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CONTRACTS-DOCTRINE OF "COMMERCIAL FRUSTRATION" AS APPLIED TO LEASES OF REAL PROPERTY

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COMMENTS

CONTRACTS—DOCTRINE OF “COMMERCIAL FRUSTRATION” AS APPLIED TO LEASES OF REAL PROPERTY—A mushroom crop of litigation has sprung up as a result of wartime governmental restrictions on production and consumption of civilian goods, particularly with respect to regulations of the sale of gasoline, tires, automobiles, and automobile accessories. Numerous problems have confronted the courts involving leases of property for the purpose of selling or servicing motor vehicles, where the lessee has sought to be released from his covenant to pay rent by invoking the so-called doctrine of “commercial frustration.”

The early English common law¹ did not recognize even impossi-

¹ The old English common-law rule set forth by Chancellor Kent was to the effect “that upon an express contract to pay rent, the loss of the premises by fire, or inundation, or external violence, will not exempt the party from his obligation to pay the rent.” 3 KENT’S COMMENTARIES, 14th ed., 466 (1896). But Chancellor Walworth has pointed out that this is contrary to most of the legal systems of the world and it would seem to be obsolete today. At least the exceptions have become so important as to, in effect, replace the rule.

bility as an excuse for failure to perform a promise; the theory being that the parties could have provided against any and all contingencies by contract and, if they did not do so, the court refused to remake their bargain for them. This was the hard and fast rule laid down in *Paradine v. Jane*.² Logically the stand taken was sound, but as a practical matter it is a virtual impossibility to guard contractually against every situation which may arise to interfere with the performance of promises.

Gradually the courts of both England and America have come to graft certain exceptions onto the rule of *Paradine v. Jane*. If subsequent unforeseen events make the terms of a contract impossible of fulfillment, without any fault on the part of the promisor, the court may excuse him from performance.³ The most commonly accepted bases, given by Williston,⁴ are impossibility by operation of law, failure of the specific subject matter with reference to which the bargain was made, incapacity of the individual in contracts where the services of a particular person are the essence of the agreement, and perhaps also where the contemplated mode of performance fails.

Beyond the doctrine of absolute impossibility of performance the courts have recognized the situation where unforeseen events may operate to defeat the purpose for which the contract was entered into, as in the well-known *Coronation* cases⁵ where places were rented at rather large fees to prospective spectators along the route which King Edward VII was to pass upon the way to his coronation. The procession did not take place as scheduled, however, because His Majesty was taken ill, and the ceremonies had to be postponed. Among the many legal problems raised by this turn of events was the question of whether the persons who had engaged rooms along the coronation way could be made to pay the agreed sums, even though the places they rented had now become valueless to them. The would-be spectators could not logically claim impossibility of performance or a failure of consideration. The landowners stood ready and willing to carry out their part of the bargain and allow the promisors to use the rooms upon the appointed day; and certainly nothing legally prevented the defendants from paying

² Aleyn 26, 82 Eng. Rep. 897 (1647).

³ Perhaps the exceptions can be summarized in a general rule:

Where it appears that the parties contracted with reference to the continued existence of a set of conditions, performance will be excused if the conditions change so as to make the performance impossible or to defeat the purpose for which the contract was made. In the last analysis whether or not an excuse will be accepted should depend, it would seem, upon the answer to the inquiry: If the parties had thought about such an occurrence would the promisor have been expected to bear the risk of loss? If so, regardless of the subsequent impossibility of performance, he should not be released from liability on the contract.

⁴ 6 CONTRACTS, rev. ed., § 1935, p. 5418 (1936).

⁵ E.g., *Krell v. Henry*, [1903] 2 K. B. 740.

the sums they had agreed upon. Still the Court of King's Bench, feeling the harshness of enforcing such a bargain, devised the theory that the promisors should be released from their agreement because the whole purpose for which these contracts were entered into had been to witness the coronation procession and this was defeated by the illness of the King and the postponement of the event.

"Frustration of venture"⁶ has since become a recognized excuse for non-performance of a contract. It is subject, however, to the same qualifications as the other exceptions to *Paradine v. Jane*. It must be a risk that the parties would not have expected the defendant to assume if they had considered the matter in advance. And apparently also, the frustration must be full and complete. It is not enough that the deal is rendered unprofitable by the subsequent change of circumstances.

Evidently upon this basis the New Mexico Supreme Court in a recent case, *Wood v. Bartolino*,⁷ held that the doctrine of "commercial frustration" did not apply to release the lessees of a filling station from their covenant to pay rent.

Appellees had leased a building from appellant for an automobile service station, for a term of five years beginning June 1, 1939. The premises were so used until February 1, 1942 when the appellees, finding the business to be operating at an increasing loss, ceased its operation and offered to restore possession of the building to the lessor, seeking to avoid liability for rents due for the remainder of the term upon the ground that the purpose for which the lease was made had been "frustrated" by the Federal Government's wartime rationing of tires and gasoline.⁸

⁶ Where the value of the performance has been destroyed by a supervening event, this has been termed "frustration of the venture" or the doctrine of "commercial frustration." The precise theory behind the doctrine of frustration of purpose is hazy. Failure of consideration has been suggested, but it will not explain cases like *Krell v. Henry*, [1903] 2 K. B. 740, cited supra note 5, where, as Edwin Patterson pointed out, "although the owner of the rooms advertised them as suitable for viewing the coronation procession, he did not promise that the coronation would take place as scheduled, and he could perform his express obligation (to let the promisor use the rooms on certain days) without the occurrence of the coronation." Patterson, "Constructive Conditions in Contracts," 42 COL. L. REV. 903 at 951 (1942).

⁷ (N. M. 1944) 146 P. (2d) 883, the principal case discussed and hereinafter referred to as the "principal case."

⁸ Werner W. Schroeder in "The Impact of War on Private Contracts," 42 MICH. L. REV. 603 at 610 (1944), puts the contractual impediments that come in the wake of war in three categories; (1) where a governmental order or event of war has made the contract physically impossible of performance; (2) where the governmental order does not prevent or prohibit the carrying out of the contract but makes it performable only at a loss; (3) where the governmental order "does not directly affect the contract but impairs the use to which the parties can put the fruits of the contract. Under this classification are leases of business property made for specific purposes."

By the terms of the lease the premises were demised "for use solely as a filling station."⁹ The court found that "the parties, at the time the lease contract was entered into, did not contemplate, and could not reasonably have contemplated, that such laws, rules and regulations would be enacted, promulgated or enforced, or that they would materially and substantially change the conditions of the business operated in the leased premises."¹⁰ Yet the court held that the tenant was not excused from the obligations of the lease. "The appellant may enforce the covenant to pay her rent . . . relief lies only in the conscience of the landlord."¹¹

Wood v. Bartolino is hardly a case of impossibility of performance due to operation of law, for nothing made it illegal to pay the rent.

A complication arises in the *Bartolino* case which was not present in the *Coronation* cases and others dealing with simple contracts.¹² A lease of real property is involved here. Many courts have been reluctant to apply the doctrine of "commercial frustration" to a lease of real property. "A contract may be frustrated but a lease is more than a contract, it is a conveyance of an interest in land or a chattel real."¹³ The covenants in a lease are deemed independent and are not the consideration for one another. Thus the general rule is that the liability to pay rent remains unless the premises are utterly destroyed. When the lessee gets the term he receives what he bargained for and the mere fact that he cannot put the property to its anticipated use is no fault of the landlord and is considered no excuse for the tenant's breach of covenant.¹⁴

The New Mexico court, however, while mentioning the reasoning of the early English law, seemed to prefer to base its conclusion upon the ground that the purpose of the lease had not been fully frustrated, and therefore, even as a simple contract, performance on the part of

⁹ Principal case at 884. In the absence of restrictive provisions as to the use of the premises, the tenant cannot claim release on the ground of "frustration of purpose." *Mitchell v. Ceazen Tires*, (Cal. App. 1944) 146 P. (2d) 49.

¹⁰ Principal case at 885.

¹¹ *Id.* at 890.

¹² *Krell v. Henry* was a license, not a lease.

¹³ *Leightons Investment Trust Ltd. v. Cricklewood Prop. and Investment Trust Ltd.*, (K. B. 1942) 167 L. T. Rep. 348.

¹⁴ But, as is pointed out in 17 S. CAL. L. REV. 173 (1944), "the modern lessee is primarily interested in the building which he leases rather than the land on which it stands," and when it is leased for a specific use and no other and that use is prevented by unforeseeable subsequent events, it would seem that a strong case is made out for relief from the burden of rent for the lessee. The landlord may in many instances re-rent the premises for another purpose. But it seems unfair to hold the lessee to a use he cannot maintain. Thus there has been a tendency to treat leases as bilateral contracts and subject to the doctrine of impossibility of performance and frustration of the purpose for which the bargain was made.

the lessee would not be excused. The contract or lease was rendered less profitable by the advent of governmental regulations, but this in itself cannot be a basis for relief.¹⁵

The court said,¹⁶ "If this rule [commercial frustration] should be applied to leases, then it should be limited to those cases where the law or rules, regulations and orders have made illegal or prohibited absolutely the conducting of the business contemplated by the parties." Continuing, the court said:

"There are no Federal regulations prohibiting the sale of gasoline, oil, tires, tubes and other merchandise ordinarily sold at filling stations, though the enforcement of such regulations has drastically reduced the appellees' income . . . , nor has any Federal law, rule or regulation deprived appellees of the use of the premises as a filling station."

A contrary conclusion was reached in a recent California case, *Lloyd v. Murphy*,¹⁷ in which the court so interpreted the doctrine of "commercial frustration" as to excuse the lessee if the "governmental statute, decree or regulation deprives the tenant of the beneficial use of the property—that is—prevents him from using it for the primary and principal purpose for which it was rented,"¹⁸ whereas the test applied in the *Bartolimo* case was whether "the law or rules, regulations and orders have made illegal or prohibited absolutely the conducting of the business contemplated by the parties."¹⁹

Lloyd v. Murphy was cited in the principal case but its reasoning was rejected as a minority view.

Likewise *Brown v. Oshiro*²⁰ indicated that a lessee of Japanese ancestry would be excused from the obligations of his lease when war orders transferred all Japanese on the coast to inland camps, so that defendant's hotel business in the Japanese section of Los Angeles was seriously affected.

A number of recent New York decisions, however, accord with the

¹⁵ Patterson says in 42 Col. L. Rev. 903 at 953 (1942): "Yet the practice of making promises will lose much of its effectiveness in an economic order of co-operation and exchange if promises are to be performed, only when it suits the promisor's convenience. A promise which imposes no risk-taking on the promisor is no promise at all: either it is illusory ('I will if I want to') or it is a prediction of an event which is practically certain to occur (that the sun will rise tomorrow)."

¹⁶ Principal case at 890.

¹⁷ (Cal. Ct. App. 1943) 142 P. (2d) 939. The premises were leased for an automobile salesroom. The sale of new cars constituted ninety percent of defendant's business. The court found that federal governmental restrictions on the sale of new cars so defeated the purpose for which the lease was made that the tenant should be released from his bargain.

¹⁸ Id. at 942-943.

¹⁹ Principal case at 890.

²⁰ 58 Cal. App. (2d) 190, 136 P. (2d) 29 (1943).

rule of the principal case and in a large measure provide the basis for the New Mexico court's decision.

That court relied heavily on *Colonial Operating Corporation v. Hannan Sales and Service, Inc.*²¹ in its decision. The fact situation in the *Colonial Operating* case was strikingly parallel to the above-mentioned California case of *Lloyd v. Murphy*. The lease restricted the use of the premises to the sale of automobiles. It was not, however, limited to new cars alone, the appellate division decided. The court said, "As far as second-hand automobiles were concerned, the defendant could have sold the same in the demised premises without let or hindrance from the government." The court continued:

"... It is clear, also, that nothing in the lease prevented the tenant from selling new automobiles to those within the exceptions... enumerated. Therefore it must be said as a matter of law that the primary purpose of the lease as to use was not frustrated, and... that the tenant was not relieved from continuing the use and occupation of the premises and from paying rent reserved in the lease."²²

Colonial Operating Corp. v. Hannan Sales and Service, Inc. seems to have become a leading case on frustration as applied to leases, and not only the New York decisions²³ but those of other states quote the opinion in *Colonial Operating Co.* in their holdings.²⁴

²¹ 265 App. Div. 411, 39 N.Y.S. (2d) 217 (1943).

²² *Id.*, 39 N.Y.S. (2d) 217 at 220. *Schantz v. American Auto Supply*, 78 Misc. 909, 36 N.Y.S. (2d) 747 (1942) may perhaps be distinguished on its facts from *Colonial Operating Corp. v. Hannan Sales and Service, Inc.*, and the instant case, but its principle would seem not quite in harmony with the other New York cases of the *Colonial Operating* line. (The *Schantz* case was decided, however, before the appellate court rendered its decision in the *Colonial Operating* case.) The premises were leased "for the sale of tires, radios, washing machines, and refrigerators." The court held the lessee released from his covenant to pay rent by virtue of governmental orders restricting the manufacture and sale of these articles. The court observed, "The restriction by the landlord of the use of these stores for the purposes stated creates a special equity in favor of the tenant. If the tenant were to be held to its covenant to pay the rent, then the premises must remain idle because they can be utilized for no other purpose by the tenant without violating the lease. On the other hand, if the lease is cancelled, they can be used by the landlord for any lawful purpose." *Id.*, 36 N.Y.S. (2d) at 752. But there may be equities on the side of the lessor as well. In *Byrnes v. Balcom*, 265 App. Div. 268, 38 N.Y.S. (2d) 801 (1942), the owner had remodeled the premises to make them suitable for an auto showroom. If the lessee is released from his obligation, it may well be that the owner will have to stand the loss. He may not be able to find another tenant at the same rental.

²³ *Port Chester Central Corp. v. Leibert*, 179 Misc. 839, 39 N.Y.S. (2d) 41 (1943); *Knorr v. Jack and Al, Inc.*, 179 Misc. 603, 38 N.Y.S. (2d) 406 (1942).

²⁴ *Wood v. Bartolino*, (N. M. 1944) 146 P. (2d) 883, the principal case; *Deibler v. Bernard Bros.*, 319 Ill. App. 504, 48 N.E. (2d) 422 (1943), involving a lease for "automobile showroom and garage." Tenant not released, citing *Colonial Operating Corp. v. Hannan Sales and Service*, 265 App. Div. 411 (1943).

Though the conclusion thus reached may be harsh in many instances, it would seem to be the general rule.²⁵ The lease contract was rendered less profitable by the advent of governmental regulations but if this can be a basis for relief then it may be argued that all unprofitable contracts could be terminated in a like manner. Just where the line should be drawn between partial and complete frustration (assuming the courts treat leases as ordinary contracts for this purpose) is a knotty problem which remains unsolved. How complete must the frustration be?²⁶ The New York courts and those which follow its line of decisions seem to insist upon a showing that all use is cut off, while California has been more lenient and permitted the tenant to get out from under the burdens of his lease if he could show that the regulations cut down his volume of business materially. Perhaps a line might be drawn whereby the lessee would be released if he could show that his income from the premises, due to governmental restrictions, has gone below the amount of the rent?

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²⁵ As a decision note in 42 COL. L. REV. 1058 (1942) suggests, one of the criteria of frustration is whether the purpose of the contract is completely or only partially defeated. Two recent cases, *Canrock Realty v. Vim Electric Co.*, 37 N.Y.S. (2d) 139 (1942) and *Byrnes v. Balcom*, 38 N.Y.S. (2d) 801 (1942) seem to sum up the stand of the New York courts which was the view adopted by the New Mexico court in the Bartolino case.

"If the tenant is deprived by the governmental regulations of the beneficial use of the property, that is, prevents him from using it for the primary and principal purpose for which it was rendered, the lease is terminated, although other incidental uses might still be made of it." *Canrock Realty Corp v. Vim Electric Co.*, 37 N.Y.S. (2d) 139 at 141 (1942).

"A change in the law during the term of a lease, however, which merely restricts but does not wholly prohibit the conduct of the business carried on, does not release the tenant from his obligation to pay rent." *Byrnes v. Balcom*, 38 N.Y.S. (2d) 801 at 803 (1942).

In *Canrock Realty Corp. v. Vim Electric Co.*, 37 N.Y.S. (2d) 139 at 140 (1942), the lease provided: "Tenant shall use and occupy the demised premises as a retail store for the sale of radios, radio apparatus, . . . musical instruments, phonographs and records, electrical supplies and appliances, washing machines, refrigerators, toys, cameras, oil burners, gas stoves, electric ranges, sporting goods, . . . sports apparel of every kind, nature and description, and for no other purposes." Termination of the lease was refused because the premises were still usable for some of the purposes contemplated in the lease. There were no restrictions on the sale and manufacture of sporting goods.

²⁶ "That the governmental acts make performance unprofitable or more difficult or expensive does not constitute a frustration of the contract." Schroeder, "The Impact of the War on Private Contracts," 42 MICH. L. REV. 603 at 607 (1944). "Such a principle [commercial frustration] if given the proverbial inch, may form the basis of a panacea for any promisor who has made even a suggestion of a bad bargain. Although the results should aim at preserving justice and avoiding undue hardship, still this should not be done without due regard to the fundamentals of the law of contracts." John Wood, 16 UNIV. CINN. L. REV. 339 at 345 (1942).