WILL THE LIQUIDATED DAMAGES CLAUSE GO DOWN THE DRAIN IF YOUR COMMERCIAL LEASE IS IN HOT WATER?

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A typical commercial lease permits the Landlord, upon the Tenant's default, to collect "liquidated damages" based upon the remaining rent due for the balance of the lease term. The Circuit Court for Montgomery County recently found, in a case of first impression in the State of Maryland, that liquidated damages in a commercial lease may be a proper remedy for a tenant's default, but will not be enforceable when the damages are a penalty instead of a fair estimate of the potential damages the Landlord would suffer as a result of the Tenant's default. Although a decision from a Circuit Court has no precedential value and, therefore, is not binding on other Maryland courts, the Court's analysis could be persuasive in other similar cases, and thus provides some useful lessons on how to draft, and how not to draft, a liquidated damages clause.

Saul Holdings Limited Partnership, et al. v. Raquel Sales, Inc. and Barefeet Enterprises, Inc. (Cir. Ct. for Montgomery County), arose out of a 10-year shopping center lease (the "Lease") entered into on January 23, 2006 between Raquel Sales, Inc., as the Tenant, and Briggs Chaney Plaza, LLC, as the Landlord, for space in the Briggs Chaney Shopping Center in Silver Spring, Maryland. [1]The Tenant's obligations under the Lease were guaranteed by Barefoot Enterprises, Inc. The Lease required the Tenant to make minimum monthly rental payments, as well as monthly payments for common area maintenance, commercial fees, taxes and other miscellaneous charges. The minimum monthly rent was to increase by 2% per year. The Tenant stopped paying rent in October, 2008, and abandoned the premises in January, 2009.

In a clause similar to the default remedy commonly found in commercial leases, the Lease provided that in the event of the Tenant's default, the Landlord could seek "Liquidated Damages" equal to the monthly rent and additional rent payable at the time of the default, multiplied by the number of months remaining in the lease term, discounted to present value at a rate of 6%. The clause additionally required the Landlord to credit the Tenant any rent received as a result of the reletting of the leased premises, but did not include an affirmative obligation of the Landlord to mitigate its damages by seeking a new tenant.

Because Maryland courts have not addressed the issue of whether the acceleration of rent, is a proper remedy for breach of a commercial lease under Maryland law, the Court first had to determine whether such a remedy was permissible under any circumstances. The Court then determined that liquidated damages, in cases unrelated to commercial leases, have previously been upheld as a proper remedy, so long as the liquidated damages are a fair estimate of potential damages and not a penalty. Thus, the agreed sum must be "a reasonable forecast of the just and fair compensation of the harm that would result by a breach of the contract". Citing multiple cases, the Court stated that "Maryland courts will enforce a liquidated damages provision if it provides a fair estimate of potential damages at the time the parties entered into the contract and

[1] At the same time, the Tenant entered into a 10-year lease for 7,020 square feet of space in a shopping center in Decatur, Georgia. Because that lease was governed by Georgia law, it is not discussed in this article, although the court also found in that case that the liquidated damages clause was a penalty and thus, not enforceable.

the damages were incapable of estimation at the time of contracting." On the other hand, if the liquidated damages are "grossly excessive and out of all proportion to the damages that might reasonably have been expected to result from a breach, the courts will find that the provision is an unenforceable penalty." Thus, the Court determined that liquidated damages in the case at hand could be enforceable, but only if 1) the damages that would arise from a breach could not have been known at the time the Lease was entered into, and 2) the agreed upon damages were intended as an approximate estimate of the injury the Landlord would suffer due to the Tenant's default, and not as a penalty.

Applying the two prong test, the Court first found that it would been difficult, at the time the Lease was entered into, to determine the damages that would result from a breach, particularly since, in this case, the breach occurred only ten months into the 10-year term, and because the rent was calculated in part as a percentage of the Tenant's gross revenues from its business operations at the premises. However, although the first prong of the test was satisfied, the second prong was not, because the Court additionally found that the liquidated damages provided for under the Lease were not a "fair estimate of potential damages", and were "disproportionate to the damages that might have reasonably been expected to result from [the Tenant's] default," and thus were an unenforceable penalty.

The Court further stated that awarding possession to the Landlord, as well as a judgment for the remaining rental obligations, was a disincentive for the Landlord to mitigate its damages by seeking a new tenant for the premises, and so would contravene Maryland law which, the Court found, requires a party to exert such efforts.

While the Court was unwilling to award as liquidated damages a lump sum payment of all rent due for the remainder of the lease term, it instead awarded all unpaid rent that was due under the Lease during the time that the Landlord had been unable to find a new tenant for the premises.

In failing to enforce the liquidated damages clause, the Court seemed most troubled by the fact that the breach occurred during the first year of a ten year term. As a result, by the time the case went to trial, if liquidated damages were awarded, the Landlord would be able to collect more than 7 years of rent without having to show any efforts to find a replacement tenant. In such a case, the liquidated damages appear more like a windfall, than the amount required to make the Landlord whole. It seems likely that there might have been a different result if the breach had instead occurred during the 9^{th} or 10^{th} year of the 10 year term.

The good news for commercial landlords is that the Court, at least in theory, was willing to uphold such a clause, even though it was not willing to do so in the present case. And the Court's reasoning provides some guidance on how such a clause should be written to increase the odds of it actually being upheld.

Most importantly, it appears, the calculation of liquidated damages in a commercial lease should be based on something more that the amount of the remaining rent. For example, liquidated damages could be based on the future rent for only the period of time that might reasonably be required to find a new tenant for the premises (understanding, of course, that

without a crystal ball it is impossible to know with certainty what that period of time should be, although industry averages provide some guidance). But because a Court will be very reluctant to award damages that appear excessive, a clause which limits the period of time to which the liquidated damages will relate, such as 1 to 2 years, is more likely to be upheld than a clause awarding the landlord all of the rent remaining for the balance of the term. And so long as the clause is properly written, a time limitation in the liquidated damages clause won't preclude the landlord from collecting any additional rent at a later time if the space isn't relet by the end of that period (or for the deficiency if the new tenant enters into a lease for less rent than what was required to be paid by the defaulting tenant).

Additionally, including an affirmative obligation on the landlord's part to mitigate the tenant's damages by seeking a new tenant for the space, and providing that the tenant will be repaid any rent that the new tenant pays for the same period covered by the liquidated damages, will also help to convince the Court that the landlord is not being awarded a windfall. Finally, the provision should state that the liquidated damages clause has been agreed to because, at the time the lease is being executed, the parties are unable to ascertain with certainty the damages that would be incurred in the event of the tenant's breach, and that the amount provided is agreed by the parties to be a fair estimation of the landlord's damages and not a penalty.

Although there are no guarantees that a liquidated damages clause will be upheld by a court, with careful drafting a commercial landlord can at least increase the chances of such a clause being enforced.

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