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AWARD OF LIQUIDATED DAMAGES UPHeld IN A RETAIL LEASE WHERE THE TENANT IMPROPERLY DISCONTINUED OPERATIONS

In today's troubled economic climate, it is increasingly common for retail tenants to cease or suspend operations and "go dark." Even if the tenant continues to pay contract rent and common area maintenance charges, discontinuance of operations by itself will often be an actionable default if the lease contains a continuous operations clause. In just these circumstances, the California appellate court in *El Centro Mall, LLC v. Payless ShoeSource, Inc.*, 174 Cal. App. 4th 58 (May 21, 2009), upheld an award of damages to a shopping center landlord based upon a liquidated damages clause contained in the retail lease.

Background Facts

Payless entered into a commercial lease for 3,300 square feet in the landlord's shopping center. The lease contained a fairly typical continuous operations clause obligating the tenant to operate during specified hours seven days a week throughout the term of the lease. The continuous operation clause also contained a liquidated damages provision setting forth an additional daily charge equal to the greater of \$100 or 10 cents per square foot of floor area for each and every day that the tenant failed to operate in the premises (applicable after a five day grace period for the first breach). The poorly drafted liquidated damages clause expressly noted that "such additional charge is a liquidated sum representing the minimum damages which Landlord is deemed to have suffered, including damages as a result of Landlord's failure to receive Percentage Rental, if any, under this Lease..."

Due to poor sales over a prolonged period, Payless had not paid percentage rent for nearly six years. 284 days prior to expiration of the lease term, Payless ceased operations in the premises. Notwithstanding that Payless continued to pay rent and all other amounts due under the lease, Payless' closure constituted a breach of the lease's continuous operations clause. The landlord sought to collect the additional charge under the liquidated damages clause. Payless refused to pay claiming that the liquidated damages clause was an unenforceable penalty under California Civil Code Section 1671.

As stipulated by the parties, trial was based on briefs and written evidence but without live testimony. Payless contended that the liquidated damages clause was arbitrarily applied by the landlord among the shopping center's tenants and thus could not be a reasonable estimate of the potential damages at the time the lease was executed. The landlord asserted that the liquidated damages clause was properly intended to reimburse the landlord for its loss in business at the shopping center arising from Payless' discontinuance of operations. The trial court held that Payless had not overcome the presumption of validity of the liquidated damages clause and awarded \$98,000 in liquidated damages to the landlord.

Analysis of Decision

In reviewing the trial court's ruling, the appellate court noted the changes made by the legislature in 1977 amending California Civil Code Section 1671 to delete the prior presumption of invalidity of liquidated damages clauses and replacing it in most cases with a presumption of validity. Section 1671(b) currently provides as follows:

"[A] provision in a contract liquidating the damages for the breach of the contract is valid unless the party seeking to invalidate the provision establishes that the provision was unreasonable under the circumstances existing at the time the contract was made."

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The court recognized that the objective of a liquidated damages clause is to stipulate an estimate of damages so that the parties may know with reasonable certainty the extent of liability in the event of breach, *ABI, Inc. v. City of Los Angeles* (1984) 153 Cal.App3d, 669,685, and that courts apply a “reasonable endeavor test” which requires that the parties have attempted to “estimate a fair average compensation for any loss” (*Ridgely v. Topa Thrift & Loan Assn.* (1998) 17 Cal.4th 970, 977).

The subject liquidated damages clause was intended to represent “the minimum damages which the Landlord is deemed to have suffered, including as a result of Landlord’s failure to receive Percentage Rental.” The court separated its review of the clause’s application to lost percentage rental from the landlord’s other losses. As to percentage rental, the court rejected the liquidated damages clause as an invalid penalty as the lease contained a readily ascertainable separate formula for determining damages for loss of percentage rental. As to the landlord’s other losses from breach of the continuous operations clause, however, the court acknowledged the role of liquidated damages as “it is difficult to estimate the amount of damages from the loss of synergy, goodwill, and patronage accompanying the breach of the continuous operations covenant by a national tenant such as Payless...”

In support of its position that the liquidated damages clause was not a reasonable attempt to estimate future damages for breach of the continuous operations clause, Payless presented evidence regarding the absence of or inconsistent liquidated damages provisions in other leases in the shopping center. Although it observed that Payless’ evidence could give rise to an inference that the liquidated damages clause was arbitrary, the court upheld the trial court’s decision that Payless had failed to meet its burden of proof to demonstrate that the clause was not intended by the parties to be a reasonable estimate of damages and thus a penalty. The decision was thus affirmed.

Observations

Because there has been scant, if any, authority on the application of liquidated damages clauses to breaches of the continuous operations provisions in retail leases, landlords and tenants have grappled for years with the enforceability and even the desirability of such clauses in their retail leases. This case suggests that in the right circumstances even a poorly drafted liquidated damages clause can survive judicial scrutiny. As a consequence, the stakes have been raised so that landlords and tenants need to focus more carefully on the decision to include such clauses and the substance of those clauses. From the landlord’s perspective, liquidated damages may now be viewed as a viable remedy for the tenant’s closure in violation of a continuous operations provision. From the tenant’s perspective, liquidated damages may now provide some certainty as to the tenant’s potential exposure and aid the tenant in deciding whether or not to “go dark” in violation of its lease.

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