

Excuses for Non-Performance

A breach is the non-performance of a contractual obligation when it is due. As noted in the section on express conditions, parties can explicitly state when their promises are due. Otherwise, courts can read implied conditions into the contract. Notably, As further explored in other sections on this book, those implied conditions mean a party might not need to perform when the other party materially breaches or repudiates the contract. In this section, we discuss another type of implied conditions that allow a party to stop performance: excuses for nonperformance. What is unique about excuses is that they are not rooted in the other party's objectionable behavior but with substantial changes in external circumstances.

Caldwell, the owner of a famous music hall in London, promised to allow Taylor to use it for four events in return for a substantial fee. A week before the first event, the music hall was burned to the ground through no fault of any of the parties, thus preventing Caldwell from performing his promise. Taylor sued for damages. The Queen's Bench, the highest court in England, ruled that the parties assumed the continued existence of the music hall and, therefore, that existence was a condition for Caldwell's duty to perform. Its destruction, thus, makes performance not only impossible, but excused. In other words, Caldwell was not breaching the contract. This case, *Taylor v. Caldwell*, 122 Eng.Rep. 309 (Q.B.1863), helped establish the common law doctrine of impossibility.

Compare the facts of *Taylor v. Caldwell* to those of another famous English case: *Krell v. Henry*. Paul Krell, the owner of a London apartment, and C.S. Henry agreed that, in return for a substantial amount, Henry would be allowed to use the apartment on June 26. The apartment overlooked the route of the expected procession before the coronation of King Edward VI, scheduled for that day. However, due to the king's illness, the events were postponed by a few weeks. Must Henry perform, meaning pay for the right to use the apartment on June 26? Here, unlike in *Taylor v. Caldwell*, performance was possible. Nevertheless, the court held that it was excused. The court read an implied condition into the contract concerning its purpose, watching the procession. Once that purpose was unattainable—frustrated—Henry's performance was excused. The case, *Krell v. Henry*, 2 KB 740 (1903), was one of the basis for the common law doctrine of frustration of purpose.

Using any of those excuses brings the contractual relationship to an end. Specifically, once the duty of one side is excused, the other party does not need to perform its dependable promises either, which leads to the termination of the agreement. For example, after Caldwell's music

hall was burned and his duties discharged, Taylor's obligation to pay was also discharged. Any amount that Taylor paid in advance should have been returned as restitution.

The following cases consider modern applications of those two common-law excuses.

Karl Wendt Farm Equipment Co., Inc. v. International Harvester Co.

931 F.2d 1112 (6th Cir. 1991)

JONES, Judge.

Plaintiff Karl Wendt Farm Equipment Company ("Wendt") appeals and defendants International Harvester Company and International Harvester Credit Corp. (collectively "IH") cross-appeal from a deficiency judgement and preceding trial verdicts in this contract action relating to a dealer sales and service agreement. For the reasons set forth below, we reverse and remand in part and affirm in part.

I.

This diversity action arises out of IH's decision to go out of the farm equipment business after a dramatic downturn in the market for farm equipment. In the fall of 1974, Wendt and IH entered into a "Dealer Sales and Service Agreement" ("agreement") which established Wendt as a dealer of IH goods in the area of Marlette, Michigan. The agreement set forth the required method of sale, provisions for the purchase and servicing of goods, as well as certain dealer operating requirements. The agreement also provided specific provisions for the termination of the contract upon the occurrence of certain specified conditions.

In light of a dramatic recession in the farm equipment market, and substantial losses on the part of IH, IH negotiated an agreement with J.I. Case Co. and Tenneco Inc. ("Case/Tenneco") to sell its farm equipment division to Case/Tenneco. The sale took the form of a sale of assets. The base purchase price was \$246,700,000.00 in cash and \$161,300,000.00 to be paid in participating preferred stock in Tenneco. While IH asserts that it lost \$479,000,000.00 on the deal, it also noted that this was a "paper loss" which will result in a tax credit offsetting the loss.

In its purchase of IH's farm equipment division, Case/Tenneco did not acquire IH's existing franchise network. Rather, it received "access" to IH dealers, many of whom eventually received a Case franchise. However, there were some 400 "conflicted areas" in which both a Case and an IH dealership were located. In these areas Case offered only one franchise contract. In nearly two-thirds of the conflicted areas, the IH dealer received the franchise.

However, Marlette, Michigan was such a “conflicted area” and Wendt was not offered a Case franchise.

Wendt filed this action alleging breach of IH’s Dealer Agreement and several other causes of action, but all Wendt’s allegations save the breach of contract action were disposed of before trial. . . .

At trial, the court allowed IH’s defense of impracticability of performance to go to the jury on the contract action. The jury returned a verdict of no cause of action on the contract and the district court denied Wendt’s motion for J.N.O.V./new trial, which was based on the invalidity of the impracticability defense. These actions by the court form a substantial basis of Wendt’s appeal. In addition, however, the court ordered a directed verdict for Wendt as to IH’s defenses of frustration of purpose [and other defenses]. The court’s directed verdict on the viability of these defenses forms the basis of IH’s cross-appeal....

II.

We review the trial court’s interpretation of a contract de novo. . . . The test for determining whether a J.N.O.V. should be granted is whether the evidence is insufficient as a matter of law to support the judgment....

Wendt asserts a number of errors surrounding the district court’s allowing the defense of impracticability of performance to go to the jury. Wendt first contends that the defense of impracticability due to extreme changes in market conditions is not a cognizable defense under Michigan law. In the alternative, Wendt argues that there was insufficient evidence to withstand Wendt’s motion for a directed verdict on impracticability. The jury’s verdict of no cause of action against IH based on the impracticability defense also forms the basis of Wendt’s motions for J.N.O.V. and new trial....

Wendt first contends that impracticability is only cognizable under Michigan law as a defense to contracts for sale of goods governed by the U.C.C. . . .

The district court . . . asserted that the Michigan Supreme Court’s recognition of the doctrine of impossibility was not altered by its adoption of the U.C.C. in 1964 and further that the doctrine of impossibility was broadened by the Michigan Court of Appeals in *Bissell v. L.W. Edison Co.*, 9 Mich. App. 276, 156 N.W.2d 623 (1967) to excuse future performance when circumstances make performance impracticable. . . .

Generally, under Michigan law, “[e]conomic unprofitableness [sic] is not the equivalent to impossibility of performance. Subsequent events which in the nature of things do not render performance impossible, but only render it more difficult, burdensome, or expensive, will not operate to relieve [a party of its contractual obligations].”

In *Bissell*, the Michigan Court of Appeals, relying on the Restatement of Contracts section 457, concluded that the doctrine of impossibility is a valid defense not only when performance is impossible, but also when supervening circumstances make performance impracticable. Section 457 of the Restatement of Contracts, now section 261 of the Restatement (Second) of Contracts (1981) provides:

Discharge by Supervening Impracticability

Where, after a contract is made, a party’s performance is made impracticable without his fault by the occurrence of an event the non-occurrence of which was a basic assumption on which the contract was made, his duty to render that performance is discharged, unless the language or the circumstances indicate the contrary.

Although *Bissell* did not involve non-performance due to economic causes, the court relied extensively on section 457 which defines impossibility to include, “not only strict impossibility but impracticability because of extreme and unreasonable difficulty, expense, injury and loss involved.” In the instant case the district court relied heavily on the language of section 457 quoted in *Bissell* to conclude that the extreme downturn in the market for farm products was “unreasonable and extreme” enough to present a jury question as to the defense under Michigan law.

Recognizing that *Bissell* suggests that an impracticability defense may be cognizable under Michigan law in some circumstances, we must turn to the question of whether under Michigan law, the defense of impracticability was appropriately presented to the jury under the circumstances involving a dramatic downturn in the market for farm equipment which led to the contract action before us in this case. The commentary to section 261 of the Restatement (Second) provides extensive guidance for determining when economic circumstances are sufficient to render performance impracticable. Comment d to section 261 makes clear that mere lack of profit under the contract is insufficient: “[I]mpracticability’ means more than ‘impracticality.’ A mere change in the degree of difficulty or expense due to such causes as increased wages, prices of raw materials or costs of construction, unless well beyond the normal range, does not amount to impracticability since it is this sort of risk that a fixed price contract is intended to cover.” Comment d also provides:

A severe shortage of raw materials or of supplies due to war, embargo, local crop failure, unforeseen shutdown of major sources of supply, or the like, which either causes a marked increase in cost or prevents performance altogether may bring the case within the rule stated in this Section.

More guidance is provided in Comment b to section 261. Comment b states: “In order for a supervening event to discharge a duty under this Section, the non-occurrence of that event must have been a ‘basic assumption’ on which both parties made the contract.” Comment b goes on to provide that the application of the “basic assumption” criteria

is also simple enough in the cases of market shifts or the financial inability of one of the parties. The continuation of existing market conditions and of the financial situation of one of the parties are ordinarily *not* such assumptions, so that mere market shifts or financial inability do not usually effect discharge under the rule stated in this Section.

(Emphasis added). Comment b also provides two helpful examples. In Illustration 3 of comment b, A contracts to employ B for two years at a set salary. After one year a government regulation makes A’s business unprofitable and he fires B. A’s duty to employ B is not discharged due to impracticability and A is liable for breach. In Illustration 4, A contracts to sell B a machine to be delivered by a certain date. Due to a suit by a creditor, all of A’s assets are placed in receivership. A is not excused for non-performance under the doctrine of impracticability.

In our view, section 261 requires a finding that impracticability is an inappropriate defense in this case. The fact that IH experienced a dramatic downturn in the farm equipment market and decided to go out of the business does not excuse its unilateral termination of its dealership agreements due to impracticability. IH argues that while mere unprofitability should not excuse performance, the substantial losses and dramatic market shift in the farm equipment market between 1980 and 1985 warrant the special application of the defense in this case. IH cites losses of over \$2,000,000.00 per day and a drop in the company’s standing on the Fortune 500 list from 27 to 104. IH also put on evidence that if it had not sold its farm equipment division, it might have had to declare bankruptcy. While the facts suggest that IH suffered severely from the downturn in the farm equipment market, neither market shifts nor the financial inability of one of the parties changes the basic assumptions of the contract such that it may be excused under the doctrine of impracticability. Restatement (Second) of Contracts, section 261, comment b. To hold otherwise would not fulfill the likely understanding of the parties as to the apportionment of risk under the contract. The agreement provides in some

detail the procedure and conditions for termination. IH may not have been entirely responsible for the economic downturn in the company, but it was responsible for its chosen remedy: to sell its farm equipment assets. An alternative would have been to terminate its Dealer Agreements by mutual assent under the termination provisions of the contract and share the proceeds of the sale of assets to Case/Tenneco with its dealers. Thus, we find that IH had alternatives which could have precluded unilateral termination of the contract. Further, application of the impracticability defense in this case would allow IH to avoid its liability under franchise agreements, allow Case/Tenneco to pick up only those dealerships it sees fit and leave the remaining dealers bankrupt. In such circumstance, application of the doctrine of impracticability would not only be a misapplication of law, but a windfall for IH at the expense of the dealers.

We find this understanding of the doctrine of impracticability to be more consistent with Michigan law than the district court's interpretation. In applying the doctrine of impossibility, the Michigan Supreme Court has repeatedly held that economic loss or hardship was not enough to excuse performance. *See Sheldon*, 319 Mich. at 408, 29 N.W.2d at 835 (a government regulation which placed a ceiling on the price of scooter bikes making their manufacture unprofitable did not excuse performance on a contract for sale of scooter bikes) . . . The fact that IH's losses in this case involved millions of dollars does not change the scope of the doctrine as the proportional effect of those changes is equivalent to the hardship imposed on the small businesses in the impossibility cases just described.

In the end, IH simply asserts that it would have been unprofitable to terminate its agreements with its dealers by invoking the six-month notice and other termination procedures embodied in the Dealer Agreement, or by sharing the proceeds of its sale of its farm equipment assets with dealers. This assertion does not excuse IH's performance under the agreement.

. . . we hold that while the Supreme Court of Michigan might recognize the defense of impracticability, it would not do so in the circumstances of this case as a matter of law. Accordingly, we find that the district court erred in permitting the defense of impracticability to go to the jury and that Wendt was entitled to a directed verdict on this issue as a matter of law.

III.

In its cross-appeal, IH asserts that the court improperly granted a directed verdict for Wendt on its other affirmative defenses. Specifically, IH objects to the court's grant of a directed verdict on IH's defense of frustration of purpose . . .

It is undisputed that Michigan law recognizes the defense of frustration of purpose. *See Molnar v. Molnar*, 110 Mich. App. 622, 625–26, 313 N.W.2d 171, 173 (1981) (allowing the defense of frustration of purpose in a suit to discontinue child support payments when the beneficiary child died). However, the district court in the instant case determined that the defense was unavailable. In making this determination, the court relied on section 265 of the Restatement (Second) of Contracts which provides:

Where, after a contract is made, a party's principal purpose is substantially frustrated without his fault by the occurrence of an event the non-occurrence of which was a basic assumption on which the contract was made, his remaining duties to render performance are discharged, unless the language or the circumstances indicate the contrary.

In interpreting this provision, the district court relied on the Supreme Court of South Dakota's analysis of this same defense when raised by IH in a suit by a dealer for breach of the same dealer agreement in *Groseth Int'l. v. Tenneco*, 410 N.W.2d 159 (S.D.1987).

In *Groseth*, the court found that under the Restatement (Second), the defense of frustration requires the establishment of three factors. The first is that the purpose frustrated by the supervening event must have been the "principal purpose" of the party making the contract. Quoting section 265, comment a, the court noted, "It is not enough that [the contracting party] had in mind a specific object without which he would not have made the contract. The object must be so completely the basis of the contract that, as both parties understand, without it the transaction would make little sense." The court interpreted this passage to require an inquiry into the principal purpose of the contract and a finding that the frustrating event destroys the primary basis of the contract.

According to the *Groseth* court, the second factor required under the Restatement is that the frustration be "substantial". Once again quoting comment a to section 265, the court stated: "It is not enough that the transaction has become less profitable for the affected party or even that he will sustain a loss. The frustration must be so severe that it is not fairly to be regarded as within the risks that he assumed under the contract." The court added, "[t]he fact that performance has become economically burdensome or unattractive is not sufficient to excuse performance."

Finally, according to *Groseth*, the third factor required to make out a defense of frustration under the Restatement is that the frustrating event must have been a "basic assumption" of

the contract. *See* Restatement (Second) of Contracts, section 265 comment a. In analyzing this element, comment a states that the analysis is the same as under the defense of impracticability.

Applying these three factors in the instant case, the district court found that the primary purpose of the Dealer Agreement was stated in section 1 of the agreement. Section 1 provides,

The general purposes of the agreement are to establish the dealer of goods covered by this agreement, and to govern the relations between the dealer and the company in promoting the sale of those goods and their purchase and sale by the dealer, and in providing warranty and other service for their users.

The court interpreted this language to mean that the primary purpose of the agreement was to establish the dealership and the terms of interaction and was not “mutual profitability” as asserted by IH. Therefore, the court reasoned that a dramatic down-turn in the farm equipment market resulting in reduced profitability did not frustrate the primary purpose of the agreement. The court went on to suggest that continuity of market conditions or the financial situation of the parties were not basic assumptions or implied conditions to the enforcement of a contract. Thus, following *Groseth*, it held that the doctrine of frustration was not applicable to this case.

IH does not offer any arguments which challenge the correctness of the *Groseth* decision or the district court’s analysis. Rather, IH challenges the court’s finding that the primary purpose of the contract was not “mutual profitability.” In our view, the district court had substantial grounds for so finding and we affirm the district court’s grant of a directed verdict for Wendt on the frustration defense. If IH’s argument were to be accepted, the “primary purpose” analysis under the Restatement would essentially be meaningless as “mutual profitability” would be implied as the primary purpose of every contract. Rather, like the doctrine of impracticability, the doctrine of frustration is an equitable doctrine which is meant to fairly apportion risks between the parties in light of unforeseen circumstances. It is essentially an implied term which is meant to apportion risk as the parties would have had the necessity occurred to them. In this case, the frustrating event was IH’s decision to sell its farm equipment assets and go out of that line of business. While IH might have determined that such a move was economically required, it may not then assert that its obligation under existing agreements are discharged in light of its decision. For these reasons, we affirm.

RYAN, Circuit Judge. (dissenting)

The court has held that the district court erred in submitting the defendants’ defense of impracticability of performance to the jury. I disagree.

. . . the Michigan Supreme Court, in all probability, “would,” if asked, adopt the doctrine of impracticability of performance as defined in Restatement (Second) of Contracts § 261. . . . In declaring that the Michigan Supreme Court would not apply the doctrine “in the circumstances of this case,” I take the court to mean the “facts” of this case. The court cannot mean that the impracticability doctrine can never be applied in a case involving unforeseeable, extreme, and unreasonable economic circumstances. There is simply no authority to be found in the Michigan cases, or indeed in the commentary to section 261 of the Restatement (Second) of Contracts, to suggest that no change in economic circumstances, no matter how catastrophic, would ever be sufficient to invoke the impracticability defense. Indeed, the majority opinion observes that the commentary to section 261 “provides extensive guidance for determining *when* economic circumstances are sufficient to render performance impracticable.” (Emphasis added.)

It appears that the majority opinion rejects the impracticability defense “in the circumstances of this case” because, in the court’s view, the economic reverses confronted by International Harvester were not so “extreme and unreasonable,” severe, or catastrophic as to excuse performance of the franchise agreement with the plaintiffs. Although claiming to recognize that whether impracticability of performance has been proved is a question of fact for the jury, the court appears to disagree with the jury that International Harvester was confronted with economic circumstances sufficiently disastrous to justify discharge for impracticability. There were “alternatives,” the court says, “which might have precluded unilateral termination of the contract.” . . .

Whether the “alternative” the court suggests ever occurred to International Harvester’s management, or, if considered, was a feasible business solution, is entirely irrelevant on this appeal because it is the jury, not this court, that is empowered to determine whether International Harvester proved impracticability of performance as that defense was defined by the trial court. . . .

The “event” International Harvester relies upon is a sudden, massive, near total collapse of the farm equipment industry that was nationwide, drove two major suppliers into bankruptcy, and resulted in losses to International Harvester of over \$2 billion in four years. . . .

When all facts and reasonable inferences therefrom are taken in a light most favorable to International Harvester, they reveal a sudden, unforeseen, nationwide collapse of the farm implement industry so severe and so widespread that International Harvester, after losing over \$2 billion in four years, was faced, in its business judgment, with no alternative but bankruptcy or selling off its farm implement division. Those are the facts as we must view them for

purposes of this appeal. The question for us, then, is whether “reasonable people could differ” that those facts amounted to “an event, the non-occurrence of which was a basic assumption on which the contract was made.” Manifestly, they could. The majority opinion is an indication of that.

Since there is nothing in the jurisprudence of the impracticability defense to suggest that a market collapse of the kind shown by International Harvester is not, as a matter of law, within the doctrine, we are not free to disturb the jury’s verdict.

Notes and Questions

1. *Taylor v Caldwell* was a case about performance that became impossible. As the Sixth Circuit in *Karl Wendt* noted, the doctrine scope is broader nowadays. The Restatement explains, “[a]lthough the rule stated in this Section is sometimes phrased in terms of ‘impossibility,’ it has long been recognized that it may operate to discharge a party’s duty even though the event has not made performance absolutely impossible. This Section, therefore, uses ‘impracticable,’ the term employed by UCC § 2-615(a), to describe the required extent of the impediment to performance.” Restatement (Second) of Contracts §261, cmt. d.
2. Section 261 of the Second Restatement, on which the *Karl Wendt* court heavily relied, requires the non-performing party to point to an event, not at the fault of that party, whose non-occurrence was a basic assumption on which the contract was made. Impracticability cases often come down to the question of whether the event that happened—a significant decline in the demand for farm equipment in the case of *Karl Went*—was indeed one whose non-occurrence was a basic assumption of the contract. While this principle might apply to any event, the Restatement lists “three categories of cases where this general principle has traditionally been applied”: the death or incapacity of a party, the destruction of an item necessary for performance (such as the music hall in *Taylor v. Caldwell*), and a new law that prohibits or impacts performance (not to be confused with laws that existed when the contract was formed, which might make the contract unenforceable due to public policy). Restatement (Second) of Contracts § 261, cmt. a.
3. The *Karl Wendt* decision nicely demonstrates that while impracticability and frustration of purpose are generally adopted, convincing a court to accept such an excuse for non-performance in a particular case is difficult and rare. What can explain this hostility? First and foremost, courts are concerned that generosity in granting excuses will

undermine the contract's allocation of risk. Indeed, excusing one party's performance often places the risk of the event's occurrence on the other side. For example, in *Taylor v Caldwell*, harm was caused because several events had to be canceled on short notice. Someone had to bear that harm: Caldwell, the property owner, Taylor, the concerts' organizer, or third parties (maybe the performers or the audience). The implication of excusing Caldwell is that Taylor and/or the third parties bore the risk of the fire. Is it reasonable to assume that this is how the parties meant to allocate the risk? That's not a trivial inquiry, and in many cases, it is not obvious that courts can easily resolve it.

Professor Richard Posner and Andres Rosenfield famously analyzed the excuses for non-performance and called on courts to use them to place the risk for the unexpected event, like a fire, on the party that can better bear the risk or that who can better insure against it. Richard A. Posner & Andrew M. Rosenfield, *Impossibility and Related Doctrines in Contract Law: An Economic Analysis*, 6 J. LEGAL STUD. 83 (1977) (calling courts to use the excuses for non-performance). Can you apply those considerations to the facts of *Taylor v Caldwell* or *Karl Wendt*?

A second reason why courts are hesitant to excuse non-performance is moral hazards. If a party knows that excusing performance is easy, it might not spend ideal efforts trying to prevent the occurrence of harmful events or mitigate the harm once such an event occurs. To what degree is such a concern relevant to the facts of *Taylor v Caldwell* or *Krell v Henry*? Can you locate traces of that rationale in the majority opinion in *Karl Wendt*?

The third reason that can explain the rarity of successful impracticability and frustration of purpose claims is a preference for certainty. Broader adoption of those doctrines might cause more parties to be less certain whether they (or the other party) must perform and might lead to more litigation.

4. As the *Karl Wendt* majority notes, it is well established that lack of profitability or losses are not excuses for non-performance, even if those losses result from broad market declines. Nevertheless, difficulties that are "well beyond the normal range" can give rise to an excuse for impracticability. Restatement (Second) of Contracts § 261, cmt. d. How do we know that the facts of *Karl Wendt* fall under the rule and not the exception ("beyond normal range")? Shouldn't that decision be left to the jury? As we will see, the Sixth Circuit's hesitancy to excuse performance because of market conditions, even extreme ones, is consistent with the approach of many courts.

Gap Inc. v. Ponte Gadea New York LLC
524 F.Supp.3d 224 (S.D.N.Y 2021)

SWAIN, Judge.

Plaintiff The Gap Inc. (“Gap”) brings this action, asserting claims for breach of contract, declaratory judgment, rescission, reformation, money had and received, and unjust enrichment against Defendant Ponte Gadea New York LLC (“Ponte Gadea”). Ponte Gadea asserts counterclaims for declaratory judgment and breach of contract. The parties’ claims arise out of a lease agreement for premises at the corner of 59th Street and Lexington Avenue in Manhattan, in which Gap has operated a retail business, and the impact of the COVID-19 pandemic, and Gap and governmental actions in response thereto. Gap contends, in essence, that its closure of the two stores operating on the premises in response to the pandemic, the governmental measures taken in response to the pandemic that restrict or condition store operations, and changes in the volume of foot traffic in the vicinity of the stores warrant Gap’s release from its obligations under the lease as of March 19, 2020. Ponte Gadea, pointing to provisions of the lease and Gap’s failure to vacate the premises, contends that it is entitled to continued payment of rent and to holdover rent for occupancy after Ponte Gadea gave notice of termination of the lease for non-payment. . . .

The parties have cross-moved for summary judgment . . .

BACKGROUND

Unless otherwise indicated, the following facts are undisputed. Gap operates a national retail network of stores specializing in fashion for men, women, and children. On February 18, 2005, Gap entered into a lease agreement with Ponte Gadea’s predecessor-in-interest for premises for the operation of two “first-class retail businesses,” a Banana Republic store and a Gap store, at 130 East 59th Street, New York, NY 10022. The term of the Lease extended to January 31, 2021, unless terminated or extended by the parties.

Four provisions of the Lease—section 1.7(H), Article 16, Article 21, and Article 25—are of particular relevance to the parties’ cross-motions. First, section 1.7(H) defines a “Force Majeure Event” to mean “a strike or other labor trouble, fire or other casualty, governmental preemption of priorities or other controls in connection with a national or other public emergency or shortages of fuel, supplies or labor resulting therefrom, or any other cause beyond Tenant’s reasonable control.”

Second, Article 16, titled “Casualty,” sets forth the parties’ restoration obligations, termination rights, and rent obligations in the event of a “fire or other casualty.” . . . Section 16.4 provides for a proportional abatement of Gap's rent obligations if, “as a result of a fire or other casualty, all or a portion of the Premises shall not be usable by Tenant” for a period of more than 14 days. . . . section 16.8 provides that Gap has “no right to cancel this Lease by virtue of a fire or other casualty except to the extent specifically set forth herein.”

Third, Article 21 governs defaults under the Lease. It defines an “Event of Default” as occurring when (among other circumstances not relevant here) Gap *fails to pay monthly rent when due* pursuant to section 1.6(A) (and fails to remedy that failure within five business days of notice from Ponte Gadea). It also defines an “Event of Default” as occurring when:

Tenant defaults in the observance or performance of *any other covenant* of this Lease on Tenant’s part to be observed or performed and Tenant fails to remedy such default within thirty (30) days after Landlord gives Tenant notice thereof, *except that if (i) such default cannot be remedied with reasonable diligence during such period of thirty (30) days (including by reason of the occurrence of a Force Majeure Event), (ii) Tenant takes reasonable steps during such period of thirty (30) days to commence Tenant’s remedying of such default, and (iii) Tenant prosecutes diligently Tenant’s remedying of such default to completion, then an Event of Default shall not occur by reason of such default[.]* (emphasis added).)

Section 21.1(F)’s reference to a Force Majeure Event is the Lease’s only use of that defined term. The occurrence of an Event of Default provides Ponte Gadea with a right to terminate the lease, in which event “Tenant immediately shall quit and surrender the Premises, but Tenant shall nonetheless remain liable for all of its obligations hereunder[.]”

Finally, Article 25 of the Lease, which governs the end of the Lease term, imposes a holdover rental payment liability for use and occupancy after the expiration or termination date of the Lease.

In December 2019 and the first quarter of 2020, a new coronavirus disease referred to as COVID-19 spread throughout the world, resulting in a global pandemic. Beginning in March 2020, the spread of COVID-19 caused significant disruptions in New York State and New York City. On March 7, 2020, the State declared a state of emergency and, on March 20, 2020, the State ordered non-essential businesses (including those operated by Gap in the leased premises) to reduce their in-person workforces by 100% no later than March 22, 2020, at 8:00 p.m., in order to reduce transmission of the virus.

Gap's response to the COVID-19 pandemic was also significant. On March 17, 2020, Gap "decided ... to close all its stores in the United States, Canada, and Mexico to protect the wellbeing of its employees and customers." In Gap's Form 8-K filing dated April 23, 2020, Gap disclosed that, in April 2020, it had "suspend[ed] rent payments under the leases" for all of its stores in North America. Consistent with that decision, Gap has not paid rent pursuant to the Lease since March 2020. On June 8, 2020, Ponte Gadea served Gap with a Notice of Termination, which stated that Gap's failure to pay rent, if not cured within five business days, would constitute an Event of Default under section 21.1 of the Lease, and that Ponte Gadea would have the right to terminate the Lease and to seek recovery of unpaid rent and other relief and remedies available under the Lease.

Also on June 8, 2020, New York City entered "phase one" of its reopening, allowing retail stores, including Gap, to offer curbside pick-up. On June 22, 2020, New York City entered "phase two" of its reopening, allowing retail stores, including Gap, to permit customers to shop indoors at no more than 50% capacity, subject to mandatory masking and social distancing requirements. Thereafter, Gap opened certain of its other retail locations in Manhattan to indoor shopping, but did not so open its stores at 59th and Lexington—though it did offer curbside pick-up at the Banana Republic store between June 12, 2020, and September 20, 2020, and at the Gap store between August 27, 2020, and September 20, 2020. Gap also continued to use the stores for online order fulfillment, and to store its merchandise. As of September 25, 2020, Gap's Senior Director of Real Estate, Jennifer Rondholz, attested that Gap was "currently on pace to vacate the Premises by October 15, 2020."

DISCUSSION

...Gap's Complaint in this action asserts six causes of action, each of which hinges on Gap establishing that the parties' Lease terminated in, or should be deemed to have been rescinded or reformed as of, March 2020, as a result of the COVID-19 pandemic and associated governmental restrictions, such that, from March 19, 2020, Gap had no rent payment liability under the Lease. ...

... Gap's failure to pay monthly rent after March 2020 is undisputed. Gap cross-moves for summary judgment in its own favor on its Complaint and Ponte Gadea's counterclaims, however, relying on five theories as to why the parties' Lease terminated (or should be deemed rescinded or reformed) as of March 2020. Gap argues that: (1) the COVID-19 pandemic constituted a "casualty" for purposes of section 16.4 of the Lease, entitling Gap to abatement of its rent obligations; (2) the pandemic frustrated the primary purpose of the Lease; (3) the

pandemic rendered performance under the Lease impossible, illegal, or impracticable; [other theories omitted].

Ponte Gadea's counterclaims rest on the propositions that: Gap is obligated under the Lease to make timely rent payments; it is undisputed that Gap has not done so; the sole force majeure provision of the Lease only prevents certain non-monetary defaults from triggering the landlord's right to terminate the lease; Ponte Gadea gave proper notice to cure the non-payment, and proper notice of termination, effective June 15, 2020; and Gap is liable for rent payments through the termination date and for holdover payments thereafter, in light of its failure to vacate the premises. Gap's six affirmative claims are largely in the nature of affirmative defenses to Ponte Gadea's claims of rights to payments in accordance with the Lease.

Because both parties' claims rise or fall on the resolution of Gap's [] theories as to why the parties' Lease terminated (or should be deemed rescinded or reformed) as of March 2020, the Court first addresses each separately below.

Casualty

Gap's first theory as to why it bears no liability for rental payments under the Lease after March 2020 is that the COVID-19 pandemic and its resulting lockdowns constituted a "casualty" within the meaning of Article 16 of the Lease that rendered the entire premises unusable such that Gap was entitled to an abatement of its rent payment obligations under Article 16.4 of the Lease.

The text and structure of Article 16, which refers in several instances to a "fire or other casualty" causing "damage" occurring "in" or "to" the "Premises," and describes in detail the restoration obligations of the parties in the event such damage occurs, leave no doubt that "casualty" refers to singular incidents, like fire, which have a physical impact in or to the premises—and does not encompass a pandemic, occurring over a period of time, outside the property, or the government lockdowns resulting from it. . . .

Frustration

Gap's second theory as to why the parties' Lease terminated in March 2020 is that the COVID-19 pandemic and resulting governmental restrictions frustrated the principal purpose of the Lease, which Gap characterizes as its operation of two first-class retail businesses on the premises.

“The doctrine of frustration of purpose discharges a party’s duties to perform under a contract where a ‘wholly unforeseeable event renders the contract valueless to one party.’” *Axginc Corp. v. Plaza Automall, Ltd.*, 759 F. App’x 26, 29 (2d Cir. 2018). . . . “In order to be invoked, the frustrated purpose must be so completely the basis of the contract that, as both parties understood, the transaction would have made little sense.” *In re Condado Plaza Acquisition LLC*, 620 B.R. 820, 839-40 (Bankr. S.D.N.Y. 2020). The event which allegedly frustrates performance must be both “virtually cataclysmic” and “wholly unforeseeable.” *Gander Mountain Co. v. Islip U-Slip LLC*, 923 F. Supp. 2d 351, 359 (N.D.N.Y. 2013). . . . “Examples of a lease’s purposes being declared frustrated have included situations where the tenant was unable to use the premises as a restaurant until a public sewer was completed, which took nearly three years after the lease was executed ... and where a tenant who entered into a lease of premises for office space could not occupy the premises because the certificate of occupancy allowed only residential use and the landlord refused to correct it.” *Ctr. for Specialty Care, Inc. v. CSC Acquisition I, LLC*, 185 A.D.3d 34, 42-43, 127 N.Y.S.3d 6 (2020). . . .

“It is not enough,” however, “that the transaction will be less profitable for an affected party or even that the party will sustain a loss.” *In re Condado Plaza Acquisition LLC*, 620 B.R. at 839-40. See also *Latipac Corp. v. BMH Realty LLC*, 93 A.D.3d 115, 123 n.4 (2012) (“Manifestly, the return of nine apartments to rent-stabilized status does not render impossible plaintiff’s contemplated use of the building; it simply reduces the profitability of that use to a certain extent.”); *Bierer v. Glazę, Inc.*, No. 05-CV-2459 (CPS), 2006 WL 2882569, at *7 (E.D.N.Y. Oct. 6, 2006) (“Under New York law, changes in market conditions or economic hardship do not excuse performance.”).

In this case, Gap has not framed a genuine issue of material fact in connection with its frustration defense. First, to the extent Gap contends that New York State’s blanket prohibition on non-essential business between March 22 and June 8, 2020, frustrated the purpose of the Lease, the possibility of just such a prohibition was referenced in the Lease itself, defeating any claim that the possibility was “wholly unforeseeable.” (Lease § 1.7(H) (defining a “Force Majeure Event” to mean “a strike or other labor trouble, fire or other casualty, *governmental preemption of priorities or other controls in connection with a national or other public emergency* or shortages of fuel, supplies or labor resulting therefrom, or any other cause beyond Tenant’s reasonable control.”) (emphasis added).)

Second, to the extent Gap contends that the pandemic itself frustrated the purpose of the Lease to operate a retail business, Gap has not shown that the purpose of the Lease (according to Gap, the operation of a “first-class retail business”) was “so completely” frustrated by the COVID-19 pandemic that “the transaction [makes] little sense.” Gap argues that, as a result

of the COVID-19 pandemic, “Gap was forced to shut down retail operations at the Premises to protect its customers and employees from an unforeseeable and highly contagious virus[.]” Gap also states that it entered into the Lease for the purpose of operating stores located “in the heart of what, until recently, was one of the busiest high end shopping districts in Midtown Manhattan”, with extensive foot traffic that has diminished substantially in light of COVID-19. Gap claims that “without the ability to operate the Premises as a retail store, ‘the transaction would have made little sense.’”

Gap does not dispute, however, that it in fact operated the stores at issue here for periods of time since the onset of the pandemic, offering customers curbside pick-up, or that it opened other retail locations in Manhattan to in-person shopping, during the pandemic. Instead, Gap maintains that it has since stopped offering even curbside pick-up at the stores on the premises, and that its other stores, at which it has offered in-person shopping notwithstanding the capacity and hygiene restrictions imposed as a result of the pandemic, are “in other parts of the City, with different demographics, under different leases, with different landlord-tenant relationships[.]” Gap makes no proffers regarding any relevant differences in the terms of its leases for the other premises, and it points to no covenant in the Lease in which Ponte Gadea made any guarantee regarding foot traffic or the nature or demographic characteristics of the area of the Lexington Avenue store premises.

While undeniably unfortunate, the COVID-19 pandemic has not amounted to a frustration of the Lease’s purpose of Gap operating a retail business at the Premises. Instead, the evidence suggests that Gap has made a business decision to close its stores at 59th and Lexington, perhaps due to the pandemic’s greater financial impact on those stores than on its other stores (*see* [Gap’s motion]) (“[F]oot traffic on Lexington Avenue never recovered ... the precipitous decline in foot traffic and office workers destroyed the entire economic justification for the consideration demanded and paid for the premises and monthly rent.”), while it continues to operate its retail businesses at other locations in Manhattan that are also subject to the health and safety risks of the COVID-19 pandemic.⁸ The possibility that the stores at issue in this case may suffer particularly adverse financial consequences from the COVID-19 pandemic does not amount to frustration of the purpose of the Lease. *1140 Broadway LLC*, 2020 WL 7137817, at *2 (“Here, the lease was for office space in a building and the tenant’s business was devastated by a pandemic. That does not fit into the narrow doctrine of frustration of

⁸ The Court recognizes Gap’s health concerns about its employees and customers. However, the undisputed evidence presented establishes that Gap has operated other retail locations, including in Manhattan, on an in-person basis, notwithstanding these concerns.

purpose.”) (granting summary judgment on frustration defense in favor of landlord); *35 East 75th Street Corp. v. Christian Louboutin L.L.C.*, No. 154883/2020, 2020 WL 7315470, at *2 (N.Y. Co. Sup. Ct. Dec. 9, 2020) (“Contrary to defendant’s argument, [the frustration] doctrine has no applicability here. This is not a case where the retail space defendant leased no longer exists, nor is it even prohibited from selling its products. Instead, defendant’s business model of attracting street traffic is no longer profitable because there are dramatically fewer people walking around due to the pandemic.”) (granting summary judgment on frustration defense in favor of landlord); *Dr. Smood*, 2020 WL 6526996, at *2 (rejecting tenant’s argument that the purpose of its lease had been frustrated where the tenant had “been operating out of the demised premises,” providing “both counter service and pickup of orders submitted online,” since “at least July, 2020,” while asserting it had no obligation to pay rent); *Greater New York Auto. Dealers Ass’n, Inc. v. City Spec, LLC*, 70 Misc. 3d 1209(A), 136 N.Y.S.3d 695, 2020 WL 8173082, at *9 (N.Y. Civ. Ct. 2020) (“[E]ven if Respondent were forced by the Executive Order to close in-person operations at the Premises, a four-month closure out of a five-year lease did not frustrate the overall purpose of the Lease.”). *See also Cai Rail, Inc., v. Badger Mining Corp.*, No. 20-CV-4644 (JPC), 2021 WL 705880, at *9 (S.D.N.Y. Feb. 22, 2021) (“At most, Badger has shown that the contract has become unprofitable and ‘more onerous,’ which does not excuse performance under New York law.”); *In re CEC Entertainment, Inc.*, 625 B.R. 344, 351 (Bankr. S.D. Tex. 2020) (concluding that the debtor, which operated a nationwide chain of Chuck E. Cheese venues, could not rely on the COVID-19 pandemic to avoid its obligations to pay rent to six lessors in three states, in part because “the purpose of each lease is not entirely frustrated”). *But see Intern. Plaza Associates L.P. v. Amorepacific US, Inc.*, No. 155158/2020, 2020 WL 7416600, at *2 (N.Y. Co. Sup. Ct. Dec. 14, 2020) (denying summary judgment for landlord based on a tenant’s failure to pay commercial rent during COVID-19 pandemic because court found issues of fact regarding foreseeability).

The Court therefore concludes that Ponte Gadea is entitled as a matter of law to summary judgment dismissing Gap’s claims to the extent they rest on the proposition that Gap’s Lease obligations terminated because the purpose of the Lease was frustrated.

Impossibility

Gap’s third theory as to why the parties’ Lease terminated in March 2020 is that the COVID-19 pandemic and resulting governmental restrictions rendered the parties’ performance of the Lease impossible or impracticable.

“[U]nder New York law, impossibility (which is treated synonymously with impracticability) is a defense to a breach of contract action ‘only when ... performance [is rendered] objectively

impossible ... by an unanticipated event that could not have been foreseen or guarded against in the contract.” *Accord RW Holdings, LLC v. Mayer*, 17 N.Y.S.3d 171 (2015) (“a party seeking to rescind a contract [on impossibility grounds] must show that the intervening act was unforeseeable, even if the intervening act consisted of the actions of a governmental entity or the passage of new legislation”). “The [New York] Court of Appeals explained that a defense to contract performance such as impossibility should be applied narrowly and only in extreme circumstances ‘due in part to judicial recognition that the purpose of contract law is to allocate risks.’” *Sher v. Allstate Ins. Co.*, 947 F. Supp. 2d 370, 383 (S.D.N.Y. 2013) (quoting *Kel Kim*, 70 N.Y.2d at 902, 524 N.Y.S.2d 384, 519 N.E.2d 295); *accord Ebert v. Holiday Inn*, No. 11-CV-4102 (ER), 2014 WL 349640, at *7 (S.D.N.Y. Jan. 31, 2014) (“Case law is clear that impossibility excuses a party’s performance ‘under very limited and narrowly defined circumstances.’”) (citation omitted), *aff’d*, 628 F. App’x 21 (2d Cir. 2015). “Economic hardship, even to the extent of bankruptcy or insolvency, does not excuse performance” under the doctrine of impossibility.

Gap’s impossibility defense fails because the very text of the Lease demonstrates that the conditions that Gap claims render performance impossible were foreseeable. To the extent Gap relies on the government’s prohibition and limitations of physical retail business as a result of the pandemic, the inclusion and limited application of the Force Majeure Event definition of the Lease demonstrate that the parties foresaw, and apportioned the risk associated with, the possibility that government measures in the event of a public emergency could affect performance under the Lease. Furthermore, to the extent Gap relies on the COVID-19 pandemic itself as the basis of impossibility or frustration of purpose, Gap’s contentions are insufficient to raise a genuine issue of material fact because the undisputed evidence shows that Gap in fact operated a retail business at the stores at issue in this case by way of curbside pick-up, and operated other retail locations on an in-person basis, during the pandemic. The fact that its continued performance may be burdensome, “even to the extent of insolvency or bankruptcy,” does not render Gap’s performance objectively impossible under New York law. *Accord 35 East 75th Street Corp.*, 2020 WL 7315470, at *3 (“The subject matter of the contract—the physical location of the retail store—is still intact. And defendant is permitted to sell its products. The issue is that it cannot sell enough to pay the rent. That does not implicate the impossibility doctrine.”); *1140 Broadway LLC*, 2020 WL 7137817, at *2 (same); *Atlantic Garage Management LLC v. Boerum Commercial LLC*, No. 512250/2020, 2020 WL 7350542, at *2 (N.Y. Co. Sup. Ct. Dec. 2, 2020) (rejecting parking garage tenant’s theory that COVID-19 restrictions made it “impossible ... to perform under the terms of the lease,” in light of the general rule that “[i]mpossibility occasioned by financial hardship does not excuse performance of a contract”) (citation omitted); *Cai Rail, Inc.*, 2021 WL 705880, at *10

(rejecting impossibility defense premised on the effects of the COVID-19 pandemic, even where the parties' contract became "dramatically" unprofitable to one party).

The Court therefore concludes that Ponte Gadea is entitled as a matter of law to summary judgment dismissing Gap's claims to the extent they rest on the proposition that Gap's Lease obligations terminated due to impossibility of performance.

[The court rejects Gap's other arguments as to why the agreement was terminated in March 2020]

Because Gap has not proffered any facts framing a genuine dispute as to the existence of any basis for termination, rescission, or reformation of the Lease, the Court concludes that Ponte Gadea is entitled as a matter of law to summary judgment dismissing Gap's claims based on the Lease's termination in March 2020, rescission, or reformation. Because all of Gap's claims . . . turn on Gap's unsupported and legally flawed assertion that it had no obligations to make payments under the Lease after March 19, 2020, Ponte Gadea is entitled as a matter of law to summary judgment dismissing Gap's Complaint in its entirety.

For the reasons set forth above, Ponte Gadea is also entitled to summary judgment as to liability on its first and second counterclaims. In that connection, the Court finds and declares, based on the undisputed facts of record, that the Lease was terminated by Ponte Gadea effective June 15, 2020, and that Ponte Gadea is entitled pursuant to section 25.2 of the Lease to payment for holdover occupancy from that date. [The court provide instructions concerning the next stage of this litigation which will set Ponte Gadea's damages].

Notes and Questions

1. Impracticability and frustration of purpose are default rules and constructive conditions that courts imply unless the parties state otherwise. It is common, especially in commercial transactions, for the parties to contract around those doctrines and specify their own arrangements in case of a catastrophic event. Those provisions are most often called *force majeure provisions*. In another COVID-19 era litigation between a landlord and commercial tenant, the agreement included the following force majeure provision:

If either party is delayed, hindered or prevented from the performance of an obligation because of strikes . . . restrictive governmental laws or regulations . . . or another reason not the fault of or beyond the reasonable control of the party delayed (collectively, "Force Majeure"),

then performance of the act shall be excused for the period of the delay; provided, however, the foregoing shall not: (A) relieve Tenant from the obligation to pay Rent . . .

Not surprisingly, the court rejected the tenant's request to be excused from paying rent, noting:

We dismiss the amended counterclaims because the force majeure clause of the lease prohibits the requested relief. In Pennsylvania, parties have broad discretion to allocate risks between them in a contract. Only where there has been no contractual allocation of a risk should a court determine the allocation based on common law theories, such as impossibility and frustration of purpose.

1600 Walnut Corporation v. Cole Haan Company Store, 530 F.Supp.3d 555 (E.D. Pa. 2021).

2. Carefully read the force majeure provision in *Gap* and its use in the contract. Note that the contract in question did not explicitly state whether an event defined as force majeure will exempt rent payment. Nevertheless, the court held that once an event falls under such a provision, it is not “wholly unforeseeable,” which means that the common law excuses for non-performance are inapplicable.

Foreseeability is a tricky concept in this context. While courts sometimes consider foreseeability as part of their analysis, it's important to remember that most events are foreseeable to some degree. *Taylor v Caldwell* was not the first instance in which a fire prevented performance, nor *Krell v Henry* the first time that illness postponed an event. Those possibilities were foreseeable on some level, and yet, in both cases, courts found the performance excused.

The UCC does not mention foreseeability as a factor in its section on excuses to non-performance, UCC § 2-615, but the official comments note that it applies when “performance has become commercially impracticable because of *unforeseen supervening circumstances not within the contemplation of the parties* at the time of contracting.” UCC § 2-615, *cmt. 1* (emphasis added). The Restatement, on the other hand, suggests that “[t]he fact that the event was foreseeable, or even foreseen, does not necessarily compel a conclusion that its non-occurrence was not a basic assumption.” Restatement (Second) of Contract § 261, *cmt. a*.

The real question, we think, is often not whether the parties knew that a catastrophic event is possible, but whether a reference in the contract to the possibility of such an event, even in general terms, implies that the parties assumed the risk in that event happening. That question focuses on the assumption of risk and not just foreseeability. As the Restatement notes, “[e]ven absent an express agreement, a court may decide, after considering all the circumstances, that a party impliedly assumed such a greater obligation.” Restatement (Second) of Contract § 261, *cmt. c*. Can you apply this approach to the facts of *Gap*?

3. Courts often use a form of *inclusio unius* to hold that by expressly listing the parties’ rights in case of an undesirable event, the contract implies that other consequences of such an event, including the common law excuses, are excluded. For example, in one case, the contract stated that a developer could terminate the contract if he could not secure mortgage financing *after* submitting final development plans. While working on the plans, the developer learned that he would not be able to secure financing. The Connecticut Supreme Court held that if the contract provides an excuse for a certain event (here, failing to secure financing) under certain circumstances (here, *after* the plans are finalized), that event cannot excuse non-performance under different circumstances (for example, *before* the plans were finalized). *Dills v. Town of Enfield*, 210 Conn. 705 (1989).
4. One of the reasons that the court rejected Gap’s frustration of purpose claim was that after a short period of time it was able to use the space for other purposes, such as fulfilling online orders. Going back to *Krell v. Henry*, how is that different from Henry’s ability to use Krell’s balcony even after the procession and the coronation of King Edward VI were delayed?
5. Do you think the result would have been different if Gap had not been a chain but a single store operating at 59th Street and Lexington Avenue in Manhattan?
6. The court in *Karl Wendt*, as well as the Restatement, note that typically, the lack of profitability and losses, even significant losses, do not make performance impractical, but those “well beyond the normal range” do. Isn’t the COVID-19 pandemic and its economic impact “well beyond the normal range”?

Regardless of your (or our) views on this question, the *Gap* court’s approach (and the many other COVID-era opinions it quotes) is the dominant one. The COVID-19 pandemic has sparked many contractual disputes. Many of those disputes are still

making their way through our judicial system. With that important caveat in mind, the trend is clear so far. Unless the contract itself provides otherwise, courts are rarely going to excuse businesses from performing their contractual obligations (and, in particular, the duty to pay rent) due to the hardship of the pandemic. As a federal court recently noted:

Many New York courts assessing commercial lease disputes amidst the COVID-19 pandemic have held that the temporary and evolving restrictions on a commercial tenant's business do not warrant rescission or other relief based on the frustration-of-purpose doctrine.

Ruradan Corp. v. City of New York, No. 22-CV-3074 (LJL), 2024 WL 2882185, at *9 (S.D.N.Y. June 6, 2024) (internal citations omitted).

7. Excuse cases typically require courts to adopt an all-or-nothing approach. Either the performance to pay rent is excused, which means that the tenant bears none of the risk, or it is not excused, which means that the tenant bears all of it. Wouldn't it make more sense to split the baby and adopt a rule that would divide the harm between the parties?