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Ensuring Enforceability of Liquidated-Damages Provisions

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Liquidated-damages provisions of agreements set forth in advance the amount of damages the breaching party must pay in the event of a breach. These provisions are intended to avoid often costly and lengthy litigation precipitated by a contractual breach. The enforceability of these provisions, which is a question of state law, is frequently challenged in bankruptcy cases and other forums. This article discusses bankruptcy cases in which the liquidated-damages provision was deemed enforceable and other cases where the court found such a provision unenforceable, and highlights key takeaways and best practices for protecting liquidated-damages clauses from invalidation.

Cases Enforcing Liquidating-Damages Provisions

In March 2019, the U.S. Bankruptcy Court for the Southern District of New York upheld a liquidated-damages clause in a mortgage loan agreement that entitled the lender to recover a yield-maintenance (make-whole) default premium in the event of post-default payment of the debt.[2] The yield-maintenance premium totaled approximately $3.1 million of the lender's total claim against the debtor of approximately $32 million.[3]

The court found that the debtor failed to satisfy its burden of proof to demonstrate that the provision was unenforceable under New York law.[4] The debtor was required to show "either that the damages flowing from prepayment were readily ascertainable at the time the parties entered into the [agreement] or the [liquidated damages were] 'conspicuously disproportionate' to the lender's foreseeable losses."[5] To its detriment, the debtor relegated its argument, which was "bereft of any legal or factual analysis," to a footnote.[6]

The same month that the *1141 Realty Owner LLC* decision was rendered, the U.S. District Court for the Western District of Pennsylvania in *rue21 Inc. v. Los Lunas Investors LLC* affirmed part of a bankruptcy court order enforcing a liquidated-damages clause in a commercial retail space lease.[7] The agreement allowed the debtor tenant to recover more than 25 months' worth of rent abatement as a result of the landlord's delivery of the space 84 days late.[8] The lease was governed by New Mexico law.[9] Courts applying New Mexico law will only deny a party bargained-for liquidated damages if "the stipulated amount is so extravagant or disproportionate as to show fraud, mistake or oppression."[10]

The bankruptcy court found no proof of fraud or oppression.[11] The fact that the liquidated-damages clause did not change from the letter of intent to the final lease agreement, which was executed a year later, indicated lack of a mistake.[12] The court also agreed with the bankruptcy court that the damages were not "'grossly disproportionate' because the amount of damages was based on a credit for each day ... which was in the control of [the landlord]."[13]

Default interest rate clauses in loan agreements are also viewed as liquidated-damages provisions.[14] In *Kimbrell Realty*, a court applying Illinois law

1 This article represents the views of the author, and such views should not necessarily be imputed to Simmons Legal PLLC or its respective affiliates and clients.
2 *In re 1141 Realty Owner LLC*, Case No. 18-12341 (SMB), 598 B.R. 534, 537, at *1 (Bankr. S.D.N.Y. 2019).
3 *Id.*
4 *Id.* at 541-42.
5 *See id.* at 541 (citation omitted).
6 *See id.* at 542.
7 18-CV-715, 2019 WL 1375405, at *1 (W.D. Pa. March 27, 2019) (affirming in part and reversing in part lower court's decision).
8 *Id.* at *4.
9 *Id.* at *3.
10 *See id.* (internal citation omitted).
11 *See id.* at *4.
12 *See id.*
13 *See id.*
14 *See, e.g., Kimbrell Realty/Jeth Court LLC v. Fed. Nat'l Mortg. Ass'n (In re Kimbrell Realty/Jeth Court LLC)*, 483 B.R. 679, 690 (Bankr. C.D. Ill. 2012).

found a default interest rate bump of 4 percent under a mortgage loan to be reasonable under the circumstances.[15] Under Illinois law, a "liquidated-damages clause is enforceable if the damages are reasonable in light of the anticipated loss and if the actual damages would be uncertain in amount and difficult to prove."[16] Further, Illinois's highest court previously found a default interest rate bump to be reasonable where "(1) the additional amount was not for a fixed sum; (2) the default interest was computed only from the date of the breach and not before; (3) the default interest was charged only for the duration of the default; and (4) actual damages would be uncertain and difficult to ascertain or prove."[17]

The default interest of a 4 percent increase was within the range of rates approved by Illinois courts in the past; the interest was computed from the date of default or acceleration, and because the amount of default interest decreased as the principal balance decreased, it bore relation to the potential loss.[18] As added protection, the mortgage note contained an express acknowledgment:

> (1) that a payment default would "cause Lender to incur additional expenses in servicing and processing the Loan,"
> (2) that "Lender will incur additional costs and expenses arising from its loss of the use of the money due,"
> (3) that "it is extremely difficult and impractical to determine those additional costs and expenses,"
> (4) that "during the time that any monthly installment or other payment due under this Note is delinquent for more than 30 days, Lender's risk of nonpayment of this Note will be materially increased and Lender is entitled to be compensated for such increased risk," and
> (5) that Borrower agrees that the 4 percent increase represents a "fair and reasonable estimate ... of the additional costs and expenses Lender will incur by reason of the Borrower's delinquent payment and the additional compensation Lender is entitled to receive for the increased risks of nonpayment associated with a delinquent loan."[19]

In *Madison 92nd Street Associates*, the debtor, who challenged a 5 percent prepayment premium governed by New York law, failed to satisfy its burden to prove that at the time of contract formation damages were not difficult to determine and that the 5 percent premium was disproportionate to the anticipated loss.[20] The court noted that the premium was designed to compensate the lender for future changes in interest rates and that such rates were not ascertainable at the time of contracting.[21]

Applying Arizona law, the U.S. Bankruptcy Court for the District of Missouri in *In re Vantage Investments Inc.* allowed a national hotel chain's recovery of liquidated damages for a hotel's continued use of the chain's logos and trademarks after the termination of a membership agreement with the chain.[22] The per-day damages amount was calculated by multiplying 15 percent of the hotel's mean room rate by the number of rooms available for rent in the hotel.[23] The court found that the damages amount, which was a percentage of the breaching party's potential daily revenues, was not unreasonable given that the breaching party's "revenues [were] enhanced by its ability to hold itself out as affiliated with a [national hotel chain]."[24] Further, the court reasoned that the damage to the national hotel chain's reputation resulting from the breach, at the time of contracting, was very difficult to estimate.[25]

Cases Deeming Liquidated-Damages Provisions as Unenforceable

In *In re Republic Airways Holdings Inc.*, the court recently concluded that liquidated-damages clauses in aircraft leases were unenforceable penalties.[26] In this case, the parties on the lessor side of the aircraft-lease transaction (collectively, the "lessor") filed claims totaling more than $55 million against Shuttle America Corp. (the lessee under the aircraft leases) and Republic Airways Holdings Inc. (the debtors), which guaranteed the lessee obligations under the leases.[27] The debtors objected to the claims, asserting that the lessor's actual losses were only $5.7 million.[28] The lessor claimed that the claims included more than $50 million in liquidated damages.

Pursuant to the leases, upon an event of default, the lessor could request a return of the aircraft and demand payment of unpaid overdue rent, plus an added amount that was designed to provide the lessor a 4 percent return on its investment in the aircraft.[29] Thus, the liquidated-damages amount functioned only to safeguard the lessor against investment risk and was not correlated with the nature and extent of any foreseeable breach of the terms of the leases.[30]

The leases were governed by New York law, which requires (among other things) that liquidated damages be "reasonable in light of the then anticipated harm caused by the default."[31] What is reasonable is determined by assessing what the parties could estimate as a potential loss at the time the agreement was entered into rather than at the time of breach.[32] Further, an amount that is "plainly disproportionate to the probable loss" is an unenforceable penalty that violates New York public policy.[33]

The lessor calculated the liquidated-damages amount using the stipulated loss value of each aircraft. The court found that the stipulated loss values of the aircraft under the leases were 47-115 times greater than the remaining unpaid rent obligations under the leases.[34] Citing prior decisions, the court refused to uphold the provision because, among other reasons, "'[t]he unreasonable nature of the clause [was] well illustrated by [a comparison of] the Debtors' cash cost of performing under the Leases' versus the liability under the liquidated-damages clause."[35]

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15 *See id. Cf. In re Charles St. African Methodist Episcopal Church of Boston*, 481 B.R. 1, 10-12 (Bankr. D. Mass. 2012) (finding 18 percent default rate of interest an unenforceable penalty under Massachusetts law).
16 *See Kimbrell Realty/Jeth Court LLC*, 483 B.R. at 690.
17 *Id.*
18 *Id.* at 690-91.
19 *Id.* at 689.
20 *See In re Madison 92nd St. Assocs. LLC*, 472 B.R. 189, 197 (Bankr. S.D.N.Y. 2012).
21 *See id.*
22 328 B.R. 137, 144-45 (Bankr. W.D. Mo. 2005).
23 *Id.* at 144-45.
24 *Id.* at 145.
25 *Id.* at 144.
26 *See In re Republic Airways Holdings Inc.*, 598 B.R. 118, 134-35 (Bankr. S.D.N.Y. 2019).
27 *Id.* at 126-27.
28 *Id.* at 127.
29 *Id.* at 133.
30 *See id.*
31 *Id.* at 131 (internal quotations omitted).
32 *See id.*
33 *See id.* at 129-30 (internal citation omitted).
34 *Id.* at 135-36.
35 *See id.* at 137 (quoting *In re Nw. Airlines Corp.*, 393 B.R. 352, 356 (Bankr. S.D.N.Y. 2008)).

The debtor that guaranteed the lease obligations was likewise relieved of the obligation to pay what was deemed a penalty in violation of public policy.[36] The fact that sophisticated parties were on both sides of the lease transaction did not save the provision from invalidation.[37]

In *In re WM Distribution Inc.*, the creditor sought to enforce a claim for $600,000 in liquidated damages for the debtor's default on a $1.3 million promissory note.[38] The note provided that liquidated damages would be payable upon (1) the dissolution, liquidation or reorganization of, or appointment of a receiver over, the debtor and the other maker of the promissory note; or (2) an inability of the debtor or the other maker of the promissory note to pay its debts as they became due or in the ordinary course of business.[39]

If the liquidated-damages amount functions as a punishment rather than reasonable compensation for anticipated losses resulting from a specific breach, it is an unenforceable penalty.[40] Applying New Mexico law, the court found the $600,000 liquidated-damages amount to be an unreasonable penalty.[41] In its analysis, the court expounded that the debtor's "damages arising from nonpayment of the Note other than attorney's fees and costs of collection (*i.e.*, failure to pay the amounts due on the schedule provided in the note) are readily ascertainable and can be determined [by] adding accrued interest to the unpaid principal balance."[42]

The court's decision in *In re Exemplar Manufacturing* illustrates the proposition that liquidated damages must bear a relation to the anticipated losses flowing from a breach.[43] In this case, the agreement provided for liquidated damages of $16,667 per day for each day that the breaching party failed to complete performance by a date certain.[44] The damages amount was based on an unsubstantiated anticipated monthly loss amount of $500,000.[45] Upon review of the evidence by the court, it was determined that the actual anticipated monthly and daily losses resulting from delay in performance were $103,333.33 and $3,444.44, respectively.[46] The unreasonably high amount of $16,667 per day in liquidated damages was unenforceable because it was in contravention of the Michigan state law principle that a party is entitled to compensation that is "just" in light of the injuries resulting from a breach.[47]

Key Takeaways and Best Practices

As the cases discussed have demonstrated, the sophistication of the parties will not save a liquidated-damages clause that is against public policy. Thus, safeguarding against a challenge to the recovery of bargained-for liquidated damages is key.

The first step in drafting an enforceable liquidated-damages clause is an analysis of applicable state law, including common law regarding the appropriate standard for evaluating liquidated damages. The nature of the transaction will determine whether damages are easily ascertainable at the time of contracting. In addition, the transaction's nature, the parties' business relationship, and the extent and type of breach must be considered in setting the liquidated-damages amount and/or the formula for calculating the amount. A sum that is not tied to anticipated losses will most likely not be enforceable, nor will a large amount that is designed more to deter a breach versus compensate for the estimated loss resulting from a breach. Damages related to debt and lease obligations should also decline over time during the course of the performance of payment obligations under the agreement.

As added protection, the parties should include an acknowledgment in the liquidated-damages clause that states that "the parties agree that upon a [certain type of] default under the agreement, the default will cause [the nonbreaching party] losses that are very difficult at the time of execution of the agreement to quantify," and that the "parties further agree and acknowledge that in consideration of the nature of the transaction and the type of loss resulting from the [certain type of] default, the sum [or damages calculation formula] included in the agreement is a reasonable estimation of damages flowing from the default and is not a penalty." Also, in certain jurisdictions the agreement must provide that a payment of the liquidated damages is the party's sole and exclusive monetary remedy.[48]

Lastly, should a court decline to enforce a liquidated-damages provision, all is not lost. Although the court will not rewrite the parties' agreement to reform an improper liquidated-damages clause, the court will allow the aggrieved party to prove and recover actual damages in lieu of the stipulated liquidated-damages amount. abi

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36 *See id.* at 145-46.
37 *See id.* at 132.
38 *See In re WM Distrib. Inc.*, 591 B.R. 52, 54 (Bankr. D.N.M. 2018).
39 *Id.* at 59-60.
40 *See id.* at 65-66.
41 *Id.* at 67.
42 *See id.* at 66.
43 *See Exemplar Mfg. Co. v. Lear Corp. (In re Exemplar Mfg. Co.)*, 331 B.R. 704, 714 (Bankr. E.D. Mich. 2005).
44 *Id.* at 715.
45 *Id.* at 715-16.
46 *Id.*
47 *See id.* at 718.
48 *See, e.g., Brown v. Real Estate Res. Mgmt. LLC (In re Polo Builders Inc.)*, 388 B.R. 338, 366 (Bankr. N.D. Ill. 2008) (applying Illinois law).