

## NEW YORK COURT OF APPEALS ROUNDUP

### PERMISSIBLE DAMAGES FOLLOWING BREACH OF COMMERCIAL TENANT AGREEMENTS

WILLIAM T. RUSSELL, JR. AND LINTON MANN III\*

SIMPSON THACHER & BARTLETT LLP

December 15, 2020

In *The Trustees of Columbia University in the City of New York v. D'Agostino Supermarkets*, the Court of Appeals unanimously reaffirmed the principle that “parties are free to agree to a liquidated damages clause provided that the clause is neither unconscionable nor contrary to public policy.” However, the judges split 4-3 on the issue of whether the relevant damages clause in a commercial lease was unenforceable as a matter of law because it was so grossly disproportionate to the ascertainable amount due upon full performance.

D'Agostino Supermarkets (D'Agostino) leased commercial space from The Trustees of Columbia University (Columbia). After D'Agostino failed to make certain rent payments in a timely manner, the parties agreed to terminate the original lease and enter a separate Surrender Agreement in exchange for D'Agostino's (1) surrender of the premises and (2) staggered payment of back rent. If D'Agostino defaulted, the Surrender Agreement required that “the aggregate amount of all Fixed Rent, additional rent or other sums and charges due and payable during the term of the Lease shall immediately thereafter come due and payable by Tenant to Landlord and [ ] Tenant shall no longer be entitled to be released and relieved from and against any Released Claims.” After executing the Surrender Agreement, Columbia was able to relet the premises to a new tenant. D'Agostino subsequently failed to make all required payments under the Surrender Agreement, and Columbia sued for breach of that Agreement. Columbia filed a motion for summary judgment seeking more than \$1 million pursuant to the damages provision in the Surrender Agreement which represented the future rent payments due under the terminated lease. D'Agostino filed a cross-motion for summary judgment in which it agreed to pay the approximately \$176,000 in outstanding payments due under the Surrender Agreement and accrued interest, but argued that liquidated damages in the amount of future rent under the terminated lease are grossly disproportionate to any actual damages sustained by its breach of the Surrender Agreement. The Supreme Court denied Columbia's motion and granted D'Agostino's cross-motion. The Appellate Division, First Department affirmed, and the Court of Appeals granted leave to appeal.

On appeal, Columbia argued that the liquidated damages provision of the Surrender Agreement, which required D'Agostino to pay all the rent that would have been due under the terminated lease if D'Agostino breached the Surrender Agreement, should be enforced as written because the Surrender Agreement was a practical resolution of D'Agostino's breach of that lease. D'Agostino countered that the liquidated damages provision in the Surrender Agreement is grossly excessive.

In a majority opinion written by Judge Jenny Rivera and joined by Judges Fahey, Garcia and Feinman, the court agreed with D'Agostino that the liquidated damages provision is unenforceable and that damages should be

\* **William T. Russell, Jr.** and **Linton Mann III** are partners at *Simpson Thacher & Bartlett LLP*.

limited to those that flow from D'Agostino's breach of the Surrender Agreement rather than its breach of the terminated lease. Instead of suing D'Agostino for breach of the terminated lease, Columbia chose to enter into the Surrender Agreement terminating the lease and all prospective obligations flowing from that lease. Accordingly, the liquidated damages provision in the Surrender Agreement which required payment of amounts due under the terminated lease is an unenforceable penalty because it is plainly disproportionate to Columbia's damages under the Surrender Agreement.

According to the court, "[l]iquidated damages are 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." "Liquidated damages that constitute a penalty, however, violate public policy and are unenforceable. A provision which requires damages grossly disproportionate to the amount of actual damages provides for a penalty and is unenforceable."

As the party seeking to avoid payment of the liquidated damages, D'Agostino had the burden of establishing that the damages provision is so disproportionate to the anticipated harm to Columbia that the provision constitutes a penalty. Here, the court held that D'Agostino met that burden by showing that the damages provision effectively reinstated D'Agostino's liability for future rent payments under the terminated lease, which were not related to any actual damages flowing from the breach of the Surrender Agreement. While Columbia was entitled to seek damages flowing from the breach of the Surrender Agreement, including the full amounts for past due rent, it could not seek payment grossly disproportionate to the amount due under the Surrender Agreement. The court held that the more than \$1 million plus interest demanded by Columbia is disproportionate to the approximately \$176,000 of unpaid rent under the Surrender Agreement. The court was not willing to allow Columbia to effectively "enforce a non-existent lease under the guise of damages for a breach of a separate contract."

The dissent, in an opinion written by Chief Judge Janet DiFiore and joined by Judges Stein and Wilson, agrees with the majority that "the public policy favoring freedom of contract can be overridden by another weighty and countervailing public policy," and that liquidated damages provisions serve an important purpose allowing parties to estimate, in advance of default, the extent of the injury resulting from breach where it would be difficult to calculate an amount of actual damages. But the dissent disagrees that the public policy concerns described by the majority are sufficient to override the principle of freedom of contract and the strong public policy favoring enforcement of settlement agreements—especially as applied to this dispute between two sophisticated, counseled commercial entities.

According to the dissent, the Surrender Agreement constituted a settlement of the claims Columbia possessed upon D'Agostino's breach of the lease, including a right to collect future rent owed until conclusion of the lease term, even if D'Agostino vacated the premises. Columbia agreed to settle under terms that significantly discounted the amount it would collect on account of D'Agostino's breach, but did so because, if D'Agostino breached the Surrender Agreement it would be immediately liable for all future rent due under the lease (along with other costs) and D'Agostino would "no longer be entitled to be released and relieved from and against any Released Claim." The fact that D'Agostino would be obligated to pay far more upon breach of the Surrender Agreement than the discounted damages Columbia agreed to accept is described by the dissent as "a component of a settlement after a breach—not a liquidated damages clause crafted at the beginning of a contractual relationship."

The dissent also takes issue with the majority's conclusion that the difference between \$1 million and approximately \$176,000 is "exponentially disproportionate" under the circumstances. According to the dissent, when the parties agreed to the Surrender Agreement they understood that D'Agostino's potential liability was much greater than the value of the payments under the Surrender Agreement alone. If payment was not made

timely, the dissent believes the parties intended to compensate Columbia for D'Agostino's earlier breach of the terminated lease. When one includes the damages that would have flowed from D'Agostino's breach of the terminated lease, the liquidated damages figure is not so disproportionate as to operate as an unenforceable penalty as a matter of law.

The dissent warns that the majority's refusal to enforce the liquidated damages provision injects uncertainty into commercial tenancy agreements and the settlement of related disputes, increases the transaction costs for all involved, and discourages commercial landlords from agreeing to settlements of this nature to the detriment of defaulting tenants. The majority responds by asserting that Columbia chose to terminate the lease in exchange for a fixed damages amount and the right to re-enter the premises immediately for purposes of entering a new lease with a different tenant. In other words, the judgment requiring D'Agostino to pay the amounts owed under the Surrender Agreement allowed Columbia to realize the benefit of its bargain under the Surrender Agreement while also putting the property to its highest and best use. According to the majority, this resolution "encourages surrender agreements as providing a benefit to all parties—the tenant is released from future liability and the landowner regains the premises and the opportunity to relet on its own account. In contrast, the dissent's approach would disincentive tenants from negotiating a mutually agreeable surrender because the tenant would remain on the hook for back rent, future rent and other contractual damages without the benefit of enjoyment of the premises."

Going forward, this issue is likely to recur given the prolonged impact of COVID-19 and the economic challenges imposed on commercial tenants and landlords. Parties should review their agreements and be mindful of the court's guidance when drafting future agreements regarding the permissible damages that are expected to flow from the breach of commercial tenant agreements.

---

*This article is reprinted with permission from the December 15, 2020 issue of New York Law Journal. © 2020 ALM Media Properties, LLC. Further duplication without permission is prohibited. All rights reserved.*