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DISPATCHES FROM THE TRENCHES

A LITTLE SOMETHING ABOUT LIQUIDATED DAMAGES

This issue of Dispatches from the Trenches discusses liquidated damages under true leases. A variety of factors make it difficult to assess the damages incurred by a lessor under a true lease in the event of a lessee's default. As such, it is common for some lease forms to rely on a stipulated loss value table to calculate the lessor's damages. Other lease forms instead rely on a formula which generally provides the manner in which a lessor will calculate damages. These provisions, called "liquidated damages clauses," are generally enforceable. However, as is usually the case with legal rules, there is some complexity.

A common liquidated damages clause allows the lessor to recover for losses of the following: (1) the remaining rents that would have been paid by the lessee but for the default; (2) the residual value of the leased equipment that would have been realized by the lessor at the end of the term; (3) the various tax benefits that the lessor has lost due to the default and the termination of the lease; and (4) incidental damages, such as legal fees. Historically, the enforceability of these clauses has been a gray area of the law since courts were forced to rely on a variety of poorly coordinate laws and theories to shed light the enforcement of such clauses-- such as real estate law, bailments, general contract law principles, Article 2 of the UCC (which governs sales) and Article 9 of the UCC (which governs secured transactions). The results were varied and inconsistent.

When drafting Article 2A of the Uniform Commercial Code (the "UCC"), relating to true leases, the National Conference of Commissioners on Uniform States Laws underscored

the importance of such clauses within official comments to Article 2A stating: "[m]any leasing transactions are predicated on the parties' ability to agree to an appropriate amount of damages or formula for damages in the event of default or other act or omission." UCC, §2A-504, Official Comment. More importantly, the drafters added several specific statutory provisions which attempt to clarify the landscape and provide greater certainty with respect to the enforceability of such clauses. The Official Comments to these sections also provide substantial guidance.

Article 2A begins by specifically authorizing the use of liquidated damages clauses in leasing contracts, stating that "[d]amages payable by either party for default, or any other act or omission, including indemnity for loss or diminution of anticipated tax benefits or loss or damage to lessor's residual interest, may be liquidated in the lease agreement . . ." UCC §2A-504(1). However, Article 2A continues by noting that damages may only be liquidated if the amount or formula is "reasonable in light of the then anticipated harm caused by the default or other act or omission." *Id.*

The Official Commentary highlights the fact that the requirement of reasonableness is the driving determinant, noting that whether a liquidated damages clause is enforceable "will be determined in the context of each case by applying a standard of reasonableness in light of the harm anticipated when the formula was agreed to." UCC §2A-504, Official Comment. Indeed, certain requirements previously used under state common law are explicitly inapplicable to leases governed by Article 2A. For example, under the common law in many states, a liquidated damages clause would only be enforceable if the injury caused by the breach was hard to calculate. A similar but distinct requirement under the common law of many states is that it must be inconvenient or infeasible to otherwise obtain an adequate remedy. The Official Comment to §2A-504 explicitly states that such tests are not incorporated into, and were intentionally left out of, Article 2A.

The Official Comments are quite helpful in other ways too and even go so far as to provide examples of common formulae used in the leasing industry, stating:

A liquidated damages formula that is common in leasing practice provides that the sum of lease payments past due, accelerated future lease

payments, and the lessor's estimated residual interest, less the net proceeds of disposition (whether by sale or re-lease) of the leased goods is the lessor's damages. Tax indemnities, costs, interest and attorney's fees are also added to determine the lessor's damages. . . . A third formula provides for a fixed number of periodic payments as a means of liquidating damages. Stipulated loss or stipulated damage schedules are also common. UCC §2A-504.

Article 2A of the UCC provides default and remedy provisions in case the parties to a lease neglect to include a liquidated damages clause or chose to rely solely on the provisions of Article 2A. UCC §2A-501, et seq. These provisions will also be available to a lessor whose contractual liquidated damages clause is invalidated as an unenforceable penalty. UCC §2A-504(2). The damages allowed under these provisions is similar to what most lessors would describe in their lease forms. UCC §2A-528(1). Nonetheless, to the extent this formula is "inadequate to put a lessor in as good a position as performance would have, the measure of damages is the present value of the profit, including reasonable overhead, the lessor would have made from full performance by the lessee, together with incidental damages. . . ." UCC §2A-528(2).

Courts analyzing liquidated damages clauses under Article 2A have generally upheld the clauses as long as the lessor would not be put in a better position than it would have been had the lease been fully performed.

For example, In *In re Baldwin Rental Centers, Inc.*, the relevant damages clause allowed the lessor to recover (1) any accrued, unpaid rent at the time of the breach, plus (2) the present value of the rent for the remainder of the lease term, plus (3) the residual value of the equipment, minus (4) the present value of the net proceeds resulting from the disposition of the equipment. 228 B.R. 504, 509 (Bankruptcy Ct. S.D. Ga, 1998). The lessee tried to invalidate the clause by arguing that it included the residual value of the equipment, which the lessee was never obligated to pay under the lease. The court disagreed, noting that, had the lease been fully performed, the lessor would have been entitled to possession of the equipment at the end of the lease and could have sold the equipment to the lessee or a third party. The court then calculated the amount the lessor would have received under that scenario and noted that it was the exact same amount that

the lessor was claiming under the liquidated damages clause. The court also noted that "further evidence that the liquidated damages provision is contained in the leases is reasonable is the fact that it is just such a provision contemplated by the drafters of section 2A-504."

However, on the other side of the spectrum, are cases where the liquidated damages clauses are designed to return to the lessor *more than it would have received* had the lessee fully performed its obligations under the lease.

A classic example is *Carter v. Tokai Financial Services*, where the damages clause entitled the lessor to: (a) recover (i) the present value of all future rent discounted to a rate equal to the current discount rate of the Federal Bank of San Francisco plus one percent, plus (ii) the present value of the equipment's fair market value discounted at the same discount rate, plus (iii) the amount of any loss or reduction of tax benefits, and (b) sell the repossessed equipment *without any duty to account to the lessee for any proceeds with respect to the sale*. 500 S.E.2d at 641. The court correctly held that this formula would place the lessor in a better position than it would have received had the lease been fully performed because the lessor would receive all money that would be due under the lease while the lessee possessed the equipment and would have the benefit of the leased property and any funds it could receive by re-selling or re-leasing it. In other words, the damages clause allowed the lessor to "double-dip" and was therefore invalid.

In the often cited case of *In re Montgomery Ward Holding Corp*, the lessor offered a low rental rate to obtain the lessee's business in a competitive market, gambling that the lessee would renew the lease at a rate which would have allowed the lessor to realize a substantial profit over the course of the renewal term. 326 F.3d 383 (3rd Cir. Apr. 24, 2003). Unfortunately for the lessor, the gamble did not pay off and the lessee ended up in bankruptcy. When the lessee rejected the lease pursuant to its statutory rights under §365 of the Bankruptcy Code, the lessor sued for damages pursuant to a liquidated damages clause that relied on an casualty value table attached to the lease. According to testimony at trial, that table was based on a formula to compensate the lessor for: (a) the present value of unpaid rent through the term of the lease; (b) the present value of the residual value of the equipment; and (3) an amount allowing the lessor to realize a profit. This

"profit" element was based on the assumption that the lessee would either purchase the equipment or renew the lease rather than elect to simply return the equipment. The anticipated value of the equipment at the end of the term was substantially less than the amount the lessor would have received pursuant to a renewal or purchase by the lessee---it was through this renewal and purchase that the lessor would have received its intended-profit. Since the lessee had the option to return the equipment, lessor was not entitled to receive this profit and the court would not allow it to use the liquidated damages clause to collect under a default scenario "what it hoped to gain-but had no assurance of obtaining-from the transaction, rather than its demonstrable damages measured by what [the lessee] had the absolute right to do at the end of the lease term: to return rather than to buy, or continue to lease, the equipment." *Id.*

Despite the complexity of liquidated damages clauses and the patchwork of cases on this issue, Article 2A has greatly clarified the landscape and the basic underlying rule is straightforward and simple: *If the liquidated damages clause allows the lessor to receive a greater amount than the lessor would have received if the lessee fully performed its required obligations under the lease, than the clause is unenforceable as a penalty.*

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