

ACCELERATION OF DAMAGE CLAUSES: CRITICAL CHOICES IN LEASE ENFORCEMENT

By Anthony L. Lamm

Although most lease contracts contain some provision for the acceleration of rental payments in the event of a lessee's default, the question has often been raised as to the validity of these clauses. Are they actually enforceable and if so, when. The answer to this question revolves significantly around the way in which the lessor chooses to proceed in the event of the default.

To Repossess or not to Repossess

When a lessee defaults on a lease obligation, one of the critical decisions for a lessor is whether to repossess the equipment covered by the lease. The reason this decision is critical focuses on the impact it will have on the damages that the lessor can recover in terms of their ability to accelerate the balance of rental payments due under the remaining term of the lease measured from the date of the actual default.

If the lessor does repossess the equipment then, the lessor will be entitled to sue for the remaining balance of the lease payments due under the lease and recover the sum of those payments (discounted to present value) if the lessor holds the equipment for the lessee for the remaining term of the lease agreement. 2A529(b). With the same result, if the lessee retains possession of the equipment, an action for the full, unpaid rent (discounted to present value) is available as to goods not lost or damaged. 2A 529(a)(1)(ii). Under Article 2A 529(a)(2)(ii), the same result is also true if the lessee returns possession of the goods to the lessor and the lessor is or apparently will be unable to dispose of them at a reasonable price after a reasonable effort.

The reason the statute contains the requirement that the lessor repossess and hold the equipment or be unable to repossess the equipment from the lessee before the lessor has the right to recover from the lessee the full rent for the remaining term of the lease (discounted to present

value) is because of the expectation that the lessor will realize upon its residual interest in the equipment at the end of the lease term by sale or re-lease. See, Uniform Commercial Code Comment, 2A-529.

Mitigation of Damages

It is apparent then that the law then does not sanction the recovery as damages from the lessee of the full, unpaid balance of the remaining lease payments due under the terms of the lease (discounted to present value) unless the equipment has been repossessed and held for the entire remaining term of the lease agreement or can not be repossessed from the lessee.

Another way of saying this is that the law recognizes a non-breaching party's duty or obligation to mitigate damages that is co-existent with the right to accelerate the rental due for the remaining months of the term of a lease agreement. See, *Fairfield Lease Corp. v. 717 Pharmacy, Inc.*, N.Y. City Civ. Ct., 441 N.Y. S.2d 621 (1981). The general rule on mitigation of damages is that a party has "the active duty of making reasonable exertions to render the injury as light as possible," *Hamilton v. McPherson*, 28 N.Y. 72, 76-77 (1863) and that "no recovery may be had for losses which the person injured might have prevented by reasonable efforts and expenditures," *Mayes Company, Inc. v. State of New York*, 18 N.Y. 2d 549, 554, 277 N.Y. S.2d 881(1966); Williston on Contracts, 3rd Edition, Section 11: 174-181.

Must Identify as an Attempt to Collect Liquidated Damages

However, acceleration clauses are valid in cases where the only obligation is the payment of money, such as a loan transaction. See, *Matter of Merwin v. Willoughby Co.*, 206 Fed. 116(N.D. N.Y. 1913); *Fairfield Lease Corp. v. Marsi Dress Corp.*, 60 Misc.2d 363, 303 N.Y. S.2n 179 (Civ. Ct., N.Y. Co., 1969). On the other hand, if lessor has not made reasonable efforts to minimize its loss, courts have denied summary judgment in actions brought by lessors to recover accelerated rental payments because of lessee's breach. *A.M.F., Incorporated v.*

Cattalani, 430 N.Y. S.2d 731, 77 A.2d 779 (4th Dept. 1980); Chemical Bank v. Queen Wire and Nail, Inc., 75 A.D. 2d 999, 429 N.Y. S.2nd 100 (4th Dept. 1980).

Upon a breach in payment by the lessee, lessors need to know that accelerating the balance of the payments remaining to be paid over the term of the lease agreement is viewed by the courts as an attempt to recover liquidated damages. This identification is important since courts will only enforce liquidated damages clauses as recoverable damages if they represent a sum that reflects an agreement by the parties, which was arrived at by a good-faith effort to estimate in advance the actual damages that will probably ensue from the breach. On the other hand, if the liquidated damages clause merely represents a "penalty" because the clause is not a preestimate of probable damages and is in the form of a punishment designed to prevent breach, the clause will not be enforced. Commonwealth Dept. of Environmental Resources v. Hartford Acc. and Indem. Co., 40 Pa. Cmwlth. 133, 396 A.2d 885 (Pa. Cmwlth. 1979). A penalty provision will be held unenforceable even if parties of equal bargaining power, negotiating at arms length, agreed to the penalty provision in good faith. Restatement of Contracts 2d, § 356 comment: Robbins Motor Transport, Inc. v. Associated Rigging & Hauling Corp., 944 F. Supp. 409 (E.D. PA 1996).

Therefore, the measure of the damages in the formula called an "acceleration clause" defines whether a court will enforce the attempted recovery of the agreed upon damages. Electrical Products Consolidated v. Sweet, 83 F.2d 6 (C.A. 10th, 1936), held that the lessor of preconstructed and maintained neon advertising signs was entitled to repossess signs and declare the balance of rentals due but recover only actual damages for the breach thereof after repossession of the signs. In defining actual damages, the Circuit Judge maintained the long settled view in assessment of damages for breach of contract that the injured party is entitled to the benefit of his bargain; citing Section 329 The Restatement of Contracts wherein in it is stated: "Where a right of action for breach exists, compensatory damages will be given for the net amount of the losses caused and gains prevented by the defendant's breach, in excess of savings made possible...." The Comment to that section, however, goes farther in discussing the measure of damages for a breach of full performance of a contract and states that the value of the completed, full performance of the contract (e.g., the accelerated rental payments due under the

term of a lease agreement) is one of "the chief elements in fixing the amount that may be recovered as damages. The difference between this value and the cost of the plaintiff's own performance, if the latter is the lesser sum, is a profit to which the plaintiff practically always has a right as a part of the damages." Specifically, the Court in *Sweet Id.* held that "the measure of damages is the cash value of those agreements (leases) less whatever savings accrues to lessor from the breach. " (explanation supplied) *Id.* at 5. "To arrive at the actual damages in these cases, the unpaid balances should be used as a basis" *Id.* at 6.

The Uniform Commercial Code's Comment to 2A 504 "Liquidated Damages" states that, "A liquidated damages formula that is common in leasing practice provides that the sum of lease payment 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...and "Whether these formulas are 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."

Conclusion

Through the analysis of the common law interpreting acceleration clauses as liquidation damage provisions, my observation is that the Article 2A formula does not arrive at actual damages because it overlooks the lessor's savings following the breach by a lessee and, therefore, does not represent a net profit formula although it does anticipate a cash value. To be enforceable in court, further allowance should be made for insurance, taxes, unearned interest and administrative savings. For this reason, even under the UCC's Article 2A § 528(b) benefit of the bargain measure of damages exception (i.e. the present value of the lessor's profit), an acceleration clause could be held unenforceable because the formula does not include savings by lessor as a result of a breach by the lessee. In practical terms, the drafting of the remedies section of a lease agreement should recognize both the lessor's obligations under Sections 527 and 528 of Article 2A of the UCC and, in addition, the obligation to mitigate damages and pre-estimate actual damages with commutation of deferred rentals to a cash basis, application of

proceeds from the disposition of goods reclaimed on an averaged basis and diminution of unperformed service, unearned interest and unpaid taxes and insurance.

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