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Defining the Limits of Liquidated Damages Clauses

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Real estate leases are, by their nature, bets the parties are placing on what the future may hold. Both landlord interests and tenant interests try to hedge their bets by inserting clauses to produce certain results in the event of an uncertain future. Chief among these mechanisms are liquidated damages clauses that seek to give to the event of breach of the contract at an unpredictable time with unpredictable consequences, certain quantification. The importance of liquidated damages clauses are two-fold: They make the tenant think twice before breaching the lease or overstaying it, thus reducing the traffic in landlord-tenant court; and they allow the landlord an award of its full damages as it envisioned them at the time of the writing of the lease.

Pushing the Limits

Any attorney drafting contracts on a regular basis knows two different client goals for liquidated damages clauses.

First, the client may genuinely not know how to compute its damages in the event of breach and wants the contract to create compensation for such an event. While some other areas of the law allow for arbitrarily assigning dollar figures to unquantifiable events (automobile accidents, for example), the liquidated damages doctrine insists that there be some nexus between the agreed-upon damages and the foreseeable loss. If the landlord writes at that time what it reasonably believes the damages will be, the court will not judge the lease by later events, but rather by how the landlord originally explained its understanding of the future damages.

Second, the client may want the consequences of breach so draconian as to be unthinkable to the breacher, giving the protected party security that the breach will never occur. As to this latter common goal, the law refuses to provide a mechanism. Penalty clauses are unenforceable and it is the foolish attorney who uses the word "penalty" in drafting a contract—except in the phrase "not a penalty."[1]

The contract's language will not control the courts.[2] Although the parties assert that the consequences are "not a penalty," the courts will look to their severity and determine "whether a provision in an agreement is an enforceable liquidation of damages or an unenforceable penalty (as) a question of law, giving due consideration to the nature of the contract and the circumstances."[3] The burden is on the party seeking to avoid liquidated damages to show that they are really a penalty,[4] but doubts will be resolved in finding it to be penalty.[5]

Explaining Damages

Although not required for enforceability that a liquidated damages clause explain in its own language what it is that makes the damages so difficult to calculate,[6] it is required that the damages actually be difficult to calculate at the time the parties execute the lease.[7] However, the careful drafter should set forth an explanation of the difficulty in calculating the damages, not necessarily to define them, but at least recognizing them on sight, like the pornography in Jacobellis v. Ohio.[8]

There are three salutary effects to having a clause that fulsomely sets forth the factors causing the difficulty.

First, it can convince the court that at the time of execution, it really was difficult.

Second, it brings the contract explicitly within the common law requirement that "There must be some attempt to proportion these damages to the actual loss. The parties must not lose sight of the principle of compensation."[9]

There is no clear statement in the law about just how proportionate the liquidated damages must be, but the standard appears to be that the clause is "reasonably proportionate" stated affirmatively10 or not "plainly disproportionate," stated negatively.[11]

Third, it forces the parties to confront the possibility that calculation is not difficult at all, and the drafters should instead of a liquidated damages clause, set forth a clause that gives the calculation's methodology. Courts will enforce a liquidated damages clause if the damages are difficult to calculate at the time of signing the lease,[12] even if they are easy to calculate once the breach actually takes place.[13]

Staying Inside the Boundaries

While largely focused on what happens if the tenant abandons the lease prior to its expiration, leases may call for liquidated damages in other events as well, such as, for example, when the tenant fails to vacate at the end of the lease.

Montgomery Trading Co. v. Cho,[14] upholds a clause calling for one and a half times the rent in a holdover.

Like RPL §229, Tenber Assoc. v. Bloomberg[15] allows for double rent for tenants holding over after notice.[16] Thirty-Third Equities Co. v. Americo

upholds a lease clause calling for two and a half times the rent and Federal Realty v. Choices Women's Medical. Center[17] upholds triple rent in a holdover.

Although there are any number of breaches that can give rise either to a penalty clause or a liquidated damages clause, the two most common categories of tenant misconduct are: when the tenant leaves too early—when the tenant abandons the tenancy; and when the tenant stays too long—when the tenant holds over after the natural conclusion of the lease. The case law uniformly tolerates best those clauses penalizing the tenant for staying too long and shows least indulgence for those clauses penalizing the tenant for leaving too soon.

New 24 W. 40th St. v. XE Capital Mgmt.[18] permits as liquidated damages a lease clause that accelerates the rent (making all the rent for the rest of the lease instantly collectible) but discounts it at the rate of 4 percent per annum. (In other words, next year's rent is recoverable at 96 percent of the full rent, succeeding years 92 percent, 88 percent, etc.) We do not believe 4 percent is the appropriate discount rate, but cannot predict what the minimum discount would be required before the acceleration of full rent would be considered a forbidden penalty. Bates Adver. USA v. 498 Seventh, LLC [19] suggests the wisdom of specific liquidated damages clauses for specific breaches, but the reasoning behind the liquidation should be included for each predicted breach. The law does not require a perfect prediction of the future, just a good faith explanation of what factors went into trying to account for it.

Going Too Far

Acceleration clauses were the one area where a landlord could literally collect the entire rent in the event of a breach, like a "get out of jail free card.

While historically, cases had permitted the landlord to accelerate the entirety of the rent for the remainder of the lease in the event of premature termination and had permitted double rent or more for holdovers, accelerating double the rent was found an unenforceable penalty.[20]

Where the lease calls for the same supposed liquidated damages for any of a variety of breaches by the tenant, the courts uniformly find it to be an unenforceable penalty.[21] Similarly unenforceable is the same penalty applied over an entire period, during which predictable actual damages will range from extremely low to approaching the landlord's actual loss.[22]

Key to any liquidated damages clause is the difficulty in computing the actual damages. Where the damages are easy to compute and it is easy to show that the supposed liquidation is significantly higher than the actual damages, the court will only award the actual damages.[23]

Penalty Clauses

That party that believed itself to have a liquidated damages clause but finds instead to have an "unenforceable" penalty still has a remedy. The court simply ignores the supposed liquidation and holds a hearing as to the actual damages.[24] However, if such party was right about the difficulty of proof of the actual damages, it may find itself with a judgment for liability with an actual dollar award that is negligible or absent altogether. Thus, in acceleration cases, if the landlord has already rented out the premises to someone else, the most that the court will award the landlord will be the rent for the period the premises stood empty, which, could come to a month or three instead of the 360-months award typical of the historical awards of the full future rent undiscounted in a large scale commercial lease. Or, the court could award the difference between the higher rent that was being charged to the breaching tenant and the lower rent being paid by the new tenant.

Sample Clauses

Although a lease for personal property rather than real property, we see the outlines of a perfect liquidated damages clause in Truck Rent-A-Center v. Puritan Farms 2d. [25]

In arriving at said liquidated damages, the parties have considered, among other factors, the following (enumerating factors that would lead to a calculation).

From the same source, a solid rent acceleration clause would say:

Upon termination of this agreement by reason of the lessee's breach, Lessor shall be entitled to damages, herein liquidated for all purposes as follows: The sum of all rents which would have become due under the normal operation of this agreement from the date of the said termination less a credit to the lessee for lessor's spared expense (as follows).

'Van Duzer'

On Dec. 18, 2014, in 172 Van Duzer v. Globe Alumni,[26] the Court of Appeals cast doubt on the doctrine of liquidated damages. While paying lip service to all of the major pronouncements cited above, Van Duzer leaves one wondering how much continued effect they may have—author Bailey believes Van Duzer is a mere aberration to be honored more in the breach than the observance and author Treiman believes Van Duzer's chaos immediately effective.

Van Duzer guts rent acceleration clauses by taking their most common form—immediate capture of all of the future unpaid rent—and sending it to the trial court for a hearing on what the actual damages will be. It holds that such a clause is a penalty. Most disturbingly, the Van Duzer clause or its equivalent is very common[27] in both commercial and residential leases.[28] By specious reasoning, Van Duzer seeks to distinguish Fifty States Mgmt. Corp. v. Pioneer Auto Parks29 upholding such clauses on the basis that the landlord gets to enforce the penalty in Pioneer because the tenant gets to remain in possession. If Van Duzer really means what it says, then the landlord should accelerate the rent in full and tender possession upon its payment.

Conclusion

Real estate law has long recognized the value of stability in the law and stability in the contractual relations of the parties.30 Review of every single reported liquidated damages clause of the past 100 years revealed their wide New York acceptance as they advance both these goals as well as the overarching goal to encourage people to abide by their contractual obligations. Destabilizing them, particularly with regard to an extremely widespread practice in the industry does little to advance well-attested policies.

ENDNOTES:

1. Bagley v. Peddie, 16 NY 469 (1857).

2. Truck Rent-A-Ctr v. Puritan Farms 2nd, 41 NY2d 420 (1977).

3. Van Duzer, discussed at length, infra.

4. Id.

5. Pyramid Centres & Co. v. Kinney Shoe Corp., 244 AD2d 625 (3d Dept 1997).

6. Bates Advertising. USA v. 498 Seventh, 291 AD2d 179 (1st Dept 2002).

8. 378 U.S. 184 (1964).

9. Seidlitz v. Auerbach, 230 NY 167 (1920). Seidlitz

is the leading case on liquidated damages.

10. City of Rye v. Public Service Mutual Insurance,

34 NY2d 470, 473 (1974).

11. Truck Rent-A-Ctr.,supra.

12. Tenber Associates v. Bloomberg L.P., 51 AD3d

573 (2008)

13. Parsons & Whittemore v. 405 Lexington, 299

AD2d 156, 753 (2002); Vernitron Corp. v. CF 48

Associates, 104 AD2d 409 (2d Dept. 1984).

14. 22 Misc.3d 135(A) (AT 2009).

15. 51 AD3d 573 (AD1 2008); accord, Parsons

& Whittemore v. 405 Lexington, 229 AD2d 156

(AD1 2002); 319 Fifth Ave. Realty v. 319 Smile

Corp., 21 Misc.3d 139(A) (AT 2008).

16. See also, Montgomery Trading v. Cho, 22

Misc.3d 135(A) (AT 2009) (1.5x rent); 319 Fifth

Ave. Realty v. 319 Smile Corp., 21 Misc.3d 139(A)

(AT 2008) (double rent).

17. 289 AD2d 439 (AD2 2001).

18. 104 AD3d 513 (2013).

19. 291 AD2d 179 (2002).

20. Pyramid Centres, supra.

21. Vernitron Corp. v. CF 48 Associates., 104

AD2d 409 (AD2 1984).