

## **Confidential and Privileged Attorney-Client Communication**

To: Mary J. Novak  
From: 427653168  
Date: November 12, 1998  
Re: Parlay Contract with Thayser & Associates: Excuse of Contract Performance by the Doctrine of Frustration of Purpose.

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### **Facts**

For the purposes of this memorandum, the following facts are assumed to be true. Parlay, a venture capital firm, entered into a contract with Thayser & Associates (“T&A”)<sup>1</sup> in July 1995 (the “Contract”) regarding the design and development of a battery for zero-emission vehicles (“ZEVs”). Because of subsequent changes in law and innovations in ZEV technology that could significantly diminish the expected return value of this agreement, Sally Tanner, a partner at Parlay, wants to determine if Parlay can get out of its contract with T&A.

In June 1995, the California Air Resources Board (“ARB”) amended its regulations to require automobile manufacturers to produce and deliver ZEVs as a small percentage of each manufacturer’s total production of light-duty vehicles (passenger cars and small trucks) for sale in California by the model year 2000. After learning of this amendment, Tanner, looking for a “change of pace” from investing in the computer industry, identified ZEVs as her next potential market for investment and had Parlay’s team conduct research to develop a market plan. Tanner determined that if Parlay could provide resources to T&A, Thayser could develop the state-of-the-art battery for ZEVs, which Parlay could then market to automobile manufacturers who would likely pay significantly for that technology. At the time, only lead-acid technology, still in development stages, existed for ZEV batteries. Tanner got approval from her partners for her

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<sup>1</sup> Dr. Paul Thayser, a Ph.D. and former fellow from the Massachusetts Institute of Technology (“MIT”) and, in 1994, the country’s leading expert on lead-acid batteries for ZEVs, founded T&A in 1994 in order to continue his work in private industry.

plan and approached Thayser. During her discussions with Thayser, Tanner talked about the “expanding market” for ZEVs in general, as well as the market created by the ARB’s regulation. In July 1995, Parlay drafted the Contract, which Thayser then read and signed for T&A.

Under the terms of the Contract, Parlay would pay T&A \$100,000 per month to develop, as fast as possible and on a strictly confidential basis, the first pilot lead-acid battery for use in ZEVs. T&A would work exclusively for Parlay to develop and improve this battery for ten years. Parlay would have the responsibility to market and sell the design to the automobile manufacturers. The Contract includes the following provision (“Purpose”):

Purpose: The purpose of this contract is for the design and development of the first pilot lead-acid battery for use in the ZEVs required by Cal. Code Regs. tit. 13, § 1960.1(g)(2) and for improvements to the design over the 10-year life of this contract. To meet the year 2000 date in that regulation, the pilot lead-acid battery is to be ready for unveiling to the auto manufacturers by January 1999.

The parties operated under the Contract until May 1998, when the ARB, after the seven largest auto manufacturers initiated significant lobbying efforts in late 1997 and over significant objection from the ZEV-related business community, repealed Cal. Code Regs. tit. 13, § 1960.1(g)(2) (“Regulation”). In a statement regarding the repeal, the ARB expressed full confidence “that the ZEV market is developing sufficiently and that the market no longer needs [the Regulation]” but also mentioned that certain ZEV-related businesses could fail. The ARB further emphasized its authority to “amend its requirements to meet changed circumstances.”

The ARB’s repeal prompted Tanner to call Thayser to terminate the Contract. Although Thayser responded that he had almost finished developing the pilot battery and that Tanner should not overreact, Tanner refused to discuss the matter further. Counsel for Thayser responded by requesting mediation of the dispute. A few days later, as Parlay prepared to respond to the mediation request, Tanner’s staff provided market research to show that the ZEV

market still provided tremendous opportunities despite the ARB's repeal of the Regulation. On June 2, 1998, Tanner called Thayser and told him to "continue working under the [C]ontract because the market for ZEVs is there, even though the ARB's regulation is not." T&A then resumed work and Parlay resumed payments until August 1998, when Tanner discovered that a new technology had emerged called "advanced battery" which vastly overshadowed the possible performance of a lead-acid battery. One battery developer even announced that his company would release a pilot advanced battery by December 1998. Tanner instructed her staff to withhold the August payment to T&A until research could confirm the existence of the new battery technology. In September 1998, after confirming the research, Tanner called Thayser to terminate the Contract, whereupon Thayser offered to take less money per month under the Contract and to conduct research in the area of advanced batteries. Tanner refused this offer.

This memo deals specifically with the issue of whether supervening events sufficiently frustrated the Contract to excuse Parlay from performance under the doctrine of frustration of purpose. A previous memo determined that courts would likely find Tanner's June 2, 1998 statements and Parlay's subsequent payments to T&A in June and July inadmissible for purposes of interpreting the Contract under the principle of "practical construction." This inadmissibility presumably extends to Parlay's and T&A's subsequent negotiations, including the September 1998 conversation between Tanner and Thayser. However, another memo determined that the courts would admit the conversations between Tanner and Thayser at or prior to the time of the signing of the Contract under the parol evidence rules for purposes of interpreting the Contract.

### **Question Presented**

Can Parlay successfully invoke the doctrine of frustration of purpose as an excuse from performing its obligations under the Contract?

### **Short Answer**

Parlay has a strong argument for the courts to excuse performance under the Contract by the doctrine of frustration of purpose. When performance under a contract remains possible but a supervening event has caused a failure of consideration, courts will apply frustration of purpose to excuse a party from performance if they find the event unforeseeable and counterperformance nearly or totally valueless. The courts must first find that neither party could reasonably foresee the ARB's repeal of the Regulation or the emergence of advanced battery technology. The courts will then determine the fundamental purpose of the Contract before finally concluding whether the unforeseeable supervening events nearly or totally destroyed that purpose.

Given commonly known facts, and knowledge common to others in the ZEV industry, the courts will determine that the parties could not reasonably foresee the ARB's repeal and the emergence of advanced battery technology. Because the courts will interpret the Purpose neither too broadly nor too narrowly, they will find that the purpose encompasses the design and development of a lead-acid battery for the ZEV market minimally defined by the Regulation. While the ARB's repeal may not substantially frustrate the Contract, the evidence suggests that the emergence of the advanced battery will nearly or totally destroy the value of the Contract. Therefore, the doctrine of frustration of purpose will excuse Parlay from performance.

### **Discussion**

Pending further research<sup>2</sup>, the courts will likely excuse Parlay's performance under the Contract by the doctrine of frustration of purpose. Under California common law, the courts will apply frustration of purpose when "[p]erformance [under the contract] remains possible but the

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<sup>2</sup> To properly analyze the remaining value of the Contract to Parlay, we will need to find out the price of the advanced battery and whether advanced batteries will truly far-exceed the performance of lead-acid batteries. For the purposes of this memo, we will assume that the advanced battery costs about the same as the lead-acid battery and performs as advertised.

expected value . . . has been destroyed by a fortuitous [or frustrating] event, which supervenes to cause an actual but not literal failure of consideration.” Lloyd v. Murphy, 25 Cal. 2d 48, 54, 153 P.2d 47, 50 (1944). To excuse a promisor from performance, the promisor must “prove [1] that the risk of the frustrating event was not reasonably foreseeable [or controllable by the promisor] and [2] that the value of counterperformance is totally or nearly totally destroyed . . . .” Id. In order to proceed with this analysis, we must determine what events the courts could construe as frustrating events. In Parlay’s case, both the ARB’s repeal of the Regulation and the emergence of the advanced battery technology could potentially qualify as frustrating events.

#### Foreseeability

To determine whether either event will qualify as a frustrating event under frustration of purpose, the courts must first find the event reasonably unforeseeable. For the courts to deem a supervening event unforeseeable, the party seeking excuse from the contract must show that the event fell wholly outside the potential reasonable contemplation of the parties. Furthermore, if commonly known facts or knowledge common to others in the same trade strongly suggest the risk of a supervening event, that event falls within reasonable contemplation. Lloyd, 25 Cal. 2d at 55-56, 153 P.2d at 51. In Lloyd, the lessee Murphy, an experienced automobile dealer, argued that he could not reasonably foresee the enactment during World War II (“WWII”) of a governmental restriction on automobile production and sales at the time he entered into a lease. The Court determined that the common person knew that the automobile industry had already begun preparing to supply the growing U.S. army’s needs, that auto sales had soared in anticipation of restricted production, and that Congress had authorized the President to allocate materials and mobilize industry for national defense. Because this common knowledge should have fallen wholly within the contemplation of either contracting party, the Court determined

that Murphy, an experienced auto dealer, could reasonably foresee the automobile restrictions that the government imposed subsequent to contract formation. Id. See also Dorn v. Goetz, 85 Cal. App. 2d 407, 409-14, 193 P.2d 121, 122-26 (1948) (government act limiting materials for construction to housing for veterans foreseeable because of veterans returning from WWII and mention of “unforeseen building difficulties” in the contract).

While Lloyd and Dorn involved governmental acts that a person could reasonably foresee as resulting from WWII, Parlay’s case differs in that it involves the repeal of a regulation that the ARB had enacted the month before the parties entered into the Contract. Unlike Murphy in Lloyd, Parlay neither had experience in the ZEV industry nor any commonly known facts from which to reasonably foresee the ARB’s repeal of the Regulation. When a new regulation passes, the common person, with no expertise in the field affected by the regulation, generally has no independent reason to contemplate the repeal of that regulation. Parlay, a novice in the ZEV arena, had no reason to consider the possible repeal of the Regulation. Even though laws by their nature can change, they typically do not, especially within only three years of their enactment. Furthermore, any evidence of the movement to convince the ARB to repeal the Regulation did not surface until more than two years after Parlay and T&A entered into the Contract, despite Parlay’s extensive research<sup>3</sup>. Therefore, the possibility of the Regulation’s repeal fell wholly outside the contemplation of Parlay at the time that it entered the Contract.

Applying those same principles of Lloyd and Dorn to the emergence of the advanced battery leads to the conclusion that Parlay could not reasonably foresee this competing

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<sup>3</sup> To conclude definitively that Parlay could not foresee either the ARB’s repeal of the Regulation or the emergence of the advanced battery technology, we must find out whether Parlay conducted its research negligently. For the purposes of this memo, we will assume that Parlay did not conduct its research negligently and discovered all reasonably available information regarding both the potential longevity of the Regulation as well as the possible emergence of alternative battery technologies.

technology. Parlay, a novice in the ZEV arena, conducted extensive research and contracted with the foremost expert in ZEV battery technology. Thayser, a Ph.D. and former fellow from MIT, had a superior position to know of any new ZEV battery technologies, yet apparently he did not foresee the emergence of a technology such as advanced battery. Even a month before Tanner first heard of the advanced battery technology, Thayser felt no need for Tanner to overreact, as evidenced in their late May 1998 conversation<sup>4</sup>. Only after both parties had learned about the advanced battery did Thayser feel the need to offer to modify the Contract. Based on the evidence we have now, we can thus infer that Thayser could not have contemplated this eventuality when he entered the Contract. If the development of a vastly superior alternative technology could not even enter the contemplation of Thayser, an expert in the field, three years after entering the Contract, the courts could not reasonably conclude that Parlay, with no expertise in the field, could have foreseen the new technology. While by its nature, a venture capital firm like Parlay takes risks, it calculates these risks very carefully based on exhaustive research to maximize potential benefits. Furthermore, the common person would only have reason to know of the still-developing lead-acid technology, the only available ZEV battery technology at the time the parties entered the Contract. The common person would also perceive that the automobile industry does not progress at the same rapid pace as the computer industry. Batteries for regular gasoline-burning automobiles have not changed significantly in a very long time. Tanner even noted that switching from the computer industry to the ZEV market would constitute a “change of pace,” presumably from the computer industry’s stressful, rapidly changing environment. Tanner could not have reasonably considered the possibility of witnessing the same leapfrogging of technology in the ZEV arena as she may have witnessed in

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<sup>4</sup> Without evidence that Tanner mentioned the ARB repeal during this conversation, we must assume that Thayser based his comments on all possible reasons for Parlay to terminate.

the computer industry. Given both commonly and uncommonly known facts, she still had no reason to consider that possibility. Therefore, unlike the frustrating event in Lloyd, the emergence of the new battery fell wholly outside the reasonable contemplation of either party.

#### Destruction of the Purpose or Value of the Contract

Even if found unforeseeable, these two events will only excuse Parlay from the Contract by frustration of purpose if they destroy or nearly destroy the fundamental Purpose. When determining the fundamental purpose of a contract, the courts will first look at the entire written purpose in a contract. Lloyd, 25 Cal. 2d at 56-57, 153 P.2d at 52. In Lloyd, the Court first looked at the parties' contract's sole written purpose for Murphy to conduct "the business of displaying and selling new automobiles . . . ." Lloyd, 25 Cal. 2d at 51, 153 P.2d at 49. When looking for the purpose written in the contract, the court will interpret the purpose of the contract based on the desired object of both parties. Dorn, 85 Cal. App. 2d at 413, 193 P.2d at 125. The plaintiffs in Dorn argued that the purpose of their contract encompassed the construction of their new home as well as the sale of their old home. Instead, the court concluded that the parties desired the sale of the old home, while the construction of the new home set the date of execution of the contract. Id. However, the courts will not construe the purpose of a contract narrowly such that neither party would have reasonably entered into the contract. Federal Leasing Consultants, Inc. v. Mitchell Lipsett Co., Inc., 85 Cal. App. 3d Supp. 44, 48-49, 150 Cal. Rptr. 82, 84 (1978). In Federal Leasing, the defendant entered into a lease agreement for the plaintiff to finance a new burglar alarm system, whereby the plaintiff took title to the equipment. The court refused to construe the purpose of the contract narrowly as merely for the plaintiff to finance the defendant. The court ruled that "the fundamental purpose . . . was to give [defendant] a functioning burglar alarm system." Id.

Applying these rules to Parlay's case, the courts will likely interpret the Purpose to encompass the design and development of the first pilot lead-acid battery for use in the ZEV market minimally established by the Regulation. As in Lloyd, the courts will first look to the Purpose, which "is for the design and development of the first pilot lead-acid battery [by January 1999] for use in the ZEVs required by [the Regulation] and for improvements to the design over the 10-year life of [the Contract]." Because neither party contemplated alternative battery technology and because of Thayser's lead-acid expertise, the courts should find that the desired object of the Contract relates to the design and development of a lead-acid battery for ZEVs. Furthermore, because the Purpose makes reference to the Regulation, the courts should recognize that both parties intended for the base market to equal or exceed the size of the market mandated in the Regulation.

One could, however, attempt to construe the Purpose either more narrowly or more broadly. As narrowly construed, the Purpose would call for the design and development of the first lead-acid battery for the specific ZEV market created by the Regulation. However, similar to Federal Leasing, a narrower construction of the Contract would produce unreasonable results. For example, if a ZEV manufacturer used T&A's battery in its models, it would not limit the usage only to the number of vehicles required by the ZEVs. Parlay would certainly have structured the deal so as to benefit from a larger market, not just the market defined by the Regulation. Likewise, a broader construction of the Purpose encompassing the design and development of a lead-acid battery for the ZEV market in general would unreasonably suggest that Parlay would enter into an open-ended Contract with no guaranteed minimums. No successful venture capital firm in Parlay's position would have accepted a market less than that established in the Regulation. Parlay did not even consider investing in ZEV technology until

the Regulation guaranteed that the manufacturers would produce a minimum number of ZEVs. Although Tanner and Thayser did discuss the “expanding market” for ZEVs during contract negotiations, they also specifically referred to the market created by the ARB’s regulation. Furthermore, the courts do not completely disregard the written language of the contract in dispute, as the broader interpretation of the Purpose would. Therefore, the courts should conclude that the Purpose pertains to the design and development of the first pilot lead-acid battery for use in the ZEV market minimally established by the Regulation.

Based on this interpretation of the Purpose and pending the further research mentioned earlier, we must next determine whether the frustrating events have destroyed or nearly destroyed the value of the Contract for Parlay. A supervening event that restricts but does not destroy the purpose of a contract does not give rise to frustration, especially when the other party offers to significantly increase the value of counterperformance by waiving some of its rights. Lloyd, 25 Cal. 2d at 56-57, 153 P.2d at 52. In denying Murphy’s frustration claim in Lloyd, the Court considered Lloyd’s offer to waive some of her rights, including the usage restriction on the property, situated in a prime commercial location, as significantly restoring the value of the contract for Murphy. Id. In addition, a supervening event that delays performance under a contract but does not significantly reduce the value of counterperformance does not frustrate the purpose. Dorn, 85 Cal. App. 2d at 415, 193 P.2d at 126. However, a supervening event that renders the object of the contract unusable and therefore valueless gives rise to frustration of purpose. Federal Leasing Consultants, 85 Cal. App. 3d Supp. at 49, 150 Cal. Rptr. at 84. In Federal Leasing, the court injunction rendered the defendant’s leased burglar alarm unusable, essentially altering the contract into a payment of rent for no return value. Id.

The effect of the repeal of the Regulation to the value of the Contract most resembles that of the supervening event in Lloyd, while the effect of the emergence of the advanced battery most resembles that of the supervening event in Federal Leasing. Like the government act in Lloyd, the ARB's repeal may only restrict, not destroy, the market for ZEVs. The ARB's confidence that the ZEV market "is developing sufficiently . . . and no longer needs [the Regulation]" indicates that a significant market for ZEVs remains despite the repeal. The research conducted by Tanner's staff confirms the strong growth of the ZEV market. However, like the supervening event in Federal Leasing, the emergence of the advanced battery technology could nearly or completely destroy the Contract's value to Parlay. Given the choice, the market would undoubtedly choose a superior product over an inferior product. Furthermore, the advanced battery appears ready to hit the market before T&A can even complete its lead-acid battery. Given these incentives, the auto manufacturers will likely ignore the lead-acid battery altogether, leaving Parlay with rights to a useless battery.

T&A may argue the emergence of the advanced battery technology more closely resembles the supervening event in Lloyd. T&A, similar to Lloyd, offered to waive partially its monthly funding. T&A also offered to conduct research on advanced batteries. Furthermore, T&A could argue that the lead-acid battery could eventually, given the ten-year time span of the Contract, outperform the advanced battery and develop into a valuable product for Parlay.

The facts of this case, however, do not adequately support these potential arguments. Thayser, the foremost expert in the field of lead-acid batteries, has yet to produce a pilot battery despite three years of working with an existing technology. If he started on an advanced battery with even less funding than he currently receives under the Contract, he would not only have to conduct significant research, but also conceivably spend at least another three years to develop

his first advanced battery. By that time, competitors would have time to improve their advanced battery products, leaving T&A perpetually behind in the marketplace and with no valuable product. Furthermore, unlike the agreement in Lloyd, the Contract apparently makes no such provision allowing Thayser unilaterally to modify the Purpose or waive any performance.

### **Conclusion**

Even if the repeal of the Regulation does not frustrate the Purpose, the emergence of the advanced battery significantly, if not totally, destroys any value that the Contract would have to Parlay. In order to support this conclusion, however, Parlay needs to conduct more research and provide more facts. As indicated in footnote two, Parlay needs to verify that advanced batteries will drastically outperform lead-acid batteries and discover whether such batteries will cost around the same price as lead-acid batteries. As further emphasized in footnote three, Parlay needs to prove that it performed its research non-negligently and to the fullest reasonably possible extent. Specifically, Parlay must show that no reasonable amount of research could have revealed either the development of the advanced battery technology or the actions by the seven largest auto manufacturers to coerce the ARB to repeal the Regulation. Finally, as mentioned in footnote four, Parlay may need to determine the extent of Tanner's May 1998 conversation with Thayser. If this additional research proves favorable, Parlay will have a solid argument for the courts to excuse its performance by the doctrine of frustration of purpose.