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Real Estate

CHANGING STANDARDS

WHY LANDLORDS MAY NOT HAVE TO MITIGATE DAMAGES IN COMMERCIAL LEASE LITIGATION

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Attorneys litigating commercial lease disputes in New Jersey usually assume that a landlord must mitigate its damages when a tenant breaches the lease. While that assumption is correct for residential leases, state courts have strongly suggested that commercial landlords don't have to mitigate damages if the lease clearly discharges that duty.

The state Supreme Court first held that residential landlords must mitigate their damages in Sommer v. Kridel, 74 N.J. 446 (1977). This rule was adopted to prevent "the unfairness which occurs when a landlord has no responsibility to minimize damages." Id. at 457.

Mechanically, the decision requires a residential landlord "to demonstrate whether he exercised reasonable diligence in attempting to re-let the premises." Id. A residential landlord who is found to have failed to mitigate its damages is barred from recovering damages that accrue after the date when its efforts are judged by the court to have become insufficient.

One of the earliest cases to recognize the duty of commercial landlords to mitigate their damages was Carisi v. Wax, 192 N.J. Super. 536 (Dist. Ct. 1983). In that opinion, Judge Leo Yanoff wrote that a commercial landlord has a duty to mitigate unless the "lease contains explicit language which exonerates the landlord from the rule of avoidable consequences." Id. at 542.

Yanoff reasoned that a commercial landlord should be bound by the same policies articulated by the Supreme Court in Sommer, while recognizing an exception that acknowledges the different commercial and residential business realities and the difference in sophistication between those tenants.

For example, commercial tenants are usually better able to obtain replacement tenants and better equipped to understand and negotiate lease terms. Commercial tenants are also frequently represented by attorneys and brokers. Consequently, it is fair to enforce a freely negotiated lease clause excusing a commercial landlord from mitigating its damages.

The Duty to Mitigate

Allocating the duty to mitigate to landlords is significant. Landlords must invest time and money to attract new tenants, often paying brokerage commissions and substantial fix-up costs. A survey of commercial cases

demonstrates that a court's decision regarding what constitutes "reasonable diligence" will always be based on a fact-sensitive inquiry.

In general, the cases refer to retaining brokers, advertising, posting "For Lease" signs, showing the property and putting the property in good condition for re-renting. The inquiry may be renewed each month when leases provide for monthly payments so that the court can determine whether the landlord has made the required effort to re-let the premises during the preceding month.

This approach strongly encourages landlords to make every effort to find a new tenant or risk a judge's determination that enough time has passed, or that the landlord's efforts are not satisfactory. The result could be an order terminating the tenant's obligation to pay rent and perform under the lease, including insurance, maintenance and other potentially costly obligations. In essence, tenants can use the duty to mitigate as a sword to free themselves from the often long-term obligations they voluntarily assumed.

In 1989, the Appellate Division first recognized the duty of a commercial landlord to mitigate its damages, as a matter of public policy, to prevent ""economic and physical waste." However, the court declined to decide whether the duty can be contracted away, preferring to wait for "a case in which the issue is squarely presented." Fanarjian v. Moskowitz, 237 N.J.Super 395, 405, 406 (App. Div. 1989) (citation omitted).

Notwithstanding the Appellate Division's reluctance to decide the issue in 1989, New Jersey's courts have continued to cite Carisi for the dual conclusions drawn by Judge Yanoff. In McGuire v. City of Jersey City, 125 N.J. 310, 321 (1991), the state Supreme Court cited Carisi for the proposition that a "commercial lessor has [a] duty to mitigate, at least in [the] absence of any contractual provision relieving [the] landlord of such duty."

The Supreme Court's decision to cite Carisi for the general rule requiring mitigation in commercial cases, as well as for the exception permitting the duty to be abrogated by a lease, is a clear indication that the Supreme Court considered Yanoff's conclusion to be sound. More recently, the Appellate Division cited Carisi for the same proposition. Harrison Riverside v. Eagle Affil., 309 N.J. Super. 470, 474 (App. Div. 1998). There are no published New Jersey appellate or Supreme Court decisions to the contrary.

Two federal courts have provided differing predictions about how the issue will be decided when directly presented. The Bankruptcy Court correctly followed Carisi and reached the conclusion that the duty to mitigate can be contracted away in a lease, but found that the lease language at issue in that case was not sufficient to release the landlord from its duty to mitigate. In re. Cornwall Paper Mills Co., 169 B.R. 844, 853 (Bkrtcy. D.N.J. 1994).

Conversely, in Drutman Realty Company L.P. v. Jindo Corp., 865 F. Supp. 1093 (S.D.N.Y. 1994) , the court held that a commercial lease that obviates the duty to mitigate is against the public policy of New Jersey. However, in reaching that decision, the court relied on a clearly distinguishable residential lease case, Carter v. Sandberg, 189 N.J. Super. 42 (Dist. Ct. 1983), in which a residential lease discharging the duty to mitigate was held to violate New Jersey public policy.

There is no question that the court's reliance on a residential case inherently flawed its entire analysis. The court also inexplicably pushed aside the portion of McGuire in which the Supreme Court cited Carisi for the proposition that the duty can be contracted away, weakly observing: "The court, however, did not indicate whether it agreed with the Carisi court's determination." Id., 865 F. Supp. at 1100. Clearly the court's decision was result driven, and should not be followed in New Jersey.

Two Open Questions

There are two open questions to be resolved by New Jersey appeals courts. The first is whether the state's public policy permits a landlord and tenant to agree in the lease that the landlord need not mitigate its damages in the event the tenant breaches.

The public policy rationale to prevent waste and nonuse of productive property is actually a red herring. A tenant who knows that the landlord need not mitigate its damages will be less likely to breach a lease where it has the

means to comply. Further, as discussed below, in the vast majority of cases the tenant is capable of mitigating its own damages by seeking and securing a replacement tenant. Finally, as a matter of practical reality, landlords are self-motivated to ensure that their property is kept in proper condition to preserve the value.

There is ample precedent to support the expectation that state courts will find New Jersey's public policy is not offended by a rule permitting the duty to mitigate to be abrogated by a freely negotiated commercial lease provision. The state Supreme Court has upheld leases in which commercial tenants give up constitutional protections in other contexts.

For example, in Callen v. Sherman's Inc., 92 N.J. 114 (1983) , the Court analyzed the landlord's right to distraint and the taking of the tenant's property for the satisfaction of lease obligations. The justices held that a tenant has a due process right to notice and a hearing before the deprivation, unless the lease gives the landlord the right to exercise distraint without due process.

The Court explicitly recognized that "constitutional rights may be waived in a commercial context." Id. at 137 . That principle was later cited by the Appellate Division, which recognized that a commercial landlord can re-enter leased premises and distrain a tenant's property "in accordance with the agreed-upon provisions of a mutually negotiated and private lease agreement." Liqui-Box v. Estate of Ehlman, 238 N.J. Super. 588, 600 (App. Div. 1990), cert. denied, 122 N.J. 142. It is fair to assume that commercial tenants, who can waive their constitutional rights, can relieve landlords of their duty to mitigate.

A rule permitting commercial entities to allocate the risks and benefits of their relationship and allow landlords to enjoy the benefits of their bargain, would place breaching tenants in the reasonable position of having to find replacement tenants or find the means to cure their breaches, if they want to reduce the damages they owe.

Where a lease permits a tenant the free right of assignment or sublease, or conditions such actions on the landlord's reasonable consent, the tenant is in as good or better position than the landlord to bring in a replacement tenant. More restrictive leases can be interpreted and applied by the courts on a case-by-case basis. In practice, insertion of a replacement tenant mitigates the tenant's damages, while the breaching tenant remains primarily liable on the lease in case the new tenant defaults.

This rule is consistent with the general principle that "a breaching tenant should not profit by his own breach." Liqui-Box, 238 N.J. Super at 602. This approach also removes the burden from the nonbreaching landlord, who is otherwise left to expend time and money -- often unreimbursed -- in an effort to mitigate damages caused by no fault of its own. (A persuasive argument can be made that this model should always be applied, regardless of the lease language.) Therefore, the answer to the first question is yes, New Jersey public policy permits a landlord to be relieved of its duty to mitigate damages.

The second question is the degree of specificity necessary to satisfy the Carisi rule requiring that the lease must contain "explicit language" excusing the duty to mitigate. Carisi, 192 N.J. Super. at 542. As a practical matter, every lease must be analyzed on its own terms. However, it should not be held that the duty to mitigate can only be waived if the lease actually quotes the "duty to mitigate."

Rather, the analysis should focus on what the lease terms accomplish if enforced. For example, in Cornwall Paper Mills, the court took a far too limited approach and held that the following phrase was insufficient: "The failure of landlord to re-let the premises or any parts thereof shall not release or affect Tenant's liability for damages." Cornwall Paper Mills, 169 B.R. at 853.

In fact, the practical effect of that language is the same as if the lease stated: "The landlord has no duty to mitigate its damages in the event of the tenant's default," and should have been found sufficient. An analysis devoted less to form, and more to substance, should be applied in analyzing commercial leases.

Going forward, every landlord should insert a clause in its leases that explicitly discharges its duty to mitigate. For example: "In the event of tenant's default under any provision of the lease, landlord shall have no duty to mitigate its damages by attempting to re-lease the premises, or in any other manner."

Of course, the exculpatory provision must be written to properly interact with other applicable lease provisions, including those governing the tenant's right to sub-lease or assign. A commercially reasonable approach to these leases will result in the proper allocation of the burdens caused by a commercial tenant's breach of a lease -- to the breaching tenant.

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