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A New Implied Covenant

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will not be disturbed. To summarize: It is not quite in harmony with the spirit of the times to declare unconstitutional a statute, the principal fault of which is found in its outspokenness. We are gradually getting away from the antiquated formalities and fictions of the law. Today, if ever, we are in need of speedy legal processes. Foreclosure and reorganization, such as would be necessary as an alternative, is not inducive to rapid results. The Schackno Act dispenses with much of the hindering red tape. It has the further advantage of being economical, thusly resulting directly to the pecuniary advantage of the certificate holder. In that respect especially, it differs from the ordinary reorganization.⁶⁴

Moreover, as has been shown, the latter method with all of its acknowledged legality accomplishes no more in the end than does the Schackno Act. The dissenters in a common law reorganization are compelled to join forces with the majority⁶⁵ if they are to obtain a remuneration which will compensate them for the value of the securities which they hold; the dissenters, by virtue of the mechanics of the Schackno Act, are compelled to assent to the plan due to the mandatory nature of the statute.

The enactment is not an example of the "all too ready resort of America to legislation."⁶⁶ The words of Mr. Rosenberg: "Let us leave the growth of our jurisprudence regarding this still developing subject of reorganization to the courts and the bar * * *,"⁶⁷ express the exact sentiment which we must avoid. The judicial growth of the law governing reorganizations has not, in spite of the *Phipps* case,⁶⁸ been toward the simplification of the problem. What is needed to relieve the present plight of both securities holders and guaranty companies is a procedure which will make possible a speedy and economical reorganization of the security without any disturbance of the guarantee. The Schackno Act satisfies such need.⁶⁹

WILLIAM E. SEWARD.

A NEW IMPLIED COVENANT.

The recent case of *Kirke La Shelle Co. v. Armstrong Co.*,¹ directs our attention to the construction and interpretation of con-

⁶⁴ Referee's opinion, *Chase National Bank v. 10 East 40th Street Corp.*, N. Y. L. J., Oct. 2, 1933, shows reorganization expenses in the amount of \$346,640.38. Appellant's brief (p. 48) estimates the average cost of reorganization under the Schackno Act to be \$3,000.

⁶⁵ *Weiner*, *supra* note 26, at 145: "The upset price * * * has become one of the most useful tools of the majority for forcing recalcitrants into line."

⁶⁶ *Rosenberg*, *supra* note 30, at 271.

⁶⁷ *Id.* at 272.

⁶⁸ *Supra* note 30.

⁶⁹ *Schmalig v. Burling*, *supra* note 4: "* * * the provisions of the Schackno Act are necessary in the exercise of the police power of the state to safeguard and protect the interests of the many against the few."

¹ 263 N. Y. 79, 188 N. E. 163 (1933).

tracts, with special reference to the implication of covenants or warranties of law, as applied to contracts involving the assignment of choses in action.² The law, as it now stands, seems to imply a covenant against acts in derogation of an assignment, by the assignor or others claiming under him;³ and an implied warranty that the claim is genuine and legally enforceable to the amount, if any, specified in the assignment, in the absence of the manifestation of a contrary intent.⁴ The case at bar⁵ would seem to add a new obligation in the form of an implied covenant of *good faith and fair dealing*, throughout the life of the contract. The effect upon the rules of construction of contracts by the application of this new doctrine is amply illustrated by the case under consideration.⁶

Briefly, the facts in this case are as follows: Mr. Armstrong, a playwright, was indebted to the plaintiff, in a considerable amount, and the plaintiff company brought an action against Mr. Armstrong in which it obtained judgment therefor. Unfortunately, however, when the litigation had ended, Mr. Armstrong was dead, and his estate insolvent, he having transferred all his assets to the Armstrong Company some time before his death. The plaintiff company brought an action to set this transfer aside as a fraud on creditors; but before this action had come to trial, the plaintiff company affected a settlement with the Armstrong Company, upon which this action was brought.

This settlement provided that in consideration of the discontinuance of the action; the assignment by the plaintiff to the defendant of the judgment, the plaintiff company was to be entitled to one-half of all the moneys which the defendant might receive from the revival of a play, "Alias Jimmy Valentine," in New York City, "on the road," or "in stock."

"In case the moneys we receive as one-half of all the moneys you are entitled to receive from revival production of 'Alias Jimmy Valentine' * * * shall not amount to \$19,337.59 [the amount of the judgment] then we are to receive one-half of all the moneys you are or may be entitled to receive from any revival of 'Salomy Jane' including productions in New York City, 'on the road' and 'in stock,' throughout the United States and Canada, from now on."

These payments were to be made to the plaintiff directly by the producers of the plays and all remittances were to be accompanied by box office statements. The settlement further reads:

² BLACK, LAW DICTIONARY (2d ed. 1910) 293.

³ Selections from WILLISTON'S TREATISE ON CONTRACTS (Student's ed.) 849, and cases there cited.

⁴ *Id.* at 849, 850, and cases there cited.

⁵ *Supra* note 1.

⁶ *Ibid.*

"In making the settlement we feel we should state that it is in reliance on the distinct understanding that all contracts, sales, licenses, or other arrangements to be made in the future affecting the title to the dramatic rights (exclusive of motion picture rights)⁷ to the above two plays, or the production of the said plays in New York City, 'on the road' or 'in stock' will be submitted to us before execution or delivery and shall be subject to our approval."

Over seven years after this settlement, the defendant granted to the Metro-Goldwyn-Mayer Corporation the exclusive "talkie" rights in the said play, receiving a substantial sum therefor. The plaintiff company brought this action to recover half of the said amount, claiming to be entitled thereto by reason of the settlement contract, or in the alternative, upon the theory that such a sale was in violation of the covenant in the settlement that the defendant had to submit any contract about to be made to the plaintiff company for its approval and the failure to do so was the breach of the contract, since this condition included within itself an implied covenant not to give away any rights which would be destructive of the plaintiff's company's interest under the contract.

The Trial Term found for the defendant. This decision was unanimously affirmed by the Appellate Division, but reversed by a five-to-two decision of the Court of Appeals.⁸

In stating that the Appellate Division was in error when it considered the relationship between the plaintiff and the defendant to be one of debtor and creditor, the Court of Appeals, by Judge Hubbs, does not, however, state what those relations were. All that we learn is: "Its [the plaintiff's] relationship with the respondent is based on the contract in settlement of the pending suit." Such a statement, in our opinion, is insufficient, without further explanation to the effect that the parties entered into a joint venture to give rise to the fiduciary relationship assumed by the learned court.

We think, however, as the Trial Court and the Appellate Division did, that a debtor and creditor relationship did exist, because the essence of the agreement was really to repay to the plaintiff company the large sum claimed by it without recourse to litigation, because of the transfer of the assets to the defendant by the plaintiff's company's insolvent debtor. For that purpose, the plaintiff was entitled to one-half of box office receipts, and in order to protect this manner of repayment the plaintiff also got the right to pass upon any contract concerning this play, *except moving pictures*, so as to direct the most advantageous disposition of the play. The court says:

⁷ Parentheses used in the original contract.

⁸ O'Brien and Crouch, *JJ.*, dissenting.

"It is without question that the contract with the Metro-Goldwyn-Mayer Corporation was a contract that would affect the production of the play, because, by entering into the contract and accepting and retaining the consideration therefore, the respondents assumed a fiduciary relationship which had its origin in the contract and which imposed upon them the duty of utmost good faith."⁹

The last preceding sentence, taken by itself, would lead one to believe that a fiduciary relationship is the natural and necessary consequences of any contract. Turning to the case cited as authority for this principle, we see that the point of departure is the opinion of Justice Cardozo in the case of *Underhill v. Schenk*,¹⁰ that he considered the parties in the case before him in relations of trust and confidence. It is true that those relations sprang out of a contract, but in that particular contract they existed owing to definite equitable grounds there controlling. The court there says:

"If Henderson is accountable at all, it is on the basis of a *quasi* partner under the duty to deal with a competing business as an asset of the joint venture." * * * Herndon, in accepting a license with royalties measured by receipts, became chargeable as a trustee * * *."

In the case at bar, however, the court does not at all discuss the question whether the parties do stand in a confidential relationship, although in some places it seems to take this for granted without stating any reasons therefor.

It is said that hard cases make bad law. This case is hard in so far as it deals with unforeseeable innovations in industry which cause a windfall to one of the contracting parties irrespective of that party's deserts, and in which the other party now seeks a share. Such a situation usually results in the indulgence upon the loose use of legal concepts, rather than rigorous rules of law in order to bolster *ratio decidendi*. The law of this case is "bad" in our opinion, in so far as a new implied covenant is sought to be introduced into all contracts indiscriminately, to-wit, that the parties shall deal "fairly" with each other.¹¹

"In every contract, there is an implied covenant that neither party shall do anything which will have the effect of destroying or injuring the rights of the other party to receive the fruits of the contract, *which means that in every*

⁹ *Supra* note 1.

¹⁰ 238 N. Y. 7, 143 N. E. 773 (1924).

¹¹ *Supra* note 1.

*contract there exists an implied covenant of good faith and fair dealing.”*¹²

As authority for this statement, the court cites the cases of *Wilson v. The Mechanical Organette Co.*,¹³ and *Brassil v. Md. Casualty Co.*¹⁴ In the first of the above cases, the defendant sought to deprive an inventor of his profits in the form of royalties by assigning the defendant's rights under the contract to the co-defendant corporation. The court, in granting judgment for the plaintiff for his part of the profits which had accrued to the defendant corporation, said that since the corporation derived its rights from the defendant, it was also subject to the duties of the latter and that equity and justice would imply a promise to do or not to do a certain act. Nothing is said in the whole case about any implied covenant of fair dealing contained *ipso facto* in the contract; on the contrary, the court emphasizes the importance of the relations of the parties and the subject matter of the contract. In the *Brassil* case,¹⁵ the court does state that principles of fair dealing and good faith enter into every contract, but the facts in that case show such unconscionable conduct on the part of the defendant insurance company, that it was found liable to the plaintiff on the principles of equity and justice, the statement of good faith being a mere *dictum*. The court itself admitted that it was shocked by the conduct of the defendant; that the circumstances of that case were peculiar; and that it did not go beyond them in making the decision.

Turning now to the question of the negative implied covenant, the court itself admits that the facts in the cases it cites do not involve substantially similar facts to those in the case at bar. We respectfully submit that the facts are sufficiently diverse not to be entitled to be used as precedents in the same line of decisions. Thus in both cases cited, *Harper Bros. v. Klaw*,¹⁶ and *Manners v. Morosco*,¹⁷ one of the parties were precluded from extending its rights by the terms of the contract, and as to the other party, the question of moving picture rights was not touched at all, in the contracts. The court precluded all the parties in both cases from disposing of the moving picture rights.

“There is an implied negative covenant on the part of the grantor not to use the ungranted portion of the copyright to the detriment, if not destruction, of the licensee's estate.”¹⁸

¹² *Ibid.*

¹³ 170 N. Y. 542, 63 N. E. 550 (1902).

¹⁴ 210 N. Y. 242, 104 N. E. 622 (1914).

¹⁵ *Ibid.*

¹⁶ 232 Fed. 609 (1916).

¹⁷ 252 U. S. 317, 40 Sup. Ct. 335 (1920).

¹⁸ *Supra* note 16.

This argument, though well fitted to the two cases in question, seems to us to be misplaced in a case where it is inconsistent with an express covenant.¹⁹ We think that in the *Morosco* case, no less eminent an authority than Justice Holmes, in saying that:

"It may be assumed that those words of the contract might carry the right to represent the play in moving pictures if the other terms pointed that way, but to our minds they are inconsistent with any such intent,"

pointed out that where an intent may be gathered from the spirit of the written instrument, it must consistently be followed; *a fortiori*, where, as here, the words expressly exclude a category, consistency requires that such express intent be diligently carried out.

It is true that if the defendant was guilty of a violation of an implied covenant, it may be liable by implication to the plaintiff for profits arising from such breach, as damages. But was there such an implied covenant? The settlement excludes expressly "motion pictures" from the agreement. "Talkies," although unknown at that time, are a species of the genus "motion pictures" and not of stage production. At best, such a lack of foresight as to the possible development of the motion picture industry, which was in its infancy at the time of the agreement in question, resulted at a later date in a latent ambiguity.²⁰ Evidence of extrinsic circumstances is allowed to clarify the meaning of such ambiguity, and we think that neither the relations nor the previous dealings of the parties warrant the finding of a mutual intention to incorporate the negative covenant excluding the talkie rights from the contract. The right to motion pictures was expressly reserved to the Armstrong Company, and if by exercising this right, it incidentally damaged the plaintiff company, we think that it was *damnum absque injuria*, as there can be no breach of a covenant which the parties did not contemplate in the first place and, which is inconsistent with the express terms of their contract excluding as it did motion pictures, in the second place.

The aforementioned doctrines in the principal case, taken alone, tend to destroy one of the most elementary general rules of the law of contracts, namely, that parties entering into a contract deal at arms' length. Indeed, in any definition of the term "contracts," there

¹⁹ "The introduction of an implied term into the contract of the parties * * * can only be justified when the implied term is not inconsistent with some express term of the contract and where there arises from the language of the contract itself, and the circumstances under which it was entered into, an inference that it is absolutely necessary to introduce the term to effectuate the intention of the parties." *Brodie v. Cardiff Corp.*, A. C. 337, 358 (1919); *Dermott v. State*, 99 N. Y. 101, 1 N. E. 242 (1885); *King v. Leighton*, 100 N. Y. 386, 3 N. E. 594 (1885).

²⁰ BLACK, LAW DICTIONARY (2d ed. 1910) 64.

is no mention made of the term "fiduciary," and such an important element would not have been overlooked.²¹ We are inclined to think that a decision like the present one tends to create a confusion in the law of contracts, which law ought to be as definite and certain as is compatible with progress, if business men are to know how far the law will protect them in their contract dealings. We think that the primary intention of the parties ought not to have been changed when industrial development proved that the bargain of one of the parties was more advantageous than that of the other, but that the benefit ought to have been allowed to lay where it fell.

RHEA JOSEPHSON.

ILLEGAL ACCUMULATIONS—UNDISPOSED-OF PROFITS—RIGHT TO PROCEEDS.

It is an oft-noted truth that the field of trusts and of their management has become one of the more important branches of the law. Certainly, in the matter of multiplicity and magnitude of litigation, trusts take a very high place. One need but scan the pages of the volumes containing the cases handed down by New York courts to come to this conclusion.

And so, it will not be amiss, despite the fact that this article deals primarily with the problem of the disposition of trust income funds which have been illegally accumulated or inadvertently ignored, to review some of the fundamental principles set up by the legislature and courts of our state as gauges for the determination of legality of accumulations of trust income.

Our statutes¹ provide that income of trusts of real or personal property may be accumulated for the benefit of a minor or minors *in being* at the time of the creation of the trust and that such accumulations must cease "at or before the expiration of their minority." If the accumulations are to commence at a period subsequent to the date of the trust instrument or the death of the person executing it, such commencement must be within the time permitted for the suspension of ownership of personal property and the vesting of future estates in realty. They must also begin during the minority of the infants to be benefited. *All other accumulations of income* (with certain noted exceptions²) *are void*.

²¹ *Id.* at 261; WILLISTON, *THE LAW OF CONTRACTS* (1926) 1. "Each party was free to act in his own interest restricted only by the stipulations of the contract." *Patterson v. Meyerhofer*, 204 N. Y. 96, 97 N. E. 472 (1912).

¹ N. Y. REAL PROP. LAW (1909) §61, N. Y. PERS. PROP. LAW (1909) §16.

² These deal with certain permitted accumulations of the income of trust funds for the benefit of religious, educational, charitable or benevolent corporations. Also, recent amendments have validated accumulations of income to be