Frustration of Purpose – Do I Have a Defense?

Article By
Angela Reid
Whitney Jones Roy
Sheppard, Mullin, Richter & Hampton LLP
Corporate & Securities Law Blog

- Coronavirus News
- Corporate & Business Organizations
- All Federal

Tuesday, March 17, 2020

The COVID-19 (“coronavirus”) public health crisis has caused unprecedented business disruptions and uncertainty for existing contractual obligations. While many are focused on whether a force majeure clause will be triggered by the recent events, contracting parties should also consider the doctrine of “Frustration of Purpose.” Under California law, the frustration of purpose doctrine may be invoked where:

1. Performance remains possible;
2. but the fundamental reason of both parties for entering into the contract has been frustrated by an unanticipated supervening circumstance; and
3. it destroys substantially the value of performance by the party standing on the contract.[1]

However, to excuse nonperformance of a contract on the ground of commercial frustration, the frustration must be so severe or substantial that it is not fairly to be regarded as within the risks that were assumed under the contract.[2]

What is the Purpose of the Contract?

The frustration of purpose defense requires that the main contractual purpose that is allegedly destroyed by the supervening event be actually recognized by both parties to the contract. According to the Restatement 2d. of Contracts “the object [of the contract] must be so completely the basis of the contract that, as both parties

[2] Id. § 261(2).
understand, without it the transaction would make little sense.’”

For example, in a case involving a real estate agreement, a court rejected a sellers’ frustration of purpose argument and held that the sellers remained bound to sell their house to the buyer even though a subsequently passed federal law prevented the sellers from constructing the new home they anticipated on building after the sale of their old home.[3] The court reasoned that the “object” of the contract was the sale and purchase of the old home, and there was no frustration of this particular object because the construction of the new home was merely an event that would determine the time of contractual performance.

Was the Intervening Event Foreseeable?

Foreseeability of the intervening event is another key factor considered by courts. In other words, if the allegedly frustrating event was within the control of the promisor, then the party seeking relief must bear the loss unless he or she can prove that the frustrating event was not reasonably foreseeable.[4] For example, in Gold v. Salem Lutheran Home Ass’n of Bay Cities, 53 Cal. 2d 289 (1959), the estate of an elderly man sought to recoup some upfront payments made in furtherance of a housing contract because, the 84-year-old man suffered a stroke and died the day after the contract was signed and executed. However, the court found that the executors of his estate were not entitled to recover any money under the frustration of purpose theory because the frustrating event—death—was reasonably foreseeable, particularly in light of the man’s advanced age.[5] A converse result was reached in Johnson v. Atkins, 53 Cal. App. 2d 430 (1942), involving a contract for goods shipped from the U.S. to Colombia. There, the court excused a buyer’s obligations under the commercial frustration doctrine when the Colombian authorities cancelled permission for the goods to enter the country after the buyer had paid for several shipments in advance.

Important Considerations

Courts have a basic reticence towards discharging parties from their contractual obligations, reflecting the general policy that parties should be held to what they agree to under a contract. Out of fairness to all contractual parties, courts are hesitant to disrupt or destroy “contract equilibrium.” Therefore, the frustration of purpose doctrine should be viewed as a narrow equitable doctrine reserved for situations of extreme hardship. The defense may not be applicable in situations where the transaction has simply become less profitable or less advantageous for one party. Businesses should carefully examine their agreements, determine the exact timing of when parties decided/engaged in discussions to enter into the agreement, and assess whether the contract already contains a force majeure clause that addresses unforeseen events.

FOOTNOTES


Copyright © 2020, Sheppard Mullin Richter & Hampton LLP.

Source URL: https://www.natlawreview.com/article/frustration-purpose-do-i-have-defense