

Real Estate Trends

LANDLORD-TENANT LAW

Liquidated Damages Provisions: An Update

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April 5, 2023

Before he infamously went insane at the twilight of his career, Gaius Marius, the famous Roman general, taught an even more famous Roman, Julius Caesar, that battles are won and lost years before they are even started. Although New York real estate litigators are unlikely to be immortalized in marble busts (most of us, anyway), we are likewise well aware that anticipation and preparation can win legal battles occurring far in the future.

In breach of contract litigation, victory begins with anticipating potential problems when negotiating and drafting the contract. As it happens, the COVID-19 pandemic—which no one had anticipated—had a re-shuffling effect in a broad range of industries, leading to a surge of legal disputes stemming from an avalanche of contract defaults.

In many cases, liquidated damages provisions were the focus of litigation, as a result of which an increasing number of parties now insist on liquidated damages clauses in their leases and other agreements.

Liquidated damages provisions are included in contracts where parties anticipate situations where a breach would result in substantial damages that may not be readily quantifiable. Therefore, the parties opt for predictability, agreeing on a fixed amount of damages to be paid upon the occurrence of a given breach.

Many optimists among the would-be-payors of liquidated damages do not truly expect to default, causing them to overlook or rubberstamp liquidated damages clauses without much forethought, leading to vehement opposition when the breach occurs and the counterparty demands payment. Liquidated damages clauses are typically (and increasingly) fertile ground for litigation, as evidenced by an extensive and growing body of caselaw on the topic.

'Truck Rent-A-Center' and Its Progeny

The seminal case on the enforceability of liquidated damages provisions is *Truck Rent-A-Center, Inc. v. Puritan Farms 2nd, Inc.*, 41 NY2d 420 (1977), where the Court of Appeals held that a liquidated damages provision will be upheld 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” (*id.* at 425).

The burden of proof, naturally, is with the party seeking to avoid the provision. The reasoning behind the *Truck Rent-A-Center* test is rooted in public policy.

As explained by the Court of Appeals: “[a] clause which provides for an amount plainly disproportionate to real damage is not intended to provide fair compensation but to secure performance by the compulsion of the very disproportion[,]” allowing the promisee to “reap a windfall well above actual harm sustained” (*id.* at 424).

The lesson to be learned from the caselaw is that liquidated damages must be justifiable and, ideally, within upheld ranges which are often industry-specific.

Notably, potentially inconsistent rulings have succeeded the Court of Appeals’ decision in *Truck Rent-A-Center*, leading to very recent appellate practice that could further define or change the relevant criteria.

Nevertheless, the courts have recognized that “[t]he term ‘grossly disproportionate’ in the liquidated damages context does not lend itself to a precise definition.” *Seymour v. Hovnanian*, 211 AD3d 549, 554 (1st Dept. 2022).

Consequently, many courts have adopted a rule-of-thumb approach. For instance, in the commercial landlord-tenant context, the courts have consistently upheld clauses permitting landlords to recover two or three times the amount of rent reserved under the lease where tenant holds over beyond the expiration or earlier termination of the lease.

In *Victoria’s Secret Stores, LLC v. Herald Sq. Owner LLC*, 211 AD3d 657 (1st Dept. 2022), the Appellate Division recently upheld a liquidated damages provision awarding holdover rent at three times the monthly rent under the lease, holding that such provisions are “routinely” upheld, especially when agreed to by “sophisticated” parties. See also *Tenber Assoc. v. Bloomberg L.P.*, 51 AD3d 573, 574 (1st Dept. 2008); *Federal Realty Ltd. Partnership v. Choices Women’s Med. Ctr.*, 289 AD2d 439, 442 (2d Dept. 2001).

However, freedom of contract, although paramount, “is not absolute and must give way to countervailing public policy concerns in appropriate circumstances.” *Deutsche Bank Nat. Tr. Co. v. Flagstar Capital Markets Corp.*, 143 AD3d 15, 20 (1st Dept 2016). The courts can and sometimes will strike contract provisions—including liquidated damages provisions—which are found to violate public policy. *Trustees of Columbia Univ. in City of New York v. D’Agostino Supermarkets, Inc.*, 36 NY3d 69 (2020) is illustrative in this regard.

There, landlord and tenant entered into a surrender agreement terminating the lease, which required tenant to surrender the leased premises and pay landlord \$261,751 in staggered installments. If any installment was missed, all amounts payable to landlord under the terminated lease would become immediately due and payable by tenant.

The Court of Appeals held, *inter alia*, that this provision is unenforceable because the full rental amounts due were over seven times what landlord would have received if tenant had fully complied with the surrender agreement.

Lessons From Caselaw

The lesson to be learned from the caselaw is that liquidated damages must be justifiable and,

ideally, within upheld ranges which are often industry-specific. Otherwise, the party that would benefit from a liquidated damages clause risks getting far less than what it had bargained for or what it could have been entitled to otherwise.

If the numbers are outside the upheld ranges, but there is a reasonable justification for a larger liquidated damages amount, the liquidated damages clause (or even a “whereas” clause) should provide context to help explain how the parties arrived at the specific amount and how such amount is related to the payee’s “probable actual loss” in the event of a breach.

Another useful lesson from *Trustees of Columbia* is that justifications for liquidated damages based on what a party may relinquish—which, there, was rent under the terminated lease—may not save an otherwise void liquidated damages clause. *Quaker Oats Co. v. Reilly*, 274 AD2d 565 (2d Dept. 2000) further underscores this lesson.

There, the parties settled a federal civil action and agreed that (1) defendants would execute a \$355,000 note in plaintiff’s favor, and (2) if the note was not paid on the maturity date, the outstanding balance of the note would automatically increase by an arbitrary amount of \$125,000 as liquidated damages. The Appellate Division held that the liquidated damages provision was unenforceable and that “it is irrelevant that the plaintiff might have recovered much more had it continued with its Federal action” (*id.* at 566).

Other useful pointers can be gleaned from the caselaw. For instance, the abundance of cases striking liquidated damages clauses labeled as “penalties” counsel against labeling liquidated damages as such. Moreover, liquidated damages

clauses which provide for escalating payments, for no apparent reason other than to “incentivize” the counterparty to perform in connection therewith, are vulnerable to challenge. *See, e.g., Free People of PA LLC v. DelShah 60 Ninth, LLC*, 169 AD3d 622 (1st Dept 2019).

That said, even a potentially voidable liquidated damages clause may prove to be an effective deterrent against defaults. And, all is not lost if a liquidated damages clause is deemed void. “Where a party establishes a penalty, the proper recovery is the amount of actual damages established by the party.” *172 Van Duzer Realty Corp. v. Globe Alumni Student Assistance Ass’n, Inc.*, 24 NY3d 528, 536 (2014).

Critically, these and other lessons from the caselaw are important in nearly any context where liquidated damages are on the table. When negotiating contracts, settlement agreements or stipulations, counsel and parties alike should be aware that the courts’ public policy scrutiny is far-reaching.

In fact, even a so-ordered stipulation may be voided on public policy grounds. *See Jazilek v. Abart Holdings LLC*, 10 NY3d 943, 944 (2008); *Second Lenox Terrace Assoc. v. Cuevas*, 24 Misc 3d 1217(A) (Civ Ct, New York County 2009) (holding that a stipulation of settlement was “void as against public policy” despite the fact that the stipulation “was so-ordered by this Court”).

Conclusion

As with many litigation-prone contract provisions, the caselaw on liquidated damages provisions continues to evolve. Thus, it behooves transactional attorneys and litigators alike to monitor the caselaw in this area so as to inform lease negotiations and litigation strategy.