

MARKS & WEINBERG, P.C.

DISPATCHES FROM THE TRENCHES

DAMAGES AND INDEMNITIES: FAIR AND CLEAR

This edition of *Dispatches from the Trenches* discusses recent cases analyzing liquidated damages and indemnity provisions.

National City Healthcare Finance v. Refine 360, LLC, 607 F.Supp. 2d 881 (N. Dist., IL, 2009)

Previous issues of *Dispatches from the Trenches* have discussed liquidated damages provisions and their enforceability. The National Conference of Commissioners on Uniform State Laws (sometimes referred to as NCCUSL) has underscored the importance of liquidated damages provisions on many occasions. Indeed, the official comments to Article 2A of the Uniform Commercial Code, governing true leases, state that “many 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. However, Article 2A also notes that damages may only be liquidated if the amount or formula is “reasonable in light of the anticipated harm caused by the default or other act or omission.” *Id.*

Courts analyzing liquidated damages clauses under Article 2A have generally upheld the clauses as long as such provisions do not place the lessor in a better position than it would have had the lease been fully performed. See *In re Baldwin Rental Centers, Inc.*, 228 B.R. 504, 509 (Bankruptcy Ct. S.D. Ga, 1998) (court upheld liquidate damages provision); *But see Carter v. Tokai Financial Services*, 500 S.E.2d at 641 (court invalidated liquidated damages provision which did not require lessor to account to lessee with respect to any proceeds of its sale of the leased equipment even if lessee had paid discounted present value of rents and residual).

The recent case of *National City Healthcare Finance v. Refine 360, LLC* sounds another loud alarm for any lessors drafting their liquidated damages provisions in such a manner as to provide a windfall upon the occurrence of an Event of Default. In the case at bar, the applicable damages provision did not provide for a discounting of damages to present value and the Court reacted strongly. According to the Court:

It takes no more than a rudimentary understanding of the concept of the damages flowing from a lessee’s breach which has triggered the premature termination of a lease, to recognize that the lessor’s consequential entitlement is the sum of (1) any past due rents plus (2) the *present value* of the future installments of lease prescribed rent up to end of the lease term plus (3) the *present value* of the anticipated fair market value of the leased property at the end of the lease term

(when it would have reverted to the lessor in the ordinary course), *minus (4) the current value of the lease property, which has been recaptured prematurely by the lessor reason of the lease termination* 607 F.Supp.2d at 881 (italics added for emphasis).

The Court criticized the formula used by the lessor in the case at bar noting that it does not properly discount future rents and residual to present value, thereby making the provision “a prototypical penalty provision of the type that, to this Court’s knowledge, no Court will enforce.” *Id.* 882. The Court also noted that the formula is missing the credit to which a lessee would be entitled based on the amount of value the lessor realized from the equipment returned early.

No doubt, many of the readers of *Dispatches from the Trenches* have been asked from time to time by lessees to add language to the remedies section of lease documents clarifying that, notwithstanding the cumulative nature of the remedies, the lessor is not entitled to a double recovery. Having a provision which requires the lessor to subtract from liquidated damages any amount the lessor receives from disposing of the leased equipment after default also addresses this issue. It does not appear that the lease in this case had “no double recovery” language, or at least the Court did not mention any.

The Court took a strong stand against the liquidated damage provisions in the current lease stating that “this Court has consistently held in the same context of the equipment lease damage provisions such as that prescribed by [the lease in question] constitute penalties and are hence unenforceable.”

Interesting, the Court misapplied the common law requirement that damages need to be difficult to ascertain, stating:

To be valid under Illinois law, a liquidation of damages must be a reasonable estimate at the time of contracting of the likely damages from breach *and the need for estimation at that time must be shown by reference to the likely difficulty of measuring the actual damages from a breach of contract after the breach occurs.* If damages would be easy to determine then, or if the estimate greatly exceeds a reasonable upper estimate of what the damages are likely to be, it is a penalty. *Id.* (quoting *Lake River Corp. v. Carborundum Co.*, 769 F.2D 1284 (7th Cir. 10985))

The Official Comments to §2A-504 explicitly reject state common law requirements that liquidated damages clauses be enforceable only if the injury caused by the breach was hard to calculate. On the contrary, the Official Comments explicitly state that such tests was not incorporated into, and was intentionally left out of, Article 2A of the UCC. It is conceivable that the underlying transaction described as a lease was, in actuality, a secured loan or leased intended as security governed by Article 9 of the UCC. However, made no such claim and its failure to do so, coupled with the inclusion of a residual value in the damages provision, both indicate that the Court was analyzing the enforceability of damages in true leases governed by Article 2A.

In any event, the Court’s anger was clear and unmistakable. After denying the lessor’s motion as currently tendered and demanding that the lessor revise the motion with a proper calculation of damages, the Court warned all readers that being over-aggressive with damages may end up resulting in additional penalties for the lessor. The Court noted that in most cases, a lessor who has an unenforceable liquidated damages provision is simply relegated to a recovery of its actual damages. The Court stated:

In candor, that seems an inadequate outcome in a case such as this one, where actual damages are readily ascertainable (something that is often not the case where a party seeks to substitute their liquidated damages provision that it hopes is reasonable and hence enforceable). If a lessor such as [this one] has the prerogative to insert a clearly overblown damages provision, comfortable in the knowledge that its invalidation will simply put the lessor back in the situation that it would have occupied in the absence of that provision, every incentive for a lessor to prepare a reasonable contractual provision vanishes. *Id.* 889.

The Court continued by saying that, although it had not arrived at a definitive solution to the motivation problem, it would hold that an invalidation of a liquidated damages provision also invalidates the provision, often found in the remedies section of leases, that allows the lessor to recover attorneys' fees that it incurs when enforcing its rights against lessees.

In any event, the moral is clear, make sure your liquidated damages provisions are fair, discount future amounts to present value and are not overly aggressive in other respects.

Midwest Concrete Placement, Inc. v. L & S Basements, Inc., 2009 US Dist. Lexis 37351 (Dist. Ct. Kansas, 2009)

Cases regarding indemnification provisions have appeared in various editions of *Dispatches in the Trenches* over the years and lessors have been warned that the safest course of action is to make sure their indemnity provisions expressly require lessees to indemnify the lessor for its own negligence. As has been mentioned, the failure to do so may provide the lessee with an outlet in the event an injured third party alleges that the injuries were caused by the negligence of the lessor. Unfortunately, such claims are sometimes alleged as injured parties have argued that a lessor was liable for failing to inspect the equipment and discover defects likely to cause injury; for failing to deliver operating manuals to the lessee; or for failing to warn a lessee of equipment defects of which the lessor knew or should have known.

The case of *Midwest Concrete Placement) v. L & S Basements, Inc.* echoes these warnings. In that case, L&S was in the business of pouring concrete and would frequently rent concrete pump trucks as needed for Midwest. L&S has leased concrete trucks from Midwest from time to time for years and the procedure always involved the execution of a job ticket which was signed on the front and had various terms and conditions on the back, including a very broadly worded indemnity which specifically required L&S to indemnify and hold Midwest harmless from any injury, liability or death of a workman or other persons and any loss or damaged property whether the liability, loss or damages is caused by or rises out of the negligence of Midwest Concrete Placement, Inc. employees or otherwise. *Id.* at 4.

When the truck was being used by L&S, it malfunctioned and injured James Beard. Mr. Beard promptly sued Midwest, alleging negligence in failing to properly maintain the equipment. Midwest settled with Mr. Beard and then brought a third party claim against L&S under the indemnification provisions of the lease.

L&S attempted to avoid its indemnity obligations by arguing that there was no meeting of the minds and that the indemnity provision was unconscionable and void for public policy. Addressing the meeting of the minds argument, the Court noted that a party to a contract is presumed to have read and understood the terms of that contract even if the provisions were on

the back; particularly, in cases, like the current one where the front page clearly indicates that there were additional terms on the reverse side.

The Court also expressed the same general requirements of indemnification provisions previously discussed in *Dispatches from the Trenches* stating that:

The general rule is that private contracts exculpating one from the consequences of his own acts are looked upon with disfavor by the Court and will be enforced only when there is no vast disparity in the bargaining power between the parties and the intention to do so is expressed and clear in the unequivocal language. However, so long as none of the parties involved were neophytes or babes in the brambles of the business world, the Court will eschew declaring that voluntarily entered into indemnification agreements or void. *Id* 23.

In this case, the Court held that neither L&S nor Midwest were öbabes in the bramble of the business worldö and that the indemnification provision provided clear and unequivocal language that L&S would be liable for Midwest's negligent failure to maintain the equipment. As such, Midwest was able to collect from L&S under the indemnity provided by the contract.

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