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Defenses of Impossibility of Performance and Frustration of Purpose

Thomas J. Hall, *New York Law Journal*

Parties in complex commercial cases that are accused of defaulting on or breaching a contract may invoke the defense of impossibility, arguing that performance of contractual obligations was rendered impossible by an intervening event. Under New York law, those arguments rarely make it past the motion stage. Courts apply the doctrine narrowly, only to executory contracts and only where the intervening event was both unforeseeable and destroyed either the contract's subject matter or the means of performance.

The related doctrine of frustration of purpose may apply more broadly, but only where it would make little sense to perform on a contract because of an intervening event. The narrowness of these doctrines—and their questionable utility for litigators—underscores the importance of striving during the contract drafting process to include contingency clauses providing for foreseeable possibilities and language making clear the contract's purpose.

Court of Appeals Precedent

The leading New York case on the impossibility doctrine is Kel Kim Corp. v. Central Markets, 70 N.Y.2d 900 (1987). In that case, plaintiff Kel Kim defaulted on a lease for a roller-skating rink it operated when it was unable to maintain adequate insurance coverage, as required by the lease, due to the liability insurance crisis affecting the United States in the mid-1980s. Kel Kim sued for a declaratory judgment, declaring that it should be excused from the obligation because performance had been rendered impossible.

The trial court granted summary judgment against Kel Kim, and the Appellate Division affirmed. The Court of Appeals then affirmed, agreeing that the impossibility doctrine did not excuse Kel Kim's nonperformance. The court reasoned that the doctrine is "applied narrowly, due in part to judicial recognition that the purpose of contract law is to allocate the risks that might affect performance and that performance should be excused only in extreme circumstances." The doctrine applies "only when the destruction of the subject matter of the contract or the means of performance makes performance objectively impossible," and it did not apply as to Kel Kim because its "inability to procure and maintain requisite coverage could have been foreseen and guarded against when it specifically undertook that obligation in the lease."

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Commercial Division Treatment

After Kel Kim, courts have looked to a number of factors in applying the impossibility doctrine, including "the foreseeability of the event occurring, the fault of the nonperforming party in causing or not providing protection against the event occurring, the severity of harm, and other circumstances affecting the just allocation of the risk." D & A Structural Contractors v. Unger, 25 Misc.3d 1211(A) (Nassau Co. 2009).

The Commercial Division has applied these factors narrowly. In Urban Archaeology v. 207 East 57th Street, 34 Misc.3d 1222(A) (N.Y. Co. 2009), Justice O. Peter Sherwood of the New York County Commercial Division rejected an argument that the doctrine should apply in the case of a severe economic crisis. In that case, a Manhattan commercial tenant brought a claim for declaratory judgment, arguing that its performance under a lease was impossible because of the nationwide economic crisis in 2009. The tenant supported its argument by citing an out-of-state federal court decision embracing a similar argument and an economist's analysis opining that the "'economic tsunami'" sweeping the country was "'unforeseeable as to its occurrence'" or its "'extent and length.'" The court rejected this argument and dismissed the tenant's claim, reasoning that the tenant, a sophisticated commercial party, could have anticipated financial disadvantage, even if not its "precise cause or extent." The court observed that allowing the doctrine to apply because of the crisis would allow "'every debtor in a country suffering economic distress [to] avoid its debts."

In another case, Justice Eileen Bransten of the New York County Commercial Division ruled that the doctrine applies only to executory contracts. In KBS Preferred Holding I v. Petra Fund REIT, Nos. 601384/09, 601836/09 (N.Y. Co. May 3, 2010), defendants argued at the summary judgment stage that their repayment under a financing agreement was rendered impossible by the economic crisis. The court rejected this argument, relying in part on University of Minnesota v. Agbo, 176 Misc.2d 95, 96 (2d Dep't 1998), where the court stated that impossibility "only excuses the performance of an executory contract"—a reasonable restriction, considering that the doctrine applies only where the contract's subject matter or means of performance is destroyed. Justice Bransten held that the doctrine did not apply as to the KBS debtors, "highly sophisticated commercial entities who received the benefit of their bargain," reasoning that to hold otherwise "would be to unjustly enrich [the debtors] at [the creditor's] expense."

The decision of Justice Leonard Livote of the Queens County Commercial Division in Leisure Time Travel v. Villa Roma Resort & Conference Center, 55 Misc.3d 780, 52 N.Y.S.3d 621 (Queens Co. 2017), is one of the rare cases where an impossibility defense has survived motion practice. In Leisure Time, a travel resort's facility in the Catskills was destroyed by fire, and it was unable to host a travel company that had a multi-year contract to rent the space. The resort rebuilt the facility but refused to resume renting it to the travel company, and the travel company sued for breach. On a motion for summary judgment the resort argued that performance was excused by impossibility even though it had rebuilt the facility, and Justice Livote agreed. The court observed that although the doctrine does not apply to a "temporary supervening impossibility of brief duration," the facility was unavailable for an extended period of two years. The court reasoned that if the travel company had chosen not to return to the resort after that time, it would have been unfair to force it to. As a result there was no longer a mutuality of obligation, and the resort's non-performance was excused.

Most recently, in Itau Unibanco S.A. v. Schahin, 2017 N.Y. Slip Op. 31636(U) (N.Y. Co. Aug. 4, 2017), Justice Barry R. Ostrager of the New York County Commercial Division rejected at the summary judgment stage an argument that the doctrine should excuse non-performance resulting from a ruling of a foreign court. In Itau Unibanco, two residents of Brazil were sued by a lender for failing to pay a debt they had guaranteed. The guarantors argued that payment was impossible because a Brazilian tax court had issued an order freezing their assets, and Judge Ostrager disagreed. Quoting Kel Kim, he reasoned that impossibility could be based only on an "unanticipated event that could not have been foreseen or guarded against in the contract"—a standard not met by the tax court's freeze.

Impossibility and Specific Performance

Impossibility may apply more broadly as a defense to a claim for specific performance, even where the intervening event was caused by a defendant. This is shown by a decision of Justice Barbara R. Kapnick, of the New York County Commercial Division, in Fillmore West Fund, L.P. v. JP Morgan Chase Bank, N.A., 41 Misc. 3d 1216(A) (N.Y. Co. 2013). Fillmore West Fund concerned a settlement agreement in the bankruptcy reorganization of a business that operated Las Vegas casinos. The agreement provided that certain mezzanine lenders would have an option to acquire an equity interest in the reorganized entity from creditor JP Morgan Chase Bank, N.A., which owned the rights. After the reorganization, however, JP Morgan sold the rights not to the

lenders but to the reorganized entity's founders. Two of the lenders then sued JP Morgan and a second bank for specific performance of the option provision.

The banks argued that performance was impossible because JP Morgan no longer owned the shares at issue—and the second bank had never owned them—and Justice Kapnick agreed. She reasoned that "specific performance may be properly denied as impossible where the defendant lacks title or control over the underlying property," and that this rule applied "'even where defendant's inability to perform is caused by his own wrongful act'" (citations omitted). The court observed that the plaintiffs were conceivably entitled to money damages, but such a claim was inapplicable because the plaintiffs had suffered no such damages.

Frustration of Purpose

Related to the impossibility doctrine is the defense of frustration of purpose, which "applies when the frustrated purpose is so completely the basis of the contract that, as both parties understood, without it, the transaction would have made little sense." D & A, 25 Misc. 3d 1211(A) at *6 (citing Crown IT Servs. v. Olsen, 11 A.D.3d 263, 265 (1st Dept. 2004)). Otherwise, frustration of purpose is applied based on the same factors discussed above for impossibility, including "the foreseeability of the event occurring."

In D & A, a decision by Justice Timothy Driscoll of the Nassau County Commercial Division, the defendant, an Oyster Bay homeowner hired a contractor to renovate her home, which had been damaged by fire and which she owned jointly with a husband whom she was divorcing. The homeowner's agreement with the contractor provided that work would be done according to a payment schedule that would be provided upon settlement of an insurance claim, and the insurer's pending payment was assigned under another contract to the contractor's affiliate. Payment was prevented, however, when the Matrimonial Court in the homeowner's divorce proceeding issued a restraining order barring the homeowner from transferring her assets. The contractor ceased work and sued the homeowner for breach.

The homeowner invoked frustration of purpose as a defense, and Justice Driscoll agreed. The court found on a motion for summary judgment that usage of the insurance payment for restoration costs "was the basis upon which [the parties] contracted" and that this purpose was frustrated by the restraining order—which the contractor effectively conceded when it ceasing work on the project after the order was issued. The court ordered, however, that claims for quantum meruit could proceed to trial to enable the plaintiffs to recoup moneys spent and prevent the homeowner from receiving a windfall.

Conclusion

The decisions above make clear that the impossibility doctrine is narrow, applying only to executory contracts where (1) the subject matter of the contract or the means of performance is destroyed, and (2) the event causing that destruction was unforeseeable. The doctrine of frustration of purpose may be more promising, provided that a party can show that a condition was so essential to a contract that in its absence the "transaction would have made little sense."

The narrowness of these doctrines underscores the need for counsel negotiating and drafting contracts to include contingency clauses providing for foreseeable possibilities—which are outside the scope of the impossibility doctrine—and language making clear the contract's purpose. As the Court of Appeals indicated in Kel Kim, courts will be wary of parties' attempts to invoke common law defense to protect themselves against events that "could have been foreseen and guarded against" in the contract.

Thomas J. Hall is a *partner* with *Norton Rose Fulbright US* and is co-head of its New York Disputes practice. *Senior associate John P. Figura* assisted in the preparation of this article .

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