlin* test for over 25 years. Except in very limited professions, the courts have consistently used a test of reasonableness to determine if a restrictive covenant should be enforced. The Court also recognized that the AMA does not view restrictive covenants to be unethical per se.

In applying the *Karlin* factors to the facts of the case, the Court found that the hospital had a legitimate interest in protecting patient information, referral bases, and business information, as well as in protecting the investment in a new physician. The Court also found that the two-year period appeared reasonable on its face and that the doctor was not subject to hardship because he was well respected and had several job offers.

However, the Court found that preventing the doctor from practicing neurosurgery at Somerset Hospital would be detrimental to the public interest. The Court recognized that there was a shortage of neurosurgeons in the restricted area, and stated that the Appellate Division should have limited the geographic area. The Court also noted that if the geographic area were reduced so that Somerset Hospital was not included, there would not be the same detriment to the public interest. The case was remanded to the Chancery Division to determine the appropriate radius of the restrictive covenant with instructions that the area should not exceed 13 miles.

Justice Roberto Rivera-Soto concurred in part and dissented in part. Justice Rivera-Soto joined in the majority opinion upholding the *Karlin* test. However, he argued that reducing the geographic area to allow the conduct sought to be prohibited renders the restrictive covenant meaningless. As the justice saw it, the doctor chose a hospital convenient to himself that needed neurosurgeons and then used that need as a justification for violating a covenant contained in three employment contracts he voluntarily signed. He further argued that the doctor acknowledged the restrictions' reasonableness and concluded that the defendant's behavior in violating the restrictive covenant was not the kind of behavior that should be rewarded.

Pierson v. Medical Health Centers also addressed a situation in which a hospital sought to enforce a restrictive covenant in a doctor's employment contract. However, the case was factually distinguishable from *Community Hospital Group* in several ways. In *Pierson*, the restrictive covenant only covered a 12-mile radius for a two-year period and the doctor was restricted from privileges at one hospital, while maintaining privileges at three other hospitals. Also, the doctor stipulated that if the covenant were not per se unenforceable, the provisions of the covenant were reasonable. The Supreme Court again upheld *Karlin* and, because the doctor had stipulated that the restrictive covenant was otherwise reasonable, affirmed the decision of the Appellate Court and upheld the covenant.

Fraud

In abrogating two Appellate Division cases, the Supreme Court held that a cause of action for creditor fraud does not exist in New Jersey. *Banco Popular North America v. Gandi*, 184 N.J. 161 (2005). Under the facts of this case, however, the Court did find that a cause of action may exist for violations of the Uniform Fraudulent Transfer Act. Further, while the Court held that the plaintiff bank had stated valid claims for civil conspiracy and negligent misrepresentation against a guarantor's attorney who had issued an opinion letter in connection with a loan, the bank failed to state a claim for negligent misrepresentation with regard to the attorney's advice regarding a transfer of the guarantor's assets.

The defendant guarantor owned three fast food restaurants through three separate single shareholder corporate entities. He became embroiled in a dispute with one of the franchises and, according to the guarantor, his counsel advised him to transfer his assets to his wife's name. Prior to this transfer, the bank had loaned one of the guarantor's corporations $550,000 and the guarantor had executed a personal guaranty with respect to the loan. After the transfer of his assets to his wife's name, the bank issued another loan to the same corporation, with a commercial guaranty, and a second loan to a second corporation, with a guarantee of payment. The commercial guaranty warranted that the guarantor had not and would not dispose of all or substantially all of his assets. The guarantee of payment provided that the guarantor had to maintain a minimum net worth of $950,000 to retain the right to dispose of assets. The guarantor's counsel, who had allegedly counseled him to transfer his assets during the franchise dispute, negotiated the second guaranty and issued an opinion letter that stated that counsel was unaware of any material matters that contradicted the representations and warranties in the loan documents. The guarantor subsequently defaulted on all of the loans.

The bank instituted an action against the guarantor and his wife, and then joined counsel as a party after the guarantor testified at a deposition that the transfers to the wife were made on the advice of counsel. Counsel moved to dismiss the counts against him for failure to state a claim and the trial court

granted the motion. The Appellate Division reinstated the claims for creditor fraud and civil conspiracy but affirmed the dismissal of claims for common law fraud and negligence.

In reversing the Appellate Division, and thereby rejecting a cause of action for creditor fraud, the Supreme Court abrogated two Appellate Division decisions: *Karo Marketing Corp. v. Playdrome America*, 331 N.J. Super. 430 (App. Div.), cert. denied, 165 N.J. 603 (2000), and *Jugan v. Friedman*, 275 N.J. Super. 556 (App. Div.), cert. denied, 138 N.J. 271 (1994). The Supreme Court reasoned that common law fraud requires several elements be met, including the existence of a material misrepresentation and reliance. Under *Karo* and *Jugan*, four of the five elements of fraud were missing, including misrepresentation and reliance, which are the cornerstones of any fraud claim. The Court noted that other causes of action have been recognized that would provide a remedy for situations like those of *Karo* and *Jugan*.

The Court also held that a conspiracy cause of action could be asserted against the attorney for advising and assisting the guarantor in transferring assets in violation of the Uniform Fraudulent Transfer Act. In so holding, the Court stated that the fact that the attorney was representing the guarantor during the transaction did not protect the attorney from liability.

Finally, the Court addressed the bank's claims of negligence against the attorney. The Court turned to its decision in *Petrillo v. Bachenberg*, 139 N.J. 472 (1995), as to the situations in which an attorney may be liable to a third party and noted that the key elements in those situations are whether the attorney invites the third party to rely on his opinion and whether the third party does actually rely on that opinion. The Court determined that the transfer of the assets was not a transaction that invited the bank's reliance. Therefore, the attorney owed the bank no duty and there was no attorney negligence in that regard. However, the attorney's actions in negotiating the second loan with the bank and issuing an opinion letter were designed to induce reliance. Consequently, a duty was found and a negligence cause of action was stated.

Consumer Fraud

Two cases dealt with damages under the Consumer Fraud Act.

To overcome summary judgment in a consumer fraud action, a plaintiff must present evidence that he sustained an ascertainable loss. In *Thiedemann v. Mercedes-Benz USA, LLC,* 183 N.J. 234 (2005), the Supreme Court held that a hypothetical devaluation of a vehicle caused by a defect is inadequate to overcome the summary judgment hurdle.

The plaintiffs had purchased a 1999 Mercedes and alleged that they broke down on two separate occasions due to inaccurate fuel-gauge readings. However, on both occasions, Mercedes corrected the problems under warranty and provided loaner vehicles at no cost to the plaintiffs.

The defendant moved for summary judgment on the grounds that its compliance with its warranty program eliminated the plaintiffs' ability to establish "ascertainable loss." The trial court granted summary judgment to Mercedes-Benz, but the Appellate Division reversed, accepting the plaintiffs' argument that the fuel-gauge defect may be present in the replacement parts, and that notice of this possible defect to future purchasers could lower the resale value of the car.

The Supreme Court found this argument unavailing and reversed. The Court noted that no expert testimony of devaluation was presented, and the opinion really rested on a failure of proofs. Despite the "low threshold for determining the existence of an ascertainable loss…," *Thiedemann,* 183 N.J. at 244, the Court noted with respect to the plaintiffs:

> [T]hey [did not] present any expert evidence to support an inference of loss in value notwithstanding the lack of any attempt to sell the vehicle, i.e., that the resale market for the specific vehicle had been skewed by the "defect." The absence of any such evidence, presented with a sufficient degree of reliability to permit the trial court, acting as a gatekeeper, to allow the disputed fact to proceed before a jury, was fatal to the plaintiffs' claim. Id. at 252.

In some detail, the Court also discussed the differences between the Attorney General's enforcement efforts under the CFA and a private cause of action, the prime one being the latter's obligation to prove ascertainable loss. The Court held that to allow a mere defect to qualify as an ascertainable loss, with no quantifiable loss suffered by a plaintiff, would squarely contradict past holdings recognizing a distinction between private causes of action and enforcement actions. The Court stated that such a holding would also dampen the manufacturer's willingness to offer warranties.

Further, the Court noted that plaintiffs in similar situations had other remedies available to them, specifically under the Lemon Law. According to the Court, allowing private consumer fraud actions to proceed without establishing ascertainable loss would render the Lemon Law meaningless.

Finally, this case actually involved a number of plaintiffs seeking class certification. The other plaintiff discussed in the opinion was dismissed on the grounds that because she leased her vehicle, she would be unable to demonstrate a loss in future resale value. Instead, the party that would possibly suffer loss upon future resale would be the lessor.

In another case, the Supreme Court held that if a consumer purchases an item on sale, and that item is defective, the consumer is entitled to recover the replacement value of that item. *Furst v. Einstein Moomjy, Inc.*, 182 N.J. 1 (2004). There, the plaintiff purchased a rug at the defendant's annual clearance sale. The rug contained a tag that provided the dimensions of the rug, and listed the "regular price" as $5,775, and

the "sale price" as $1,499. At the time of delivery, the plaintiff noticed that the rug was damaged and smaller than the size referenced on the tag. When the plaintiff demanded delivery of an undamaged rug at the size he ordered, the defendant asserted that the rug was improperly labeled, and offered only to refund his money or deliver a rug of the correct size at an additional price.

Although the trial court entered summary judgment on liability in favor of plaintiff, and determined that the plaintiff's ascertainable loss was the replacement cost of the rug, it refused to allow the plaintiff to introduce the sales tag as evidence of the replacement cost, i.e., the original sales price. The Appellate Division upheld the trial court as to the decision that the plaintiff's ascertainable loss was the replacement cost of the rug. However, it reversed the trial court's decision that the sales tag was not competent evidence of the rug's market value.

In affirming the Appellate Division, the Supreme Court considered the Consumer Fraud Act's remedial purpose. In doing so, the Court concluded that the plaintiff was entitled to the benefit of his bargain, i.e., a wool rug of a particular size and quality. Given the substantial discount price at which the plaintiff had made his purchase, the Court considered that there was little likelihood that the plaintiff would be able to replace that quality and size rug for the purchase price; therefore, the replacement cost was the only adequate remedy. Although the defendant argued that to award the replacement cost would provide the plaintiff with a windfall, in light of the act's treble damages, the Court noted that the CFA's purpose was not to make a plaintiff whole but to punish the wrongdoer and deter others from "engaging in unfair and deceptive commercial practices." Accordingly, the defendant's "windfall" argument was found to be without merit.

As to the admissibility of the sales tag, the Court turned to the New Jersey Rules of Evidence, and determined that the tag was relevant evidence of the replacement cost and was admissible as a statement of a party-opponent pursuant to N.J.R.E. 803(b)(1). Under state and federal regulations, the regular price at which a merchant offers goods for sale must bear some relationship to the item's market value. Further, it is a deceptive business practice to raise the price of an item for the purpose of artificially inflating the supposed deal passed on to consumers. Given these facts and the disparity in power and knowledge between the retailers and consumers, the Court determined that the "regular price" referenced on the sales tag would be rebuttable evidence of the replacement cost. If the merchant is able to present alternative evidence of the replacement cost, it is then up to the fact finder to make the determination. The Court made it clear that it would "not require an overly burdensome procedure for a consumer to place before the trier of fact the issue of replacement value." *Furst*, 182 N.J. at 16.

On a final note, although the issue of the appropriate sum of attorneys' fees was remanded, the Court discussed the fact that attorneys may be entitled to an enhancement under the Consumer Fraud Act. See Ronald Grayzel, "Justices Excise Serious Impact From Auto Injury Cases," 181 N.J.L.J. 868.

Uniform Construction Code

The issue in *DKM Residential Properties Corp. v. Twp. of Montgomery*, 182 N.J. 296 (2005), was whether a municipality had authority to issue a Notice of Violation to a builder after certificates of occupancy had issued. The trial court entered judgment for the township, but was reversed by the Appellate Division. The appellate panel determined that an NOV could be issued only during the construction process.

Looking to the plain language of the relevant statutory provisions, the Supreme Court reversed the Appellate Division. First, the Court considered that the UCC authorizes the imposition of sanctions against any person or corporation who, among other things, violates the Code. The Court also looked to the provisions setting forth the notice and service requirements, which specifically address the proper procedure when the violator is not the homeowner. Based upon these provisions, the Court concluded that there was no limitation on sanctioning a builder after a certificate of occupancy had issued. On the other hand, the Court did determine that it would be patently unreasonable to hold a builder liable for a continuing violation in light of the fact that the homeowner's consent would be required for access to cure.

Finally, given the expansive authority conferred upon municipalities pursuant to the UCC regulations, the Court held that it was within the municipality's authority, not just the DCA, to issue an NOV after a certificate of occupancy had issued. ■