

Clients & Friends Memo

COVID-19 Update: Can't Lose What You Never Had: Court Rejects All Legal Theories Asserted by Retail Tenant

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The United States District Court for the Southern District of New York (the "Court") decided in *Gap Inc. v. Ponte Gadea N.Y. LLC* on March 8, 2021, that a retail tenant will not be able to use the COVID-19 pandemic as an excuse for not making rent payments under multiple legal theories.

This case is one of many cases now before New York courts in the aftermath of New York's decision to shut down non-essential businesses during the rise of the COVID-19 pandemic. The Gap Inc. (the "GAP") commenced the action against its landlord, Ponte Gadea New York LLC ("Ponte") claiming, among other things, breach of contract and unjust enrichment, and seeking a declaratory judgment, rescission and/or reformation of the lease. The case arose from a lease agreement for the premises located at the corner of 59th Street and Lexington Avenue in Manhattan. The GAP claims that as a result of the COVID-19 pandemic and the shutdown of retail business in New York City that followed the rise of COVID-19, including two stores operated by the GAP at 130 East 59th Street, New York, New York (the "Leased Premises"), the GAP should be released from its obligations to make rent payments under the lease. Ponte counter-claimed that the GAP is liable for payment of holdover rent as a result of its failure to vacate the premises after Ponte gave notice to the GAP that the lease had been terminated for non-payment of rent.

Background

The GAP entered into a lease agreement with Ponte's predecessor-in-interest for the Leased Premises in which it would operate a Banana Republic store and a Gap store (the "Lease"). The term of the Lease was extended until January 31, 2021, unless terminated or extended by the parties. In December of 2019 the COVID-19 virus began to spread worldwide causing major disruptions in New York State and New York City. On March 7, 2020, New York State declared a state of emergency, and on March 20, 2020, non-essential businesses were ordered to reduce their in-person staff by 100% in an effort to contain the spread of the virus, including the two stores operated by the GAP in the Leased Premises. Further, in response to the COVID-19 pandemic, the GAP decided to close all of its stores in the United States and Mexico. The GAP also decided, as disclosed in its Form 8-K filing dated April 23, 2020, that it would suspend rent payments under

its leases for all of its stores in North America. In accordance with that decision, the GAP did not make any rent payments under the Lease after March of 2020.

On June 8, 2020, Ponte served the GAP with a Notice of Termination for failure to make rent payments and provided the GAP with a five (5)-business day cure period before it exercised its rights to terminate the Lease and pursue an action against the GAP to recover the unpaid rent and other relief and remedies (the "Termination Notice"). Also on June 8, 2020, New York commenced its "phase one" reopening, which permitted retail stores to offer curbside pick-up. On June 12, the GAP began to offer curbside pick-up at its Banana Republic store at the Leased Premises. On June 22, 2020, New York commenced its "phase two" reopening, which permitted retail stores to allow customers to shop indoors at 50% capacity, subject to social distancing and mandatory masking. The GAP thereafter opened some of its stores in Manhattan, but it did not open its stores at the Leased Premises. However, the GAP did continue to offer curbside pick-up at the Banana Republic store at the Leased Premises until September 20, 2020 and offered curbside pick-up at the Gap store at the Leased Premises from August 27, 2020 to September 20, 2020. During this time, the GAP used the stores to fulfill online orders and to store merchandise. As of September 20, 2020, the GAP's senior director had stated that it was on track to vacate the Leased Premises by October 15, 2020.

Complaint

The GAP's complaint asserted, through six causes of action, that the Lease terminated (or should have been deemed terminated) as of March 19, 2020 due to the COVID-19 pandemic and the ensuing governmental restrictions on retail businesses and therefore the GAP had no rent payment obligations under the Lease as of that date. In its first cause of action, the GAP asserted that Ponte breached the Lease by demanding rent payments after March of 2020 and by continuing to treat the Lease as valid. In its second cause of action, the GAP sought a declaratory judgment that the Lease was terminated, rescinded or reformed as of March 2020 and that the parties had no liability under the Lease thereafter. In its third cause of action, the GAP sought to rescind the Lease, "as a result of the frustration of purpose of the Lease, the illegality, impossibility and impracticability of the Lease, and/or the failure of consideration." In its fourth cause of action, the GAP sought to reform the Lease, "to reflect the Parties' true intent that Tenant would have no obligation to pay rent once it was deprived of the use of the Premises," or, that "the amount of rent for the Term would have otherwise been adjusted to account for the portion of the Lease's term during which Tenant could not operate a retail store in the Premises." In its fifth and sixth causes of action, the GAP asserted claims for unjust enrichment and sought to recover money for rent and other consideration paid to Ponte during the period of time that it was not able to operate its businesses at the Leased Premises.

Counterclaim

In response, Ponte filed for summary judgment asserting three counterclaims. In its first counterclaim, Ponte sought a declaratory judgment stating (i) that the GAP's failure to make rent payments for April and May of 2020 was an "Event of Default" under the Lease; (ii) that the Lease terminated on June 15, 2020 pursuant to the Termination Notice; (iii) that the GAP thereafter became a holdover tenant by failing to vacate the Leased Premises, entitling Ponte to holdover rent payments; and (iv) that the GAP must therefore immediately vacate the Leased Premises. In its second counterclaim, Ponte asserted that the GAP breached the Lease by failing to make rent payments, by failing to surrender the Leased Premises after the termination of the Lease on June 15, 2020 pursuant to the Termination Notice, and by failing to pay holdover rent. In its third counterclaim, Ponte asserted that if the Court were to decide that the Lease was indeed terminated as a result of a "casualty" pursuant to the Lease, the GAP still breached the Lease by failing to vacate the premises and pay holdover rent.

Thereafter, the GAP filed its own summary judgment motion on its complaint and Ponte's counterclaims. In its motion for summary judgment, the GAP argued (i) that the COVID-19 pandemic constituted a "casualty" under the terms of the Lease; (ii) that as a result of the COVID-19 pandemic, the primary purpose of the lease was "frustrated"; (iii) that performance under the Lease during the pandemic was "impossible, illegal or impracticable"; (iv) that there was a failure of consideration under the Lease; and (v) that the failure to address the possibility of a future pandemic in negotiating the terms of the Lease was a mutual mistake by the parties.

The Court addressed the GAP's five claims as follows:

Casualty: In describing a "casualty", the Court noted that the text of the Lease refers to a "fire and other casualty" that results in damage to the premises. The Lease also includes the manner in which the premises must be restored after such casualty. The Court read the text of the Lease as intending to cover only single incidents causing damage to the premises for which the tenant had the right to abate rent while the premises were being restored, which abatement period ended "on the date that Landlord Substantially Completes the restoration work". The Court also relied on recent Supreme Court decisions concluding that the COVID-19 pandemic is not a "casualty" under commercial leases (i.e., *1140 Broadway LLC v. Bold Food, LLC* and *Dr. Smooth New York LLC v. Orchard Houston, LLC*). The Court ultimately found that the language in the Lease clearly did not intend for a pandemic or the resulting governmental shutdown to constitute a "casualty" under the Lease and granted Ponte's counterclaim dismissing the GAP's claim for breach of contract as to the right to an abatement of rent due to a casualty.

Frustration: The Court concluded that the COVID-19 pandemic and the ensuing governmental shutdown of non-essential businesses did not amount to a frustration of the purpose of the Lease (i.e., the GAP's operation of a retail store). Instead, the Court noted that closing its retail operation

at the Leased Premises was a business decision made by the GAP, possibly due to a greater financial impact on those particular stores, while it chose to continue to operate its other retail stores in Manhattan. The Court stated that the possibility of an adverse financial impact on the retail stores operated at the Leased Premises did not constitute frustration of purpose under the Lease and granted Ponte's counterclaim dismissing the GAP's claim based on the theory that the Lease was terminated because the purpose of the Lease was frustrated.

Impossibility: When addressing the GAP's claim regarding impossibility of performance under the Lease, the Court noted that, under New York law, a defense of impossibility can only succeed if "performance is rendered objectively impossible...by an unanticipated event that could not have been foreseen or guarded against in the contract" (citing *Axginc Corp. v. Plaza Automall, Ltd.*). The Court found that the text of the Lease is proof that the conditions for which the GAP claims impossibility of performance (i.e., the government's limitation of retail store businesses during the rise of the pandemic) was foreseeable. The Court reasoned that the use of the defined term "Force Majeure"¹ in the Lease is evidence that the parties foresaw that governmental measures in response to a public emergency could affect the parties performance under the Lease. In addition, the Court noted that the GAP's claim of impossibility due to the COVID-19 pandemic is insufficient to raise an issue of material fact as the GAP did continue to operate its retail stores at the Leased Premises to offer curbside pick-up and continued to operate its other retail stores in Manhattan during the pandemic. Therefore, the Court concluded that the GAP's impossibility defense failed and granted Ponte's counterclaim dismissing the GAP's claim based on the theory of impossibility of performance under the Lease.

Failure of Consideration: When addressing the GAP's claim regarding failure of consideration under the Lease, the Court noted that the GAP has continued to occupy the Leased Premises and thus has continued to receive consideration under the Lease (i.e., the lease of the Leased Premises for the retail operation of its stores) during the COVID-19 pandemic. Specifically, the GAP continued to remain in possession of the Leased Premises and to use the Leased Premises to store its merchandise and offer curbside pick-up. In addition, the GAP had the right, since June of 2020, to reinstate in-person shopping if it wished to do so. The Court also noted that even if the GAP could prove a "partial failure of consideration" due to the COVID-19 pandemic, partial failure of consideration would not serve as a basis for rescission (citing *CAB Bedford LLC v. Equinox Bedford Ave, Inc.*). Therefore, the Court granted Ponte's counterclaim dismissing the GAP's claim based on the theory of failure of consideration under the Lease.

Mutual Mistake: The GAP's last theory was that the parties made a mutual mistake in negotiating the Lease as both parties failed to address the possibility of a pandemic affecting performance

¹ Force Majeure was defined in the Lease 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."

under the Lease, thus the Lease should be reformed. The GAP argued in its motion for summary judgment that the parties made a mutual mistake by not properly defining the term “first class retail business” in the Lease, which the GAP maintains should have excluded the operation of the business during a pandemic, specifically the use of “Plexiglass barriers and face masks”. The GAP asserted, through employee affidavits, that had that definition been specific to include these measures, the GAP would have never entered into the Lease. The Court concluded that the GAP failed to provide any facts to show that a mutual mistake existed at the time that the parties entered into the Lease. Further, the Court concluded that the parties’ failure to predict a pandemic when they negotiated the Lease did not amount to a mistake entitling the GAP to a rescission of the Lease. Finally, the Court noted that the GAP’s assertion that it would have negotiated different terms had it contemplated a future pandemic was not sufficient to overcome the presumption “that the plain language of the Lease” captured the intent of the parties. As a result, the Court granted Ponte’s motion for summary judgment, dismissing the GAP’s claim based on the theory of rescission and reformation as well as the GAP’s claim for unjust enrichment, money had and received, and breach of contract.

In addition to the above, the Court granted Ponte’s motion for summary judgment as to the GAP’s liability under the Lease. The Court agreed with Ponte that the Lease had in fact terminated on June 15, 2020 and that Ponte was entitled to holdover rent payments from the GAP. The GAP’s cross-motion for summary judgment was denied in its entirety.

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If you have any questions, please feel free to contact either of the following Cadwalader attorneys.

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