nyrej

Know the risks before terminating contracts when repurposing real estate developments - by Virginia Trunkes

December 15, 2020 - Design / Build

Pacta sunt servanda, i.e., agreements must be kept. This applies in both good economies and bad.

Companies considering a modification of their business operations to offset lower revenue must be mindful of existing commercial contracts. Implicit in almost every New York agreement is a covenant of good faith and fair dealing in the course of performance. Output and requirements contracts are an exception, however. With an output contract, the parties agree that the seller will sell all the goods or services it may produce to a buyer in exchange for the buyer's agreement to purchase them. A requirements contract obligates the buyer to purchase what it needs or requires from a seller in exchange for the seller's promise to supply the buyer.

Where an agreement is neither an output nor a requirements contract, then both parties have continuing obligations throughout the term. The defenses of "impossibility" and "frustration of purpose" excuse performance in only the rarest of circumstances. What may seem like an obvious obstacle may not meet the threshold. A company that fails to understand the nature of its agreement or is unfamiliar with the applicable case law is exposed to significant monetary penalties. As a leading New York case has made clear, this counts for real estate development and hotel contracts as well.

In 407 E. 61st Garage, Inc. v. Savoy Fifth Ave. Corp., 23 N.Y.2d 275 (1968), the defendant property owner (Owner) operated a hotel, the "Savoy Hilton", and contracted with the on-site garage (Garage) to park the hotel guests' cars. For a five-year term, Owner agreed "to use all reasonable efforts to enable [Garage] to have, throughout the term of this agreement, the exclusive right and privilege of storing the motor vehicles of [the hotel's] guests, tenants and patrons." In turn, Garage was to pay Savoy 10% of its gross parking charges, to have adequate supplies on hand, to obtain all necessary insurance and permits, to conform to applicable regulations of Owner, and to have its employees act in such a manner as to "promote the best interests" of Owner.

Two years later, "due to substantial financial losses," Owner ceased operating the hotel. Owner sold 50% of its capital stock to General Motors, demolished the hotel building and erected an office building on the site.

The agreement with Garage had not explicitly addressed Owner's obligations to Garage in the event

it ceased operating the hotel. The only termination clause pertained to the event of Garage's default in its obligations. Owner terminated the agreement and did not compensate Garage.

Garage sued Owner for damages, claiming that Owner breached the agreement when it attempted to terminate it. The trial court found that the agreement was a "requirements contract" and granted summary judgment in favor of the hotel, dismissing the complaint. The Appellate Division affirmed based on the trial court's reasoning.

The Court of Appeals, New York's highest court, reversed, reinstated the complaint, and remanded the matter for trial. The Court held that "by ceasing operation of its hotel, [Owner] is not excused, as a matter of law, from obligations under its agreement with the garage, and that there is, at least, an issue of fact as to implied conditions in the agreement."

The Court reasoned that the agreement was not a "requirements" contract. Rather, it was more like a license or franchise agreement that Owner granted to Garage, with Garage's services to be rendered not to the hotel but to third parties, i.e., the guests of the hotel. The benefit to Garage was it would "gain a preferred position" in obtaining the hotel guests as customers for its services, and meanwhile the hotel would be assured that its guests would obtain "adequate garage services when and if they desired them, thus making their stay at the hotel more convenient and desirable." The Court emphasized that unlike a requirements contract, a license agreement implicitly includes the covenant of good faith including a promise to remain in operation. A lack of a reason for remaining in business itself "does not nullify the liability for damages" to contracting parties.

Owner emphasized "the incongruity of an enterprise, as large as a metropolitan hotel, being obligated to 'continue in the hotel business' merely because of various relatively minor incidental service contracts…" The Court agreed that it would not have made sense for Owner to stay in the hotel business solely to avoid liability for breach of its agreement with Garage. Yet, the agreement lacked any contractual term on this point. Because of the resultant ambiguity in the agreement's interpretation, the Court invited the Owner to adduce at trial evidence of a custom or usage in the industry to regard incidental service contracts for a period terminable on the hotel's going out of business.

Additional comments made by the Court provide some tips to any business considering its contractual obligations in the context of a changed financial position.

From the outset, Owner "could and should have insisted that the agreement provide for the anticipated contingency of economic hardship" and include a conditional termination: an express provision that the agreement would terminate upon specified notice to Garage or would terminate if the hotel should cease operations.

Owner did "not even assert that bankruptcy or insolvency was a likely consequence of continuing operation of the hotel," i.e., consider whether a corporate debt structuring is an option.

Proof of a decline in the hotel's patronage, "although perhaps not justifying termination of the

garage’s contract right, may have a significant bearing on the measure of damages sustained by the garage through loss of future profits.”

Thus, unless the agreement restricts the obligation to the company’s output or requirements, or contains other context-specific qualifiers or a conditional termination, contract liability may be strict liability. It is crucial to incorporate into property-repurposing decisions the review of contract terms and, if necessary, the cost of contract-breach damages.

Virginia Trunkes is counsel at Robinson+Cole, New York, N.Y.