

## Finding Uncertainty in Certain Damage Provisions

By Robert A. Machson

For years, careful landlords and tenants have used liquidated damages as a means to avoid the uncertainty of events beyond their control. If the tenant held over beyond its term, or the landlord breached the tenant's exclusive, liquidated damages were considered a dependable remedy to avoid costly and time-consuming litigation. Unfortunately, what seems certain to lease drafters is anything but certain when presented in court. A recent decision from the U.S. District Court for the Middle District of Georgia underscores that point.

In *Big Lots Stores v. Gray Highway Partners*, 2006 WL 692347 (M.D. Ga. 2006), the landlord entered into a lease with Big Lots that contained a restrictive covenant prohibiting it from leasing to any "competing business," including any "dollar store operation." Within a year, the landlord leased space in the center to a Dollar General store. Not surprisingly, Big Lots quickly filed suit, seeking to enforce the provision of its lease that permitted it to "pay in lieu of Fixed Minimum Rent ... monthly rental equal to the lesser of two and one-half percent of Gross Sales for such month."

On a motion for summary judgment, Big Lots' vice president testified that its liquidated damages provision was "based upon usual and customary standards in the retail shopping industry [including those] recommended by the International Council of Shopping Centers." Unconvinced, the district court held that the clause was a penalty and not liquidated damages and

referred the matter to trial to determine the amount of actual damages. This is probably not the outcome Big Lots expected when it inserted the liquidated damages clause into its lease.

The *Big Lots* decision is yet another chink in a remedy that has long been used in commercial leases. In addition to exclusive covenants such as that found in *Big Lots*, landlords commonly insert a liquidated damage provision to discourage holdover tenants or to prevent a tenant from vacating the premises before its term is expired ("going dark"). For tenants, liquidated damages are particularly important because the tenant may have no other remedy in the event a landlord does not complete repairs on time or is unable to meet an opening date. In the absence of liquidated damages, each party may have to undertake expensive and uncertain litigation, the cost of which may exceed the recovery.

Unfortunately, as landlords and tenants increasingly look to liquidated damages as a means to avoid the uncertainty and expense of litigation, the courts have responded with different results that may do little to serve that end.

Courts do agree on the essential principle of liquidated damages. As stated by the New York Court of Appeals in *Truck Rent-A-Center v. Puritan Farms 2nd*, 361 N.E.2d 1015 (1977), "[a] contractual provision fixing damages in the event of breach will be sustained if the amount liquidated bears a reasonable proportion to the probable loss and the amount of actual loss is incapable or difficult of precise estimation. If, however, the amount fixed is plainly or grossly disproportionate to the probable loss, the

provision calls for a penalty and will not be enforced."

While courts have applied numerous tests to determine whether or not liquidated damages are enforceable, each has generally required the presence of three conditions: 1) the damages must be difficult or impossible to estimate; 2) the parties must intend to provide for damages and not a penalty; and 3) the stipulated damages must bear a reasonable semblance to the probable loss. The damages in an "enforceable" liquidated damages provision should be enough to compensate the non-breaching party for its damages, but not be so high as to prevent the breaching party from ending an uneconomical contract (*ie*, one that costs less to breach than to perform).

### UNENFORCEABLE 'PENALTIES'

At one end of the spectrum are those cases in which the damages appear unconscionable by any standard. Take, for example, *Mark-It Place Foods, Inc. v. New Plan Excel Realty Trust, Inc.*, 804 N.E.2d 979 (Ohio Ct. App. 4th Dist. 2004), where the landlord violated a supermarket tenant's prohibition against selling "groceries, meats, poultry, seafood, dairy products, fruits, vegetable and baked goods" when it permitted an adjoining Wal-Mart to sell packaged nuts, chips, and beverages. The lease permitted abatement of all rental obligations "during the period of such violation." The Wal-Mart lease was for a term of 20 years with six 5-year extensions. Thus, it was conceivable that the plaintiff might remain in the shopping center rent-free for 50 years before the Wal-Mart lease expired. The Ohio Court of Appeals, despite its acknowledgment

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that "Ohio law generally respects the freedom of contract," had little trouble concluding that "this is the type of draconian 'penalty' clause meant to be prohibited."

Among other things, *Mark-It Place Foods* illustrates the proposition that, when seeking to enforce a liquidated damage provision, it may not be enough to point out that the breaching party was a sophisticated business represented by highly qualified counsel. Thus, in *In re Admetric Biochem, Inc.*, 284 B.R. 1 (D. Mass. 2002), the landlord had little success arguing that a "sophisticated commercial [tenant] represented by a large, Boston law firm should pay nearly 5 years of accelerated rent in the sum of \$2,188,455 in addition, the court noted, to "\$480 for trash removal and \$35 for the administrative fee." Similarly, in *Harbor Island Holdings v. Kim*, 132 Cal.Rptr.2d 406 (Cal. Ct. App. 4th Dist. 2003), the court saw nothing but a penalty in a "deferred rent" of twice the monthly amount in the event of any breach by the tenant. Notwithstanding Cal. Civ. Code §1995.270(a)(1), which declares the public policy of California to "facilitate freedom of contract by the parties to commercial real property leases," the court in *Harbor Island* held "[t]he fact that this was a commercial lease negotiated by seasoned business entities, not a consumer lease between unsophisticated individuals, has no bearing on the result."

### HOLDOVER TENANTS

At the other end of the spectrum are the "holdover" cases, where the lease provides for liquidated damages in the event the tenant fails to vacate its premises upon the termination of its lease. In these circumstances, courts are far more likely to enforce the damages, partly because the tenant has the ability to mitigate its own damages and partly because it is hard

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to conclude that the damages are a "penalty" for coercing performance, where the tenant had not bargained for performance. As a result, decisions enforcing holdover damages of two (*Brooks v. Networks of Chattanooga*, 946 S.W.2d 321 (Tenn. Ct. App. Eastern Section 1997)) and even three times the rent (*Federal Realty Ltd. Partnership v. Choices Women's Medical Center*, 735 N.Y.S.2d 159 (2nd Dept. 2001)) are not uncommon.

### GOING DARK

The cases in which the tenant has breached its continuous operation clause require courts to focus upon the parties' reasonable economic judgments as well as their "freedom of contract." Few cases discuss each of these better than *Benderson-Wainberg v. Atlantic Toys, Inc.*, 228 F. Supp.2d 584 (E.D. Pa. 2002). In *Benderson-Wainberg*, the operator of "several stores" (whose principal — according to the court — "holds a bachelor's degree in accounting") was required to pay liquidated damages equal to the monthly minimum rent for vacating its store prior to the expiration of the term (in addition to accelerated rent). Finding (under New Jersey law) a "presumption of reasonableness that attaches to liquidated damages provisions in the commercial context," the district court was persuaded by the landlord's testimony that, at the time the contract was executed, it would have been impossible to estimate the impact of a vacant space upon the operation of the shopping center.

Of course, the continuous operations cases are the flip side of holdovers. In the case of continuous operations, there is a danger that liquidated damages that are too high may coerce uneconomical performance, forcing a retailer to operate even though its losses from continuous operation are greater than the actual damages caused by its going dark. Two cases involving the mass closing of a chain retailer may illustrate this point.

Applying a presumption (the opposite of New Jersey's) disfavoring liquidated damages — "doubt as to whether a provision constitutes an unenforceable penalty ... should be resolved in favor of a construction which holds the

provision to be a penalty" — a New York state court held in *Pyramid Centres and Company v. Kinney Shoe Corporation*, 663 N.Y.S.2d 711 (3d Dep't 1997) that liquidated damages of twice the minimum rent after the tenant went dark were "intended to coerce [Kinney's] performance rather than compensate plaintiffs for defendant's breach." In this case, the landlord was required, "in the interest of justice," to prove actual damages caused by the going dark.

A different outcome was reached in a different jurisdiction where the Kinney store went dark. Applying the same presumption under Maryland law as was applied in New York, the court in *Landover Mall LP v. Kinney Shoe Corp.*, 944 F. Supp. 443 (D. Md. 1996), held that liquidated damages equal to 100% of minimum rent were "reasonably related to the actual and consequential damages that [the landlord] might have anticipated."

Of course, there is no way of telling whether the different outcomes in the two "Kinney" cases are a result of the doubly harsh damages in the New York case. Given the absence of testimony in either case concerning the actual economic impact of going dark (other than the landlord's testimony that it would be difficult to estimate), there is no way of knowing why one times rent was "reasonably related" to the landlord's actual damages in one case, while two times rent was "grossly disproportionate" in the other.

### EXCLUSIVES

From the tenant's point of view, one of its most cherished lease provisions is its exclusivity clause. Equally dear is the right to reduce or suspend rent in the event of a violation. Without this remedy, the tenant's cold comfort is to file suit and prove its economic damages.

Like the "going dark" cases, enforcement of the tenant's remedy may well depend upon whatever appears "reasonable" to the court. In the *Big Lots* case, the tenant's reduced rent for more than 20 years was clearly too much for the court to bear. To some degree, this puts *Big Lots* at odds with other precedent.

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For example, one of the earliest cases to examine the breach of a tenant's exclusive was *Midamco Ltd. Partnership v. Fashion Bug of Solon*, 689 N.E.2d 605 (Ohio Court of Appeals 8th Dist. 1996). There, the tenant's lease permitted it either to terminate the lease or pay 3% of gross sales if its exclusive was violated. Midway into the second of its three, 5-year option periods, its exclusive was violated, and Fashion Bug reduced its rent from \$6500 to \$1700 a month. While the trial court concluded that the reduction in rent was not so great as to be a penalty, the appellate court affirmed, but for different reasons.

Reviewing the case law as it existed at the time, the court observed that the lease had been prepared by the lessor, though the economic benefit of the remedy favored the lessee. In addition, the lessor brought on the event that triggered the remedy. Thus, the court concluded that the reduced rent was not liquidated damages, but was an "optional provision"

in the lease to provide relief in the event the exclusive was violated. (These days, courts prefer to describe any provision that may be used to compel performance as liquidated damages. This was made clear in *Harbor Island Holdings*, where the landlord unsuccessfully argued that the double rent triggered by the tenant's breach was simply its enforcement of the original rental agreement, which permitted the tenant to pay one half rent if no breach occurred.)

However decided, the result in *Midamco* stands in contrast to *Big Lots*. In *Big Lots*, the court held that a tenant's right to pay 2.5% of gross sales possibly for 24 years "[raised] doubts about the reasonableness of the damages provision." In *Midamco*, the court found nothing wrong in the tenant's paying of 3% of gross sales for the next 13 years. Similarly, other courts have approved remedies that appear only slightly less "draconian" than *Big Lots*, permitting tenants to pay one half rent "for the duration of the competing use," *Red Sage LP v. Despa Deutsche Sparkassen Immobilien-Anlage-Gesellschaft MBH*, 254 F.3d 1120 (D.C. Cir. 2001) and for the

duration of the term and any extensions. *Rathbun v. Cato Corp.*, 93 S.W.3d 771 (Mo. Court of Appeals Southern Dist. 2003).

The case law suggests that somewhere above the obviously unconscionable penalty — no rent for decades — courts are likely to enforce liquidated damage remedies, but only if it appears that the parties considered the *actual* damages before they agreed to the liquidated damages. (Though *Big Lots* may be an anomaly, a lesson may be drawn from its conclusion that the lease provision failed only because there was "no evidence to show that [the rent reduction was a] reasonable pre-estimate of probable loss.") Lease drafters looking to add more certainty to their liquidated damage provisions (whether so described or not), need to show in their lease that the parties contemplated the loss that would flow from a breach and that the reduction or abatement of rent was a reasonable estimate of those damages.

