LJN LAW JOURNAL NEWSLETTERS

NEW YORK REAL ESTATE LAW REPORTER®

An ALM Publication

Volume 28, Number 8 • June 2012

The Enforceability of Liquidated Damages Clauses in Real Estate Leases

By Alexander Lycoyannis

Parties to real estate leases, as with parties to commercial contracts generally, sometimes anticipate situations where a breach would result in damages that, while significant, may not be quantifiable. In lieu of the seemingly impossible task of establishing actual damages in such circumstances, parties negotiating a lease often insist upon liquidated damages clauses fixing the amount of damages to be paid upon the occurrence of a given breach.

Clauses and the Courts

Courts have long recognized the rights of parties to agree to liquidated damages clauses, and such clauses are frequently upheld in the face of legal challenges by the breaching party. However, courts will declare liquidated damages clauses unenforceable if, instead of awarding an approximation of damages to non-breaching parties, they impose "penalties" upon breaching parties. This article discusses when a court will uphold a liquidated damages clause in a real estate lease, or strike the clause down as a penalty.

Cases in Point

In *Truck Rent-A-Center, Inc. v. Puritan Farms 2nd, Inc.*, 41 N.Y.2d 420, 424, 393 N.Y.S.2d 365 (1977), the Court of Appeals explained the rationale behind liquidated damages clauses:

> In effect, a liquidated damage provision is an estimate, made by the parties at the time they enter into their agreement, of the extent of the injury that would be sustained as a result of breach of the agreement ... Provisions for liquidated damages have value in those situations where it would be difficult, if not actually impossible, to calculate the amount of actual damage. In such cases, the contracting parties may agree between themselves as to the amount of damages to be paid upon breach rather than leaving that amount to the calculation of a court or jury (citations omitted).

A liquidated damages provision will be enforced where: 1) the amount liquidated bears a reasonable proportion to the probable loss; and 2) the amount of actual loss

continued on page 2

Liquidated Damages

continued from page 1

is incapable of, or difficult to, estimate precisely. *Id.*, 41 N.Y.2d at 425. Thus, the party seeking to avoid the effect of the liquidated damages clause has the burden of demonstrating either that: 1) actual damages by reason of the breach in question were readily ascertainable at the time the parties entered into their agreement; or that 2) the amount of liquidated damages is conspicuously disproportionate to such foreseeable losses. *See JMD Holding Corp. v. Congress Financial Corp.*, 4 N.Y.3d 373, 380, 795 N.Y.S.2d 502 (2005). Crucially, the agreement "should be interpreted as of the date of its making and not as of the date of its breach." *Truck Rent-A-Center, Inc.*, 41 N.Y.2d at 425.

'Emerging Presumption'

The Court of Appeals has noted the "emerging presumption against interpreting liquidated damages clauses as penalty clauses." *JMD Holding Corp.*, 4 N.Y.3d at 381 (citation omitted). A survey of the cases shows that consistent with this "emerging presumption," courts usually uphold liquidated damages clauses in real estate leases against challenges by breaching parties.

Typical of such cases is *Tenber Associates v. Bloomberg L.P.*, 51 A.D.3d 573, 859 N.Y.S.2d 61 (1st Dep't 2008). In *Tenber*, a commercial tenant held over in possession of the subject premises after the conclusion of an approximately 10-year lease. The lease provided that should the tenant hold over in possession of the premises after the conclusion of the term, the tenant would be liable for two times the last rent due under the lease as liquidated damages. The tenant challenged the double-rent provision as an unenforceable penalty, but the Appellate Division, First Department disagreed and upheld the agreed-upon liquidated damages:

> The liquidated damages clause, providing for two times the existing rent in the event of a holdover, was not an unenforceable penalty. Bloomberg failed to establish that damages could be anticipated in 1995, when the lease was executed, or that the amount fixed was plainly or grossly disproportionate to the probable loss (citations and internal quotation marks omitted).
>
> 51 A.D.3d at 574.

Similarly, in *Duane Reade v. Stoneybrook Realty, LLC*, 63 A.D.3d 433, 882 N.Y.S.2d 8 (1st Dep't 2009), the court affirmed a liquidated damages provision granting the commercial tenant liquidated damages in the form of a rent abatement by reason of the landlord's delay in delivering possession of the leased space:

> The rent abatement clause in the lease between these sophisticated parties was an enforceable liquidated damages provision and not a penalty, since it compensated the tenant, which was to operate in a new geographical market, for damages flowing from delays in delivering possession that were not readily ascertainable when the parties executed the lease, and such damages were not unreasonably disproportionate to foreseeable losses (citations omitted).
>
> 63 A.D.3d at 434.

On the other hand, in *LeRoy v. Sayers*, 217 A.D.2d 63, 635 N.Y.S.2d 217 (1st Dep't 1995), the tenant rented vacation premises for the summer period between July and early September. The lease required the rent to be paid prior to the commencement of the term, with the tenant paying $50,000 upon signing the lease in February, and the balance by the end of June. The lease also provided that if the tenant were to default prior to taking possession, he "shall lose his initial [$50,000] payment which shall be considered Landlord's liquidated damages."

In March, the premises were damaged by a fire. While the landlord

continued on page 3

Alexander Lycoyannis is a partner at the Manhattan real estate law firm of Rosenberg & Estis, P.C.

Liquidated Damages

continued from page 2

asserted that the premises would be repaired by the beginning of the lease term in July, the tenant attempted to cancel the lease and demanded the return of his initial payment; the landlord refused and sought to retain the payment as liquidated damages. The landlord then re-rented the premises to a third party for more than what the tenant had agreed to pay.

The tenant sued to recover his initial $50,000 rent deposit retained by the landlord as purported liquidated damages. The Appellate Division, First Department eventually held, among other things, that the liquidated damages provision was an unenforceable penalty. The court found it pivotal that the lease awarded the landlord the identical amount of liquidated damages regardless of when the breach occurred, and thus without reference to the landlord's ability to re-rent the premises in time for the summer:

> Since the clause awarded the same exorbitant sum irrespective of the time of the breach and even in the instance where, concededly, the damages flowing from a breach and immediate re-rental would be negligible, it constitutes a penalty and is unenforceable.

Conclusion

In short, courts will enforce liquidated damages clauses in real estate leases where, from the parties' perspective at the time of lease execution: 1) the anticipated damages could not be precisely estimated; and 2) the amount liquidated bears a reasonable proportion to the probable loss. Where a liquidated damages clause fails to meet this standard — including, without limitation, where the liquidated damages clause provides for a "one size fits all" remedy that is untethered to the amount of damages actually anticipated by the parties at the time of lease execution — the clause will be held unenforceable, and the party seeking to enforce its rights will instead be relegated to a claim for actual damages.

—❖—