

COMMERCIAL LEASE LAW INSIDER®

MARCH 1998

The Practical, Plain-English Monthly Newsletter for Owners, Managers, Attorneys, and Other Real Estate Professionals

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Toughen Your Late-Fee Clause to Help Get On-Time Rent

Most leases require the tenant to pay a late fee if it doesn't pay rent on time. Charging a late fee *should* act as an incentive to get the tenant to pay on time. But many of the late-fee clauses we looked at don't do the job.

What's wrong with them? Some are worded in a way that allows tenants to attack them in court as an unenforceable penalty. Others don't require payment of a late fee if the tenant pays *part* of its rent on time. And some late-fee clauses don't penalize the tenant if the tenant's rent check bounces. Or they don't allow you to easily sue a tenant that refuses to pay the late fee.

To help you toughen your late-fee clause and plug its loopholes, we got the advice of Richard Miller, president of Transtar Commercial Real Estate Services based in Costa Mesa, Calif., and Jay Hollander, a principal in the New York City law firm of Hollander and Company LLC. With their help, we've put together a checklist of tips on how to cut down on late-rent problems when negotiating the lease and later when you enforce it. Plus, we've given you a Model Lease Clause on p. 3.

☐ **Get Right to Charge Late Fee Soon After Due Date**

Many leases we've seen give the tenant a 10-day grace period to pay its rent before the owner can charge a late fee. But 10 days is too much time, says Miller. By delaying this long, you encourage the tenant to pay its rent toward the end of the 10-day period.

It's smarter to take a tough stand, says Miller, and get the right to charge a late fee after a fewer number of days. Miller typically gets the right to charge late fees after the rent is three days late. This tells the tenant that you take the late-rent issue very seriously, Miller explains.

Also, to avoid ambiguity, specify the day of the month (e.g., the fourth day) that the rent becomes late, says Hollander [Clause, par. b].

☐ **Require Full Rent Payment to Avoid Late Fee**

Give yourself the right to charge the late fee if the tenant doesn't pay the rent "in full," says Hollander [Clause, par. b]. Otherwise, if you accept a partial payment from the tenant, you may lose the right to collect

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Subscriptions: *Commercial Lease Law Insider* (ISSN 0736-0517) is published monthly. Subscription rate: \$264 for 12 monthly issues. Address all correspondence to: Brownstone Publishers, Inc., 149 Fifth Ave., New York, NY 10010-6801. Tel.: 1-800-643-8095 or (212) 473-8200; fax: (212) 473-8786; e-mail: comlease@aol.com

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TOUGHEN YOUR LATE-FEE CLAUSE (continued from p. 1)

the late fee. And make sure you say that the "rent" includes any base rent, any additional rent (such as percentage rent), or other lease costs (such as operating expenses, taxes, or electricity charges), Hollander adds.

☐ Charge a Reasonable Amount

The late fee can be a flat dollar amount per day that the rent is late (say, \$20 per day). Or it can be a percentage of the unpaid rent (say, 10% of the overdue rent calculated at the time it's paid). No matter how you choose to set up this late fee, make sure the amount you set is *reasonable*. If a court rules that the fee is unreasonably high, it may refuse to enforce the entire late-fee clause, calling the fee an unenforceable penalty [Clause, par. b].

There's no magic number that's completely safe to use. You'll want to strike a balance, says Hollander. The late fee should be high enough to dissuade the tenant from paying late—but not so high that it could be found unenforceable. The number you set will depend on how much it would cost you to try to get the tenant to pay the unpaid rent (e.g., to prepare late-rent notices, make phone calls, and send warning letters). It could also include any late fees you might be charged if the late rent makes it tough for you to pay your mortgage or ground-lease rent on time, says Miller. Ask your local lawyer how much to charge since local court cases may give you some guidance.

Should you charge interest on the late fee? No, says Hollander. A court may rule that it's onerous and looks like a penalty, which the court won't enforce. Also, calculating interest charges can be an administrative headache, says Hollander.

☐ Call Late Fees 'Liquidated Damages'

Here's another way to lessen the risk that a court may rule that the fee is an unenforceable penalty: Explain in the lease that the late fee is meant to be "liquidated damages." That's a legal term meaning a reasonable approximation of expected damages you would suffer if the rent were paid late, says Hollander [Clause, par. b].

Also explain in the lease that the tenant's failure to pay the rent—or other lease costs—on time may cause you to incur unanticipated costs, Miller suggests. And the exact amount of these costs is difficult to calculate. So the late charge acts as a reasonable "guesstimate" of these costs [Clause, par. a]. You should give some examples of what these unanticipated costs will be—for example, administrative expenses, suggests Hollander.

☐ Say that Parties Agree Late Fee Is Fair

Also say in the lease that both you and the tenant agree that the late-fee amount is a fair estimate of your costs [Clause, par. c]. This lease language should help you defeat a tenant's claim that this fee is too

(continued on p. 4)

MODEL LEASE CLAUSE

Take Tough Stance on Late Fees

The following lease clause was drafted with the help of New York City attorney Jay Hollander and California property manager Richard Miller. This clause gives you the right to charge a late fee—called a “late charge” in the clause—if you don’t get the tenant’s rent on time.

Paragraph a says that the late rent may cause you to pay unanticipated costs. Paragraph b sets the amount of the late fee and says when the tenant must pay it. Paragraph c says that the parties agree that the late-fee amount is fair. Paragraph d gives you the

right to collect a returned-check fee. Paragraph e says that these charges will be considered additional rent. Paragraph f sets up the order in which you’ll apply any money you get from the tenant. And paragraph g says that you can refuse to accept a late fee—or accept it—and still exercise your other lease rights and remedies.

Ask your attorney about adding the following clause to the rent section of your lease.

LATE CHARGES

- a. **Landlord May Incur Unanticipated Costs.** Tenant’s failure to pay Rent, Additional Rent, or any other Lease costs when due under this Lease may cause Landlord to incur unanticipated costs. The exact amount of such costs are impractical or extremely difficult to ascertain. Such costs may include, but are not limited to, processing and accounting charges and late charges that may be imposed on Landlord by any ground lease, mortgage, or deed of trust encumbering the [Building/Center].
- b. **Tenant Owes Late Charge.** Therefore, if Landlord does not receive the Rent, Additional Rent, or any other Lease costs in full on or before the [insert day, e.g., the fourth day] of the month it becomes due, Tenant shall pay Landlord a late charge, which shall constitute liquidated damages, equal to [insert amount, e.g., \$20 a day for each day rent is late after the first of the month] (“Late Charge”), which shall be paid to Landlord together with such Rent, Additional Rent, or other Lease costs then in arrears.
- c. **Late Charge Is Fair Estimate.** The parties agree that such Late Charge represents a fair and reasonable estimate of the cost Landlord will incur by reason of such late payment.
- d. **If Tenant’s Check Returned.** For each Tenant payment check to Landlord that is returned by a bank for any reason, Tenant shall pay both a Late Charge (if applicable) and a Returned Rent Charge of \$[insert amount] or such amount as shall be customarily charged by Landlord’s bank at the time.
- e. **Charges Become “Additional Rent.”** All Late Charges and any Returned Check Charge shall then become Additional Rent and shall be due and payable immediately along with such other Rent, Additional Rent, or other Lease costs then in arrears.
- f. **Application of Money from Tenant.** Money paid by Tenant to Landlord shall be applied to Tenant’s account in the following order: (i) to any unpaid Additional Rent, including, without limitation, Late Charges, Returned Check Charges, legal fees and/or court costs legally chargeable to Tenant, and [Operating Expenses/CAM Costs]; and then (ii) to unpaid Base Rent.
- g. **Landlord May Pursue Other Remedies.** Nothing herein contained shall be construed so as to compel Landlord to accept any payment of Rent, Additional Rent, or other Lease costs in arrears or Late Charge or Returned Check Charge should Landlord elect to apply its rights and remedies available under this Lease or at law or equity in the event of default hereunder by Tenant. Landlord’s acceptance of Rent, Additional Rent, or other Lease costs in arrears or Late Charge or Returned Check Charge pursuant to this Clause shall not constitute a waiver of Landlord’s rights and remedies available under this Lease or at law or equity.

TOUGHEN LATE-FEE CLAUSE

(continued from p. 2)

high and is an unenforceable penalty, says Hollander.

❑ **Collect Extra Charge for Returned Check**

Make sure the tenant doesn't escape the late fee by paying the rent with a bad check, Hollander warns. Paying on time with a bad check is as bad as not paying at all.

To avoid this scenario, say that in addition to the late fee, the tenant must pay you a set amount if its check is returned [Clause, par. d]. Make sure this right covers "returned" checks, not just bounced checks (that is, checks returned for insufficient funds). A bank may return a check for other reasons—for example, if the tenant forgot to sign the check or made it out to the wrong party. Set the returned-check amount to cover any returned-check fee that your bank would charge you, as well as your costs of handling the returned check.

❑ **Make Late Fees Additional Rent**

Say in the lease that the late fees and any returned-check charge are "additional rent," says Hollander [Clause, par. e]. If late fees are considered "additional rent," you can sue the tenant in landlord-tenant court for any unpaid amount. This is typically the fastest and easiest route for an owner to take to collect the money.

❑ **Collect Base Rent Last**

Suppose the tenant owes you \$3,000 in back base rent and \$300 in late fees. If the tenant pays you only \$3,000, what should you apply this to, the rent or the late fees?

It's a good idea here to have the lease spell out the order in which

you'll apply any money you get from the tenant, Hollander suggests. You should first apply any money to pay off the outstanding "additional rent" the tenant owes. Reaffirm that this includes unpaid late fees and returned-check charges. Also say that it includes legal fees or court costs that the lease requires the tenant to pay, as well as any operating expenses. These should be defined elsewhere in the lease as "additional rent." Base rent—also called "fixed rent" or "minimum rent"—should always be the last item paid off, Hollander explains [Clause, par. f].

With this setup, the tenant has a greater incentive to pay everything it owes. If it doesn't, it will get hit with new late fees on the unpaid base rent.

❑ **Get Right to Refuse Late Rent and Late Fee**

Give yourself the right to refuse to collect the late rent, the late fee, or the returned-check fee. You may instead want to evict the tenant, Hollander explains. But if you don't give yourself this right in the lease, the tenant may argue that you must accept the late rent, the late fee, or the returned-check charge—and let it stay in the space [Clause, par. g].

❑ **Say Accepting Late Fee Doesn't Waive Eviction Right**

Also say that your acceptance of late rent, a late fee, or a returned-check charge doesn't mean you've given up—in legal terms, "waived"—your right to pursue other remedies that the lease gives you, such as eviction [Clause, par. g]. Without this special wording, the tenant may argue that once you've accepted the late rent, the late fee, or the returned-check charge, you can't then try to evict it.

PRACTICAL POINTER: Enforce your late-fee clause vigorously. If you don't and you get into a dispute

with a tenant over late fees, a court might say you've lost the right to collect the fees. Here are some pointers:

► *Demand fees immediately.* Ask for the unpaid rent and late fee *in writing* immediately after they become due, recommends Miller.

► *Keep remittance envelopes.* The tenant's remittance envelope will show a postmark date if you need proof that the tenant sent the rent in late, says Miller.

► *Track accumulated fees.* Be prepared for late-paying tenants to send a check for the late rent, without the late fee. To help keep track of what the tenant owes, send it a monthly statement that gives a breakdown of the current rent due, the unpaid rent, and the late fees that are still outstanding, Miller suggests.

► *Don't make exceptions.* Some tenants will beg you to cut them some slack. And some tenants that have never paid late before will have plausible excuses. But giving a tenant a break can be dangerous. If you waive the late fee once, you may get flak from the tenant if you try to enforce it in the future. And the more times you waive the late fee, the more likely a court will be to rule that you've lost the right to collect it, Miller warns. ▲

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NEITHER A LENDER NOR A BORROWER BE/By Jeffrey H. Newman

Validity of Late Fees, Post-Default Interest Remedies Affirmed

A RECENT New Jersey Supreme Court decision may not necessarily afford landlords the relief they were hoping for, although it may return normalcy to the New Jersey credit markets. *Metlife Capital Financial Corp. v. Washington Avenue Assoc.*, 313 N.J. Super. 525 (1998), *rev'd*, *Metlife Capital Financial Corp. v. Washington Avenue Assoc., L.P.*, No. A-34 Slip. op. 1 (N.J., June 30, 1999).

Following this unanimous decision (which reversed the Appellate Division ruling in pertinent part), lenders seeking to impose standard default remedies on New Jersey borrowers can once again be comfortable in knowing that typical prenegotiated late-fee and increased post-default interest remedies will be treated as presumptively valid. A borrower will need to expend substantial effort before a lender will be required to endure a potentially expensive and protracted court proceeding respecting enforcement of those remedies clauses.

The twice-appealed trial court decision arose from a dispute between a defaulting borrower and its lender. The borrower not only paid 40 of 48 installments after their respective due dates (despite a positive cash flow), but also defaulted on the final balloon payment upon the maturity of the subject four-year mortgage note.

At the trial level, the court found the lender's standard 5 percent late fee to be enforceable. However, the court "re-wrote" the stipulated post-default increase in interest by reducing the rate from the 15 percent provided for in the mortgage note to 12.55 percent. The case was appealed. The Appellate Division not only found the 5 percent late fee to be unenforceable, but similarly found

even the 12.55 percent reduced post-default rate of interest approved by the trial judge to be equally unenforceable. It interpreted the test of enforceability of so-called liquidated (stipulated) damages provisions as comprised of a two-prong analysis. The Appellate Division explained that in order for such a provision to qualify as an enforceable liquidated-damages clause, rather than an unenforceable penalty, the provision must satisfy both prongs of the analysis, as follows:

(1) The late charge must be reasonably related to the anticipated or actual damages to be suffered by the lender from the delay in payment; and

(2) Actual or anticipated damages must be difficult to establish.

In a complete reversal of the damages issue (an unrelated issue was affirmed), the New Jersey Supreme Court enunciated a new standard — the "totality of the circumstances" — that has been adopted in other contexts and will now be the benchmark for determining the enforceability of liquidated-damages clauses in the lender-borrower, and apparently all other, contexts. Once the court was able to articulate a cohesion between the two elements of the "old test," as set forth above, it was easy for the court to blend the two elements into a new test of reasonableness based on the totality of the circumstances. In applying this standard, i.e., whether the liquidated-damage clause is reasonable under the totality of the circumstances, the court found both the 5 percent late fee and the 12.55 percent post-default rate of interest to be a valid measure of anticipated damages.

Thus, the New Jersey Supreme Court has reaffirmed the presumptive validity of liquidated-damages provisions and, perhaps, has raised the hurdle for a challenger to attack such provisions in the commercial-mortgage lending context. In moving to the "modern trend" of

applying the blended test of "reasonable under the totality of the circumstances" to liquidated-damages provisions, the court held that each provision must be analyzed with consideration to all relevant and even near-relevant factors. For example, in reaching the opinion, the court acknowledged that in the current lending market, late charges and enhanced rates of interest upon default are necessary to offset the increased cost of doing business in a post-default context. However, given the special considerations analyzed by the court in the commercial-mortgage lending context, one might infer that the bar that must be overcome in order to challenge the enforceability of such provisions may be lower in other contexts than in the commercial-mortgage lending context.

Hence, while calm once again reigns in the New Jersey credit markets, a distant wind may be rising in nonlending contexts.

Impact on Landlord-Tenant Relationships

In reviewing the three decisions from the trial level to the supreme court, it is difficult to disregard the finding of a trial judge and a unanimous panel of appellate division justices, all of whom found the enhanced default rate of interest unenforceable, and most of whom (all of the appellate justices) found the late fee unenforceable. Given the paucity of cases which are appealed (much less tried at the lower level prior to settlement), one can envision a different result at trial court levels. The two-pronged test, while persuasive but not dispositive in the *MetLife* case, nevertheless provides a clear formula for analyzing liquidated damages provisions. Hence, from a practical perspective, it may yet remain alive and well.

In nonlending contexts that are replete with liquidated-damages provisions, such as in the landlord-tenant area, too much comfort should not be taken from this opinion. A "one-size-fits-all" remedy remains highly vulnerable in many landlord-tenant situations. For example,

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Synthetic Leasing

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based on the debt service (principal and interest) paid under the lessor's financing, plus a return to the lessor. The loan arrangement in most synthetic leases does not include amortization of the principal amount of the debt. The rent equals the amount of the interest expense and return on equity and often is based on a floating rate, such as the London Interbank Offered Rate (LIBOR). The result is a relatively low occupancy cost.

Although synthetic leases usually provide 100 percent financing, they are relatively short term. The typical term is three to seven years, though some synthetic leases are longer. At the end of the lease term, the lessee has three options: (i) the parties can agree to extend the synthetic lease for another term; (ii) the lessee has the option to purchase the property by paying off the outstanding debt and equity, whereby, if the property value has increased, the lessee retains any residual appreciation; or (iii) to comply with accounting rules, the lessee may return the property to the lessor, so long as it pays the lessor a "guaranteed payment" and markets the property for the lessor.

The third alternative, often referred to

as the "remarketing option," is unlikely to be exercised by the lessee but is required for compliance with the accounting rules. Under this option, the guaranteed payment is an amount calculated to comply with applicable accounting rules and usually approximates 85 percent of the outstanding balance of the debt and equity. The lessor uses the guaranteed payment to pay off a portion of the outstanding debt. If the lessee is successful in selling the property for the full outstanding balance, the lessee uses the sales proceeds to pay off the remaining debt and equity and to reimburse itself for the amount of the guaranteed payment made to the lessor. The lease permits the lessee to terminate the lease upon payment of the debt and equity. If the property has appreciated and the purchase price exceeds the outstanding balance, the lessee usually keeps the residual appreciation (i.e., the excess sales proceeds that remain after payment of the debt and the equity). In the event the purchase price is insufficient to pay off the outstanding balance, the lessee may not be fully reimbursed for the guaranteed payment. However, the maximum lessee's liability under the remarketing option is the amount of the guaranteed payment.

The trick in a synthetic-lease transac-

tion is compliance with the accounting rules for leases. The Financial Accounting Standards Board continues to promulgate new rules in this area. Recent changes include limitations on the lessee's guaranties during construction, and guidance on the use of special-purpose entities as lessors, which can sometimes lead to "consolidation" of the lessor and the lessee for financial reporting purposes, resulting in "on-balance sheet" accounting treatment of the debt and the asset. Lessees contemplating synthetic leases should consult with their accounting advisers for new developments in lease accounting that could impact synthetic leases.

The quest for "off-balance sheet" financing continues to be a driving force in the proliferation of synthetic leases. By combining lease accounting with the tax benefits of ownership, a synthetic lease provides companies with the best of both worlds: It is a financing vehicle that gives the lessee the benefits of an operating lease for accounting purposes, and the advantages of a loan for tax purposes. ■

Remedies Affirmed

a remedy which allows a landlord, for purposes of calculating percentage rent, to aggregate all of the sales of a tenant's second location with the sales of a first location if the second location violates a radius restriction applicable to the tenant's first location would most likely be found to be unenforceable. The remedy assumes all of the sales of the violative location would have been enjoyed at the first location. Such a remedy would seem to flunk the two-prong test as well as be seen as unreasonable under the "reasonableness" test. Similarly, an acceleration clause, as may be found in a variety of leases, calling for the acceleration of all rents to become due following default, without regard to the

landlord's ability to obtain a replacement tenant, disregards concepts of mitigation and concepts of present value of future cash flows. Therefore, such a remedy would also seem to flunk *Wasserman* and/or be seen as unreasonable.

Hence, while the "enforcer" of the liquidated-damages provision beat the "challenger" in the *MetLife* case, it would be a questionable assumption to believe that this type of litigation will therefore wither. Cases of this nature, win, lose or draw, heighten consciousness and stimulate the truly oppressed challengers as well as those challengers who may sometimes engage in litigation perhaps almost as a form of "sport." ■

Commercial Leasing Law & Strategy

(ISSN 0898-5634) is published by
Leader Publications, a division of
American Lawyer Media Inc., 345
Park Avenue South, New York, N.Y.
10010. Telephone: (800) 888-8300;
(212) 545-6170

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EQUITABLE PRINCIPLES/By Jeffrey H. Newman and Robert Hempstead

Testing Whether Liquidated Damages Clauses Are Reasonable

MANY jurisdictions recognize leases more as contracts rather than conveyancing vehicles. As a result, basic equitable principles (i.e., good faith and fair dealing), as applied in contractual disputes, are used when interpreting and analyzing disputed lease provisions. In New Jersey, for example, courts apply a two-pronged reasonableness test to determine whether amounts stipulated under liquidated damages clauses are enforceable.

The test was recently applied in the commercial mortgage loan case of *Metlife Capital Financial Corp. v. Washington Ave. Assocs.*, 713 A.2d 527 (N.J. Super. Ct. App. Div. 1998). In that case, the court considered whether the amounts stipulated under a liquidated damages clause contained in a mortgage note were (1) reasonably related to the anticipated or actual damages incurred by the lender, and (2) unascertainable or difficult to prove. See *Metlife*, 713 A.2d at 533.

In finding for the borrower, the court held that a 5-percent late charge and a 15-percent default rate of interest (i) were not reasonably related to the anticipated or actual damages and (ii) that actual damages were not unascertainable or difficult to prove.

If the holding of the *Metlife* case stands, (the New Jersey Supreme Court has recently granted the lender's petition for certiorari and will hear the *Metlife* case during the court's current term), landlords, as well as lenders, may be faced more fre-

quently with having to defend the validity of their stipulated damages clauses. Of course, borrowers and tenants must first be able to meet their burden of proof, by demonstrating either the lack of a reasonable relationship between the stipulated amount and the actual damages incurred, or that such anticipated damages are ascertainable or calculable.

Effect on Remedies

Because of the requirement for a reasonable relationship between estimated and actual damages, the *Metlife* case may have an impact on a classic remedy for many landlords, i.e., the right of acceleration of all amounts to become due under a lease following default (without discounting to present worth and offsetting for the net proceeds realized from any reletting). Under the reasoning of *Metlife*, a court may require that a landlord discount the accelerated total to present value, based on a reasonable rate of return.

Moreover, New Jersey courts already require that a commercial landlord use reasonable efforts to relet the premises. The *Metlife* case may now require a valuation of fair rental value in the absence of an actual reletting, which amount can then be used as the basis to ascertain a net proceeds figure to subtract against the accelerated rental amount, prior to discounting the difference to present worth. (Once a fair rental value amount is determined, a vacancy factor, brokerage factor, fit-up factor, etc., can be applied to determine a reasonable estimate of the likely net proceeds to be received by the landlord for the balance of the lease term, had there not been a default.)

The enforceability of such "one-size-fits-all" type of remedies will be at greater risk under the *Metlife* holding. For example, a "sales inclusion" remedy, calling for the aggregation of the sales of a store which is the subject of a radius restriction, together with the sales of a store operating in violation of a radius restriction, may be viewed by a court as a blanket remedy applicable to all defaults under the radius restriction provision, regardless of the proximity of the store operating in vio-

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Liquidated Damages Clauses

Continued from Page 8

lation of the restriction, to the store subject to the restriction, and may, therefore, be stricken as an unenforceable penalty. The Metlife holding would seem to favor a graduated percentage inclusion approach to a liquidated damages provision for a violation of a radius restriction. Say, for example, the tenant is subject to a five-mile radius restriction in which it may not operate a similar store. Perhaps there should be a 90-percent inclusion factor if the violative store is one mile away or less, with a 10-percent decline for each subsequent mile, so that the remedy ranges from 90-percent inclusion to 60-percent inclusion. (Note that, in suggesting a "top" sales inclusion figure of 90 percent, the authors are giving deference to the analysis used in *Barr & Sons Inc. v. Cherry Hill Center Inc.*, 90 N.J. Super. 358 (App. Div. 1966), as echoed by the Metlife court in footnote 6. Finding that compensatory damages are measured by the "loss" sustained by reason of the breach, rather than by all the profits made by the party in breach, the Barr court refused to infer that all persons who purchased merchandise from the competing tenant who was in violation of the restrictive covenant would have purchased that merchandise from the protected tenant.)

Monetary vs. Nonmonetary Defaults

A more practical challenge for lenders and landlords that may arise out of the holding of the Metlife case deals with the difference in ascertaining damages based on a monetary default, as opposed to damages based on a nonmonetary default. As set forth in *Metlife*, the second prong of the reasonableness test requires the party defending the liquidated damages clause to demonstrate that the amount of damages to be incurred is unascertainable or difficult to prove. However, the Metlife court seems to imply that if the default in question is

of a monetary nature (e.g., failure to make payments of principal and interest), the amount of damages will almost always be ascertainable. For example, in *Metlife*, the court determined that the lender's loss was its inability to use the money that was owed and not repaid by the borrower. However, since the return that the lender could have realized by investing such funds was determinable, and, since the return on the money owed by the borrower was determinable, the difference (i.e., the loss incurred by the lender) was determinable as well. The same analysis may prove true for a tenant's breach of any monetary obligation under its lease.

Yet, while it can be argued that damages suffered by a landlord in the event of a monetary default by a tenant might always be determinable, the amount of damages suffered by a tenant's nonmonetary default appear more likely to be incapable of quantification. For example, if a shopping center tenant breaches an operating covenant, how does the landlord quantify the impact such an action has on the shopping center? A vacant store may have an adverse effect on the center's image, may reduce traffic at the center and could jeopardize the landlord's ability to realize maximum returns under percentage rent clauses with other tenants. The amount of gross sales that a tenant under a lease for space at a shopping center may generate is arguably directly related to the continuous operation of the other tenants of the center. Therefore, the losses that a landlord may suffer, in the event that one tenant ceases operations, may prove impossible to ascertain.

Reliance on 'Industry Standards'

A lender's or landlord's reliance on "customary" or "industry standard" liquidated damages clauses could now be misplaced as well. In *Metlife*, the court rejected the lender's defense that the stipulated amounts were the

industry standard and custom. Instead, the court forced the lender to demonstrate the relationship between the actual damages and the agreed-on damage amounts set forth in the mortgage documents. Similarly, landlords should be prepared to prove a correlation between stipulated damage amounts contained in their leases, particularly with respect to late rental payments (since presumably the losses are quantifiable, as discussed above), and their actual damages. Ironically, the administrative cost incurred in attempting to demonstrate a correlation between actual costs incurred and the stipulated damages may prove so expensive, in and of itself, that it may consume a significant portion of the damages that a lender or landlord is trying to recoup.

Liquidated damages clauses have, to a large extent, survived the scrutiny of the courts and have, in general, gone unchallenged by borrowers and tenants alike, thereby establishing the industry standards so often accepted in mortgage and lease documents. As a result, many lenders and landlords have perhaps been lulled into a false sense of security in assuming that their liquidated damages clauses are valid.

The Metlife holding serves as a wake-up call for both lenders and landlords. The otherwise customary liquidated damages clauses contained in their agreements should no longer be assumed to be valid. In light of the Metlife holding, tenants and borrowers, or, at least those whose documents are governed by New Jersey law, should now no longer blindly assume the validity of liquidated damages clauses. Moreover, they will be able to challenge them on an after-the-fact basis and, after an initial showing, shift the burden of proving (or burden of going forward to show) the reasonableness of the stipulated damage amounts to the lenders and landlords. As the lender in *Metlife* learned, meeting that burden may not be so easy. As noted above, the New Jersey Supreme Court has recently granted the lender's petition for certification and will hear the Metlife case — stay tuned. ■

**METLIFE CAPITAL FINANCIAL
CORPORATION, Plaintiff-Respondent,
v.
WASHINGTON AVENUE ASSOCIATES, L.P.
and Lawrence S. Berger, Defendants-
Appellants,
and
United States of America, Defendant.**

Superior Court of New Jersey,
Appellate Division.

Argued May 27, 1998.

Decided June 23, 1998.

After mortgagor failed to make balloon payment, mortgagee filed foreclosure action. The Superior Court, Chancery Division, Essex County, determined that five percent late fee under mortgage note had not been waived and did not constitute a penalty, that default rate of three percent over contract price was fair and equitable, and that rents received by mortgagee had been properly applied. Mortgagor appealed. The Superior Court, Appellate Division, Pressler, P.J.A.D., held that: (1) mortgagee did not waive five percent late fee; (2) mortgagee's application of collected rents against loan without a crediting of interest thereon was improper; (3) five percent late fee was an unenforceable penalty; and (4) mortgagee was not entitled to default interest rate of three percent above contract rate.

Vacated and remanded.

[1] MORTGAGES ☞298(1)

266k298(1)

Mortgagee did not waive five percent late fee provided for in mortgage note through its conduct.

[2] MORTGAGES ☞199(4)

266k199(4)

Mortgagee's application of collected rents against loan, without a crediting of interest thereon, was in derogation of its contractual undertaking and in derogation of the implied covenant of good faith and fair dealing that inheres in every contract.

[3] MORTGAGES ☞199(4)

266k199(4)

Mortgagee was required to account for rents it received after mortgagor's default by applying to the loan the net amount collected after the deduction of legitimate expenses.

[4] DAMAGES ☞163(3)

115k163(3)

Stipulated damages clauses are presumed to be reasonable, and party challenging the clause has burden of proving unreasonableness.

[5] MORTGAGES ☞460

266k460

While trial court should not have imposed burden of proving reasonableness of five percent late fee provided for in mortgage note on mortgagee, in foreclosure action, error was inconsequential, since factual proofs were largely undisputed.

[5] MORTGAGES ☞578

266k578

While trial court should not have imposed burden of proving reasonableness of five percent late fee provided for in mortgage note on mortgagee, in foreclosure action, error was inconsequential, since factual proofs were largely undisputed.

[6] MORTGAGES ☞298(1)

266k298(1)

Five percent late fee provided for in mortgage note was an unenforceable "penalty," rather than a liquidated damages clause; fixed percentage late fee was not reasonably related to mortgagee's anticipated or actual internal costs, elements of damage were not unascertainable or difficult to calculate, and late charge was coercive.

See publication Words and Phrases for other judicial constructions and definitions.

[7] MORTGAGES ☞298(1)

266k298(1)

Purpose to coerce timely payments renders the late charge so imposed a "penalty" by definition.

See publication Words and Phrases for other judicial constructions and definitions.

[8] MORTGAGES ☞581(1)

266k581(1)

Attorney fees together with all other costs of collection cannot be included as stipulated damages under mortgage note, since they are charged separately to the borrower.

[9] MORTGAGES ☞489

266k489

After concluding that 15% default rate provided for in mortgage note was excessive, trial judge should not have fixed lesser default rate of three percent over

(Cite as: 313 N.J.Super. 525, 713 A.2d 527)

contract rate, absent evidence that three percent enhancement reflected actual damages sustained by mortgagee.

[10] DAMAGES 85

115k85

Once the trial court has determined that a liquidated damages provision constitutes a penalty and is, therefore, unenforceable, the party who attempted to impose that penalty is remitted to the ordinary recourse of proving actual damages sustained.

****528 *528** Lawrence S. Berger, defendant-appellant, pro se and for defendant-appellant Washington Avenue Associates, L.P. (Berger & Bornstein, Morristown, attorneys; Paul H. Schafhauser, on the brief).

Samuel Feldman, Roseland, for plaintiff-respondent (Orloff, Lowenbach, Stifelman & Siegel, attorneys; Mr. Feldman, of counsel and on the brief; Linda S. Moore, on the brief).

****529** Before Judges PRESSLER, CONLEY and WALLACE.

The opinion of the court was delivered by

PRESSLER, P.J.A.D.

This controversy arises out of a judgment of foreclosure obtained by the mortgagee's assignee, plaintiff Metlife Capital Financial Corporation. The mortgagor, defendant Washington Avenue Associates, L.P., and its general partner, defendant Lawrence S. Berger, who have since redeemed without prejudice to the bringing of this appeal, challenged plaintiff's calculation of the amount due, asserting that (1) the contracted-for five percent late payment fee had been waived and, alternatively, that it constituted an unenforceable penalty, (2) the default interest rate on the unpaid principal of fifteen percent per annum, 5.45 percent over the contract interest rate of 9.55 percent, constituted an unenforceable penalty, and (3) the mortgagee failed properly to apply the rents it had received after the default under the assignment of rents executed by the mortgagor. The trial judge concluded that the late fee had not been waived and did not constitute a penalty; that the fifteen percent default rate did constitute a penalty but that 12.55 percent, namely, three percent over the contract rate, would be fair and equitable; and that the rents received by the mortgagee had been properly applied. The mortgagor appeals from all adverse decisions, challenging as well the judge's fixing of a default rate.

The mortgagee has not cross appealed from the determination that the fifteen percent default interest rate constituted a penalty. We reverse and remand.

I.

In March 1992, plaintiff's predecessor in interest, Metlife Capital ***529** Corporation, [FN1] granted defendants a four-year, 9.55 percent loan in the amount of \$1,500,000 secured by a mortgage on commercial property in Belleville. The loan was to be repaid on the basis of a twenty-year amortization by way of forty-eight equal monthly payments of \$14,030.98 each, with a so-called balloon payment of \$1,391,236.90 due at the end of the four-year term. The promissory note provided that "a late fee equal to the lesser of five percent (5%) of the delinquent payment or the highest late charge permitted by law shall be payable with respect to any payment which is not paid within ten (10) days of the date on which it was due." It also provided that on a declaration of default, the interest rate on the unpaid principal balance would not be the contract rate but rather an enhanced default rate. The default rate was defined as "the greater of five percent (5%) per annum in excess of the 'prime rate' as designated by Chase Manhattan Bank, N.A., from time to time, or fifteen percent (15%) per annum; provided, however, that such Default Rate shall not exceed the maximum rate allowable under law." In addition to payment of the late charge and the default interest rate, the mortgagor was also responsible, upon default, for "all costs of collection including, but not limited to reasonable attorneys' fees (and appellate counsel fees) actually incurred, whether or not suit is filed." Finally, as part of the loan documents, defendant made a present assignment of rents due, which further provided that upon default by the mortgagor,

FN1. Since Metlife Capital Corporation, the original mortgagee, and Metlife Capital Financial Corporation, its assignee and the plaintiff here, are obviously related entities, we refer to them interchangeably as either Metlife or plaintiff.

Grantee [Metlife] may enter upon and take possession of the Property, or any part thereof or, in its own name, sue for or otherwise collect such Rents including those past due and unpaid, and apply the same, less costs and expenses of the operation of the Property, of the performance of Grantor's obligations under any lease thereof, and of collection, including attorneys' fees (together with appellate counsel fees, if any), to the payment of any

(Cite as: 313 N.J.Super. 525, *529, 713 A.2d 527, **529)

of the Secured Obligations, in such order as Grantee may determine.

*530 At the time the loan was made, the mortgaged premises were leased by defendants to Walgreen Eastern Co., Inc., under a thirty-year lease that commenced in July 1988. The monthly rent for the first five years of the term was \$16,758.75, and the monthly **530 rent for the second five years of the term was \$17,543.28. The rent, therefore, was at all times during the life of the loan, greater than defendants' monthly mortgage payment.

Defendants made all forty-eight pre-balloon payments, albeit forty of them were made late. The record does not indicate how late each of these forty payments were. All that appears are five deposit slips for the latter months of the term showing that for those five months, two of the payments were timely, one was made two days beyond the ten-day grace period, one four days beyond the grace period and one six days beyond the grace period.

In any event, upon the expiration of the four-year term, defendants failed to make the balloon payment, which was due on April 1, 1996. Accordingly, Metlife declared the note in default and began collecting the rent directly from the tenant. It then commenced this foreclosure action by complaint filed in July 1996, and defendants filed a contesting answer. In December 1996, Metlife moved for summary judgment striking the answer, directing that the matter proceed as an uncontested action pursuant to R. 4:64-1, and striking defendants' counterclaim as non-germane, see R. 4:64-5. Concluding by written opinion that the only germane issues raised by defendants were their challenges to the five percent late fee and the fifteen percent default rate and, hence, that there was no genuine contest to the validity or priority of the mortgage or to Metlife's right to foreclose, see R. 4:64-1(a)(2), the court granted the motion, subject, however, to an evidential hearing to determine "whether the amount due on the Mortgage shall include late fees and the default rate of interest provided under the Note and Mortgage." In limiting the disputed issues to defendants' claims that the late fee and default rate constituted unenforceable penalties, the court had also rejected, as unsupported by the motion record, defendants' assertion that *531 Metlife had waived the late fee during the four-year term of the loan.

The evidential hearing provided for by the summary judgment order was held in February 1997. The position taken by defendants was that both the late fee

and the default rate were entirely unrelated to any anticipated or actual compensatory damages suffered by Metlife as a result of the late payments and the default and, hence, constituted unenforceable penalties. Metlife, asserting that the late fee and default rate were reasonable and valid liquidated damages provisions because of the difficulty of ascertaining actual damages, produced one of its investment portfolio managers, Barbara Geer, the import of whose testimony was an attempt to explain the nature of Metlife's compensatory damages resulting from both the late payments and the default on the payment of principal. Defendants produced the rebutting testimony of an experienced bank loan officer. We will refer with specificity to the testimony of both hereafter. Suffice it to say at this point in the procedural history that following the hearing, the court sustained the late fee as reasonable liquidated damages. As to the default rate, it concluded that the fifteen percent default interest rate was in the nature of a penalty but that a default rate of 12.55 percent would be reasonably related to actual damages. The court therefore fixed the default rate at that figure, thus adding three percent to the contract rate. It is important, moreover, to note that Metlife's original claim was not only for five percent of each of the forty late monthly installments and the fifteen percent default rate, but also for the five percent late fee on the final defaulted balloon payment of almost \$1.4 million for an additional charge of about \$69,000. The court was not, however, required to rule on that claim, since it was withdrawn by Metlife during the course of the hearing.

A conforming order was entered following the evidential hearing referring the matter to the Foreclosure Unit of the Superior Court Clerk's Office for entry of final judgment of foreclosure. The order provided for inclusion in the amount due of late fees *532 totalling \$28,062, referable to the forty late payments, and for interest on the defaulted principal from March 1, 1996 at 12.55 percent. In support of its request for entry of final judgment, Metlife then filed the required proof of amount due by certification of Geer with the sums calculated as of March 31, 1997. See R. 4:64-2. In addition to the **531 principal balance, the 12.55 percent default rate thereon [FN2] and the accumulated five percent late fees, the proof also claimed that Metlife had, after the default, paid three quarterly installments of real estate taxes on which it also claimed to be entitled to the 12.55 percent default rate. Finally, the proof accorded defendants a credit of \$188,615.50 "for amount collected by plaintiff from Tenant." There

was no other information given respecting those rent collections. The total amount of the claim set forth in the proof was \$1,452,183.91, inclusive of all charges and credits.

FN2. We find no explanation in the record for the fact that the proof of amount due used the 12.55 percent interest rate on the unpaid principal balance from March 1, 1996, although the balance was not due until April 1, 1996. The loan does not appear to have been in default prior to April 1, 1996, particularly since the last of the forty-eight monthly payments was timely made on March 6, 1996; Metlife's notice of default, dated May 9, 1996, referred to April 1, 1996, as the date of the default; the March billing to defendants from Metlife showed the principal balance not due until April 1, 1996; and, finally, the proof itself referred to April 1, 1996, as the default date.

Defendants, upon receipt of the proof, wrote to the Foreclosure Unit objecting to the rent-credit calculation and demanding an accounting of the rents. The letter was, however, received after the final judgment of foreclosure had been entered in accordance with the filed proof. Accordingly, defendants moved the court pursuant to R. 4:50-1 for relief from judgment in order to raise the issue of the proper rent credits. The trial judge considered the application but rejected it based on his finding that the rents collected under the assignment had been properly applied to the debt.

Defendants then filed their notice of appeal, challenging the trial court's determination with respect to the late fees, the default *533 interest rate and the application by Metlife of the rents it collected. As we understand the representations of the parties, while the appeal was pending, defendants paid the obligation in accordance with the judgment of foreclosure and regained the property. The financial disputes, however, continue. And, as we have noted, Metlife did not cross appeal from the court's rejection of the fifteen percent default rate as a penalty.

II.

[1] We address first defendants' claim that Metlife waived the five percent late fee. In sum, we reject that claim for the reasons stated by the trial judge in his oral opinion of January 21, 1997, granting Metlife's original motion for summary judgment. Our review of the record satisfies us that defendants failed to demonstrate a prima facie case of waiver sufficient to defeat a motion for summary judgment under the

standard prescribed by *Brill v. Guardian Life Ins. Co. of America*, 142 N.J. 520, 666 A.2d 146 (1995). There were insufficient assertions to support the contention that Metlife was either a party to, had approved of, or had agreed to the lock-box arrangement and had thereby acceded to the resultant late payments. Nor do we find any other conduct of Metlife that could reasonably support the contention that it had intentionally waived the late fee or that defendants had relied on any such waiver.

III.

We do, however, find considerable merit in the remainder of defendants' contentions. We consider first the question of the rents collected by Metlife under the assignment of rents after the default. As we have noted, there was never an accounting of rents by Metlife other than the notation on the proof of amount due that defendants were entitled to a credit for the designated sum, although it does appear that Metlife did collect the rent monthly from Walgreen's during the ten-month period between the declaration of default and the closing date of the filed proof. *534 There is no information in the record, however, as to whether Metlife incurred any expenses in effecting this collection beyond the cost of giving the appropriate notice to Walgreen's or whether Metlife, in according the credit, reduced the gross rents collected by any expenses it may have incurred.

[2] The issue before us is whether giving a credit for the accumulated amount of rent collected over a ten-month period without **532 either having applied the rent against the defendants' obligation as it was collected or crediting defendants at some point with interest on the rents collected satisfied Metlife's obligation "to apply the [rents], less costs and expenses ... to the payment of any of the Secured Obligations, in such order as Grantee may determine." We are persuaded that Metlife's apparent "tail-end" application of collected rents against the loan without a crediting of interest thereon was in derogation of its contractual undertaking and in derogation of the implied covenant of good faith and fair dealing that inheres in every contract. *Sons of Thunder, Inc. v. Borden, Inc.*, 148 N.J. 396, 420, 690 A.2d 575 (1997); *Onderdonk v. Presbyterian Homes of N.J.*, 85 N.J. 171, 182, 425 A.2d 1057 (1981).

[3] Defendants do not dispute that the assignment of rents made by them as part of the mortgage documents was a present assignment or that Metlife had the right

(Cite as: 313 N.J.Super. 525, *534, 713 A.2d 527, **532)

to collect the rent upon declaration of the default and to deduct therefrom the costs of collection, of maintaining the property, and of paying any obligations of the mortgagor in respect of the tenancy. Metlife's right to the rents is clear. But concomitantly, Metlife also had obligations with respect to those collections. It was required to account for them by applying to the loan the net amount collected after the deduction of legitimate expenses. See generally *Eisen v. Kostakos*, 116 N.J.Super. 358, 368-369, 282 A.2d 421 (App.Div.1971); *Orange Land Company v. Bender*, 96 N.J.Super. 158, 165-166, 232 A.2d 679 (App.Div.1967). Although we do not doubt that, under the terms of the assignment, Metlife was free to apply the *535 rents in any order it chose, it was nevertheless obligated to apply them in some fair and reasonable manner.

As we have noted, Metlife never rendered a formal accounting of the rents collected showing dates of collection and deductible expenses, if any. And that failure demonstrates, in our view, the essential flaw in Metlife's methodology. What Metlife did was to accord itself the interest-free use of the money it had collected on the mortgagor's account at the same time that it was charging the mortgagor the enhanced default interest rate on the entire principal balance on a daily basis. After all, Metlife is in the money business. The predicate of the money business is the charge for the use of money. It is anomalous in the extreme and, in our view, a failure of good faith and fair dealing, for the mortgagee to insist on full, if not exaggerated, payment by the mortgagor for the use of its, the mortgagee's, money, but to decline to pay the mortgagor, by an appropriate credit, for the use of money that, if not technically the mortgagor's, is functionally the mortgagor's and for which the mortgagor is entitled to a credit. Illustrative of what we perceive to be the essential unfairness of Metlife's conduct was the manner in which it addressed the advances for taxes. It treated the direct tax payments it made after the default as further advances to the mortgagor on the loan. Although it had collected rents sufficient to pay the taxes, it chose not to apply the rents to that obligation of the mortgagor but instead, while retaining the interest-free use of the rents, advanced the taxes against the loan and charged the mortgagor the post-default rate of 12.55 percent on those advances. The point, of course, is that while Metlife was free to apply the rents in any order it chose, it was not applying them at all, but was, rather, continuing to charge the mortgagor interest on the entire debt while at the same time making interest-free

use of the collected rents.

We recognize, as pointed out by Osborne, *Mortgages* (2d ed.1970), § 165 at 286-287, quoted in *Eisen v. Kostakos*, op. cit., supra, 116 N.J.Super. at 369, 282 A.2d 421, that there may be situations in which the mortgagee's collection of rents must be *536 offset by substantial, complex, and not immediately determinable expenses and other primary obligations of the mortgagor and, hence, that a periodic calculation of the rent credit cannot readily be made and a determination of the ultimate set-off to which the mortgagor is entitled must await a final accounting. In that situation, it may well be that in collecting the rents, the mortgagee is not actually obtaining the interest-free use of money. However, that hardly appears to be the case here, and we understand the representations made by Metlife's counsel at oral argument at least to suggest that it merely collected **533 the rents, had them available for use for its own purposes unrelated to the secured loan as they were collected, and credited defendant in the proof of amount due ten months later with the gross amount collected. If that is indeed the case, we are persuaded that equitable principles require Metlife to pay for the use of that money for the period during which the funds were so available to it by according defendants an appropriate credit against the total obligation due.

This matter requires further consideration by the trial court. Metlife must provide a full accounting to defendants for the rents collected, showing the dates and amounts of collection and the dates and amounts of any offsetting related expenses. The trial judge should then, based on those facts, determine whether Metlife in fact had the interest-free use of money for which it was obliged to account to defendants, and, if so, how much money and for how long a period of time. Based on equitable principles, the trial judge should then determine how much interest, if any, on that amount of money is owed as an offsetting credit to defendants.

We are also advised that defendants have instituted a separate action against Metlife seeking an accounting of rents Metlife collected between the date of the proof of amount due and the date of defendants' redemption. That action should be consolidated with this one on the remand and the entire rent-collection dispute proceeded with in a single litigation in the trial court.

*537 IV.

(Cite as: 313 N.J.Super. 525, *537, 713 A.2d 527, **533)

We next address defendants' argument that the five percent late fee is an unenforceable penalty and Metlife's counter-assertion that it is simply a reasonable liquidated damages clause. The standards for determining when a purported liquidated damages clause constitutes an unenforceable penalty have long been well-settled in this jurisdiction. As this court stated nearly thirty-five years ago in *Westmount Country Club v. Kameny*, 82 N.J.Super. 200, 206, 197 A.2d 379 (App.Div.1964), relying on Restatement of Contracts § 339 (1932):

An agreement made in advance of breach, fixing the damages therefor, is not enforceable as a contract and does not affect the damages recoverable for the breach, unless (a) the amount so fixed is a reasonable forecast of just compensation for the harm that is caused by the breach, and (b) the harm that is caused by the breach is one that is incapable or very difficult of accurate estimate. (Citations omitted.) However, if it appears that the parties have provided for an excessive sum in a case where the real damages are certain or readily reducible to certainty by proof, then the sum fixed is deemed a penalty and is not enforceable. (Citation omitted.)

In the intervening years, the original Restatement was replaced by the Restatement (Second), but the principle remained the same. Thus the Restatement (Second) of Contracts § 356(1) (1981) provides that:

Damages for breach by either party may be liquidated in the agreement but only at an amount that is reasonable in the light of the anticipated or actual loss caused by the breach and the difficulties of proof of loss. A term fixing unreasonably large liquidated damages is unenforceable on grounds of public policy as a penalty.

The Restatement (Second) position has been fully endorsed and adopted by the New Jersey Supreme Court in *Wasserman's Inc. v. Middletown*, 137 N.J. 238, 252, 645 A.2d 100 (1994), which noted, moreover, the consistency between the Restatement (Second) and the Commercial Code, N.J.S.A. 12A:2-178, which provides that:

(1) Damages for breach by either party may be liquidated in the agreement but only at an amount which is reasonable in the light of the anticipated or actual harm caused by the breach, the difficulties of proof of loss, and the inconvenience or non-feasibility of otherwise obtaining an adequate remedy.

*538 See also *Stuchin v. Kasirer*, 237 N.J.Super. 604, 613, 568 A.2d 907 (App.Div.), certif. denied, 121 N.J. 660, 583 A.2d 346 (1990); *Barr & Sons, Inc. v. Cherry Hill Center, Inc.*, 90 N.J.Super. 358, 376-377, 217 A.2d 631 (App.Div.1966).

**534 The question before us then is twofold: first, whether the five percent late charge provided for by the promissory note is reasonably related to the anticipated or actual damage likely to be suffered by the lender in the event of late payment of the installment due and, second, whether those damages are unascertainable or difficult to prove resulting in the inconvenience or non-feasibility of otherwise obtaining a remedy. Unless both components of that question can be answered affirmatively, the late charge cannot pass muster as an enforceable liquidated damages provision. The answer to that question depends, moreover, on the proofs offered by the parties at the evidential hearing.

[4][5][6] Before considering those proofs, we make this preliminary observation. As the Court made clear in *Wasserman's*, supra, 137 N.J. at 252, 645 A.2d 100, the "recent trend toward enforcing stipulated damages clauses" engenders the presumption of their reasonableness, casting upon the party challenging the clause the burden of proving unreasonableness. The trial court here imposed that burden on Metlife, another ruling from which it has not cross appealed. We regard, however, the misplacing of the burden as inconsequential. Neither party has suggested to us the availability to it of any further proofs or of any effect the misplacement of the burden may have had on trial strategy. Moreover, the factual proofs were largely undisputed. We are, therefore, satisfied that considering the record as a whole and irrespective of the placement of the burden of proof, the unreasonableness of the stipulated damages of five percent of the installment due as a late fee was clearly demonstrated. It is an unenforceable penalty.

We consider the trial proofs in the context of these further observations. First, the stipulated damages for breach of the borrower's obligation to make timely monthly payments is expressed *539 only in terms of a fixed percentage of the installment due--that is, five percent--without any reference to or consideration of the duration of the breach and without any reference to the amount of the late installment. Thus, the same five percent applies whether the late installment was \$1,000 or \$10,000 or \$100,000 and whether it was one day late or thirty or sixty. It appears to us, therefore, that in order for the late charge to constitute a reasonable stipulated damages provision as a matter of presumptive validity, it would have to appear that the anticipated or actual damage suffered by the lender in the event of a late payment is unrelated to the duration of the breach, and it would also have to

(Cite as: 313 N.J.Super. 525, *539 , 713 A.2d 527, **534)

appear that the anticipated or actual damages have a material relationship to the amount of the installment since the amount of the late charge is a function only of the amount of the installment. We address the proofs in that light.

Justification for the five percent late charge as liquidated damages was offered by Geer, Metlife's portfolio management specialist, who testified that the five percent late charge is the industry standard and custom. She also testified as to the elements of Metlife's actual damages resulting both from late payments and from default but without in any way attempting to quantify any of those elements. The purpose of the late charge, she explained, is "to assist with costs which are associated in collecting these late payments, internal costs." While no actual costs were testified to, the internal activities generated by the late payment consist, according to Geer, of sometimes but not always telephoning or writing to the borrower and entering the relevant information in computer programs whose printouts are sent to the real estate department and senior management. Thus

Delinquent monthly payments are administered by a department set up to ask and call for such payments that are delinquent. They administrate, they hire a number of people to make calls and write letters in--in an attempt to collect the payment that is delinquent.... In addition to the personnel making phone calls at various times during the month trying to collect the payment, there are reporting requirements and monitoring requirements that have to be met to other departments, especially the accounting department and senior management and reporting requirements to the real estate **535 department.... They have to notify senior *540 management and the real estate department exactly as to why the payment is late, if they've been able to reach the customer, if they've not been able to reach the customer. You know, have they sent out letters. Have they verified whether there are other accounts that are delinquent with this customer. They report to, on a monthly basis, the number of delinquency for a customer, and an attempt to contact them, what they've done. They have to report to the legal department and senior management in real estate and accounting. They have to track numbers for all accounts. Payment. Dollar amounts. Total loan amounts.

She also testified on cross examination that, I don't know of any actual costs [incurred by Metlife in the event of a late payment] other than the taking into consideration that there are a lot of them that are not--cannot pinpoint, based on certain internal

costs. And some of them that are--they have done some internal costs calculations, I know, for other Courts that I've appeared in, but it hasn't been able to be totally conclusive based on employment, and other requirements to administer these loans.

While Geer herself could not testify to the activities undertaken by the recipients of the printouts and other such reports, she presumed that senior management used them to evaluate the productivity of the loan and to determine whether litigation or other enforcement techniques should be employed. Of course, it is also clear to us that at least one other purpose of the data entries on late payments is to generate the information necessary to bill the borrower for the late fee. And although Geer did not so testify in connection with the late fee, there is also the factor to be considered of the lender's loss of the full productivity of the loan by reason of having to wait for the payment, which, had it been timely made, would have provided the lender with those additional days of investment opportunity.

It is difficult for us to understand quite how Geer's testimony provides an adequate basis for sustaining the reasonableness of the customary five percent fee. There is nothing in Geer's testimony to suggest that the unquantified internal costs, even if we assume that they are reasonably recoupable and are not merely a matter of the cost of doing business, are necessarily related to the amount of the loan or of the installment. Indeed, her testimony appeared to be to the contrary. Yet, even though all borrowers who make a late payment would, in that case, inflict the same amount of damages on the lender irrespective of the *541 amount of the installment due, nevertheless each borrower pays different stipulated damages depending only on the amount of the installment. It would appear, therefore, that to the extent that these administrative internal costs represent recoverable damages at all, a reasonable liquidated damage provision would have to be in the nature of a flat fee that would be the same for all borrowers. If, moreover, as may also be inferable from Geer's testimony, the duration and frequency of the delinquencies have a direct relationship to internal administrative costs because those factors might require closer and more constant loan management, the fact remains that the uniform five percent fee does not take these factors into account at all.

To the extent that the late fee might be justified as compensation to the lender for the loss of the productivity of the loan, it is patent that the five percent late fee is wholly unsupportable and probably usurious. [FN3] The same five percent is charged

(Cite as: 313 N.J.Super. 525, *541, 713 A.2d 527, **535)

whether the installment is one day late or thirty days late. And if it is one day late, the annualized interest rate on that delinquent installment would be 1825 percent. Moreover, if the purpose of the late fee were, in fact, to compensate the lender for loss of the use of that money for the period of the delinquency, we think it plain that that element of damage is neither unascertainable or difficult to prove. The annual contract interest or any other reasonable rate is readily calculable on a per diem basis, and the actual loss, as determined by applying the per diem rate to the duration of the lateness, could readily be **536 added to the borrower's next monthly statement. Stipulated or liquidated damages would not be necessary or appropriate. See, e.g., *Borden Company, Pioneer Ice Cream Division v. Manley*, 127 N.J.L. 461, 463, 23 A.2d 281 (Sup.Ct.1942) ("[i]f it appears that the parties have provided for an excessive sum in a case where the real damages are certain or *542 readily reducible to certainty by proof, then the sum fixed is deemed a penalty and not enforceable.")

FN3. The criminal usury statute, N.J.S.A. 2C:21-19, makes it a crime to charge an individual annual interest at a rate exceeding 30% and a corporation a rate exceeding 50%.

[7] We are thus persuaded that the five percent late charge fails to meet the liquidated damages test for two reasons. First, there was no showing on any quantified basis, and hence it is a matter of pure speculation, that the fixed percentage late fee is reasonably related to the anticipated or actual internal costs. Beyond that, at least some of the legitimate elements of damage are not either unascertainable or difficult to calculate. There is, however, yet another reason for our conclusion. Geer did not testify that one of the purposes of the late charge was coercive, that is, to provide an incentive to the borrower, on pain of incurring the late charge, to make timely payments. But we are convinced that such a purpose may be inferred. Certainly such a purpose explains the percentage technique since it imposes the same relative pain on each borrower, a result that would not obtain if the same modest flat service fee were charged on each loan. But it is well settled that a purpose to coerce timely payments renders the charge so imposed a penalty by definition. See, so holding, *Stuchin*, op cit., supra. See also *In re Tastyeast, Inc.*, 126 F.2d 879, 882 (3rd Cir.), cert. denied sub nom. *Modern Factors Co. v. Tastyeast, Inc.*, 316 U.S. 696, 62 S.Ct. 1291, 86 L.Ed. 1766 (1942); *In re Timberline Property Development, Inc.*, 136 B.R. 382, 385-86 (D.N.J.1992); *Ridgley v. Topa Thrift*

and Loan Ass'n, 17 Cal.4th 970, 73 Cal.Rptr.2d 378, 953 P.2d 484, 490 (1998). As explained by *Garrett v. Coast and Southern Federal Sav. & L. Ass'n.*, 9 Cal.3d 731, 108 Cal.Rptr. 845, 511 P.2d 1197, 1203 (1973), in assessing the punitive nature of the fixed percentage late charge there involved:

We are compelled to conclude that a charge for the late payment of a loan installment which is measured against the unpaid balance of the loan [there two percent] must be deemed to be punitive in character. It is an attempt to coerce payment by a forfeiture which is not reasonably calculated to merely compensate the injured lender.

We reach the same conclusion with respect to a late charge measured by a fixed percentage of the installment due.

*543 There is no reported case in this jurisdiction dealing directly with the question of the penal nature of a fixed percent late charge. We recognize that the issue was raised in *Crest S. & L. Ass'n v. Mason*, 243 N.J.Super. 646, 648-649, 581 A.2d 120 (Ch.Div.1990), in which the court did note that:

Late payment charges, or late charges, are collectable as liquidated damages if there is a provision for them in the mortgage instruments. When there is such a provision, an issue may arise as to whether the late charge constitutes valid liquidated damages or an invalid penalty. If the late charge is compensation to the mortgagee for its administrative expenses and the cost of money wrongfully withheld, it is a proper charge as liquidated damages.

Nevertheless, the court did not have to address the issue of whether the five percent late fee there was a penalty or not since the parties only disputed the collectibility of the late charge imposed on payments due after the filing of the complaint in foreclosure, a charge held to be invalid.

The validity of the percentage late charge has, however, been considered by other jurisdictions. Some sustain it primarily on the basis of industry custom and standard without factual or legal analysis of its nature or its relationship to anticipated or actual damages. See, e.g., *Mattvidi Assoc. Ltd. Partnership v. NationsBank of Virginia*, 100 Md.App. 71, 639 A.2d 228, 238, cert. denied, 336 Md. 277, 647 A.2d 1216 (1994), and cases cited therein. See also Gary D. Spivey, Annotation, Validity and Construction of Provision Imposing "Late Charge" or Similar Exaction for Delay in Making Periodic Payments on Note, Mortgage, or Instalment Sale Contract, 63 A.L.R.3d 50, 53 (1975 & Supp.1997). And see Mack

(Cite as: 313 N.J.Super. 525, *543, 713 A.2d 527, **537)

Fin. Corp. v. **537 Ireson, 789 F.2d 1083 (4th Cir.1986), holding a five percent late charge valid on the basis of Virginia law expressly authorizing late charges in an amount not exceeding five percent of the amount of the installment due. We find more persuasive, however, the contrary reasoning to which we have already referred of Garrett, supra, (invalidating as a penalty a late charge of two percent of the principle balance); Ridgley, supra, (invalidating as a penalty a late fee of six months' interest); Garcia v. Canan, 851 F.Supp. 327 (N.D.Ill.1994), (invalidating as a penalty a late charge of ten percent of the installment due); and *544 In re Matter of Timberline, supra, (invalidating on the basis of the Bankruptcy Court's understanding of New Jersey law, a late charge, like here, of five percent of the monthly interest installment due).

V.

[8] Finally, we consider the default interest rate of fifteen percent. We start with the proposition that the extra 5.45 percent can be regarded as liquidated damages rather than a penalty only if it meets the two-prong test we have already described. See Stuchin, supra, 237 N.J.Super. at 613-614, 568 A.2d 907. We turn again to Geer's testimony. The components of the damages she explained, again unquantified, included internal administrative costs, the loss of the use of the money, and the necessity for Metlife to obtain appraisal and environmental reports and to engage attorneys. What we have said about the internal costs and the loss of the bargain in connection with the five percent late charge obtains to the default interest rate as well. As to the other costs, we note first that attorneys' fees together with all other costs of collection cannot be included as stipulated damages because they are charged separately to the borrower. Geer, indeed, made clear that for that reason no litigation or pre-litigation expenses are taken into account as supporting stipulated damages. Moreover, we think it plain that the cost of obtaining appraisal and environmental reports are neither unascertainable nor difficult to calculate whether or not done in house.

[9][10] The trial judge, as we have noted, agreed with defendants that the fifteen percent default rate was excessive and not reasonably related to anticipated actual damages, and there was no cross appeal from that ruling. The issue before us, therefore, is whether, after so concluding, the judge properly fixed the lesser default rate of 12.55 percent,

that is three percent over the contract rate. We are satisfied that his doing so is not sustainable. In our view, once the trial court has determined that a liquidated damages provision constitutes a penalty and is, therefore, *545 unenforceable, the party who attempted to impose that penalty is remitted to the ordinary recourse of proving actual damages sustained. See Wasserman's, supra, 137 N.J. at 249, 645 A.2d 100. Moreover, we see no factual basis in the record for the fixing of a three percent enhancement as unliquidated damages. On this record, we regard as entirely speculative the conclusion that any unascertainable or difficult to calculate actual damages suffered by Metlife by reason of the default are reasonably related to a three percent enhancement over the contract rate. See also In re Timberline, supra, 136 B.R. at 385, invalidating a three percent default rate enhancement as coercive and, therefore, punitive, and noting that while "it is plausible that a three percent (3%) increase upon default bears some relationship to actual administrative expenses incurred by the lender," the proofs offered by the lender there nevertheless failed to support that conclusion. The same is true here.

VI.

As we have noted, defendants have paid the amount required by the judgment of foreclosure in full. We hold that that sum should not have included either the five percent late charge or the three percent default rate enhancement over the contract rate. We also hold that the issue of defendants' entitlement to credit for the rents collected must be reconsidered consistently with this opinion.

We therefore vacate those provisions of the judgment of foreclosure relating to the calculations of the amount due to the extent the five percent late fee and the 12.55 percent **538 default rate were included, and we reverse the order denying defendants' motion for relief from judgment seeking recalculating of the credit for rents collected. We remand in order that plaintiff may present proof of actual damages sustained by reason of the late payments and the default, for recalculation of the credit for rents collected consistent with this opinion, and for consolidation with this action of any other pending litigation respecting that credit.

END OF DOCUMENT

EQUITABLE PRINCIPLES/By Jeffrey H. Newman and Robert Hempstead

Testing Whether Liquidated Damages Clauses Are Reasonable

MANY jurisdictions recognize leases more as contracts rather than conveying vehicles. As a result, basic equitable principles (i.e., good faith and fair dealing), as applied in contractual disputes, are used when interpreting and analyzing disputed lease provisions. In New Jersey, for example, courts apply a two-pronged reasonableness test to determine whether amounts stipulated under liquidated damages clauses are enforceable.

The test was recently applied in the commercial mortgage loan case of *Metlife Capital Financial Corp. v. Washington Ave. Assocs.*, 713 A.2d 527 (N.J. Super. Ct. App. Div. 1998). In that case, the court considered whether the amounts stipulated under a liquidated damages clause contained in a mortgage note were (1) reasonably related to the anticipated or actual damages incurred by the lender, and (2) unascertainable or difficult to prove. See *Metlife*, 713 A.2d at 533.

In finding for the borrower, the court held that a 5-percent late charge and a 15-percent default rate of interest (i) were not reasonably related to the anticipated or actual damages and (ii) that actual damages were not unascertainable or difficult to prove.

If the holding of the *Metlife* case stands, (the New Jersey Supreme Court has recently granted the lender's petition for certiorari and will hear the *Metlife* case during the court's current term), landlords, as well as lenders, may be faced more fre-

quently with having to defend the validity of their stipulated damages clauses. Of course, borrowers and tenants must first be able to meet their burden of proof, by demonstrating either the lack of a reasonable relationship between the stipulated amount and the actual damages incurred, or that such anticipated damages are ascertainable or calculable.

Effect on Remedies

Because of the requirement for a reasonable relationship between estimated and actual damages, the *Metlife* case may have an impact on a classic remedy for many landlords, i.e., the right of acceleration of all amounts to become due under a lease following default (without discounting to present worth and offsetting for the net proceeds realized from any reletting). Under the reasoning of *Metlife*, a court may require that a landlord discount the accelerated total to present value, based on a reasonable rate of return.

Moreover, New Jersey courts already require that a commercial landlord use reasonable efforts to relet the premises. The *Metlife* case may now require a valuation of fair rental value in the absence of an actual reletting, which amount can then be used as the basis to ascertain a net proceeds figure to subtract against the accelerated rental amount, prior to discounting the difference to present worth. (Once a fair rental value amount is determined, a vacancy factor, brokerage factor, fit-up factor, etc., can be applied to determine a reasonable estimate of the likely net proceeds to be received by the landlord for the balance of the lease term, had there not been a default.)

The enforceability of such "one-size-fits-all" type of remedies will be at greater risk under the *Metlife* holding. For example, a "sales inclusion" remedy, calling for the aggregation of the sales of a store which is the subject of a radius restriction, together with the sales of a store operating in violation of a radius restriction, may be viewed by a court as a blanket remedy applicable to all defaults under the radius restriction provision, regardless of the proximity of the store operating in vio-

Continued on Page 7

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Jeffrey H. Newman is a partner with Sills Cummis Radin Tischman Epstein & Gross in Newark, N.J. Robert Hempstead is an associate with the firm.

Liquidated Damages Clauses

Continued from Page 8

lation of the restriction, to the store subject to the restriction, and may, therefore, be stricken as an unenforceable penalty. The Metlife holding would seem to favor a graduated percentage inclusion approach to a liquidated damages provision for a violation of a radius restriction. Say, for example, the tenant is subject to a five-mile radius restriction in which it may not operate a similar store. Perhaps there should be a 90-percent inclusion factor: if the violative store is one mile away or less, with a 10-percent decline for each subsequent mile, so that the remedy ranges from 90-percent inclusion to 60-percent inclusion. (Note that, in suggesting a "top" sales inclusion figure of 90 percent, the authors are giving deference to the analysis used in *Barr & Sons Inc. v. Cherry Hill Center Inc.*, 90 N.J. Super. 358 (App. Div. 1966), as echoed by the Metlife court in footnote 6. Finding that compensatory damages are measured by the "loss" sustained by reason of the breach, rather than by all the profits made by the party in breach, the Barr court refused to infer that all persons who purchased merchandise from the competing tenant who was in violation of the restrictive covenant would have purchased that merchandise from the protected tenant.)

Monetary vs. Nonmonetary Defaults

A more practical challenge for lenders and landlords that may arise out of the holding of the Metlife case deals with the difference in ascertaining damages based on a monetary default, as opposed to damages based on a nonmonetary default. As set forth in *Metlife*, the second prong of the reasonableness test requires the party defending the liquidated damages clause to demonstrate that the amount of damages to be incurred is unascertainable or difficult to prove. However, the Metlife court seems to imply that if the default in question is

of a monetary nature (e.g., failure to make payments of principal and interest), the amount of damages will almost always be ascertainable. For example, in *Metlife*, the court determined that the lender's loss was its inability to use the money that was owed and not repaid by the borrower. However, since the return that the lender could have realized by investing such funds was determinable, and, since the return on the money owed by the borrower was determinable, the difference (i.e., the loss incurred by the lender) was determinable as well. The same analysis may prove true for a tenant's breach of any monetary obligation under its lease.

Yet, while it can be argued that damages suffered by a landlord in the event of a monetary default by a tenant might always be determinable, the amount of damages suffered by a tenant's nonmonetary default appear more likely to be incapable of quantification. For example, if a shopping center tenant breaches an operating covenant, how does the landlord quantify the impact such an action has on the shopping center? A vacant store may have an adverse effect on the center's image, may reduce traffic at the center and could jeopardize the landlord's ability to realize maximum returns under percentage rent clauses with other tenants. The amount of gross sales that a tenant under a lease for space at a shopping center may generate is arguably directly related to the continuous operation of the other tenants of the center. Therefore, the losses that a landlord may suffer, in the event that one tenant ceases operations, may prove impossible to ascertain.

Reliance on 'Industry Standards'

A lender's or landlord's reliance on "customary" or "industry standard" liquidated damages clauses could now be misplaced as well. In *Metlife*, the court rejected the lender's defense that the stipulated amounts were the

industry standard and custom.

Instead, the court forced the lender to demonstrate the relationship between the actual damages and the agreed-on damage amounts set forth in the mortgage documents. Similarly, landlords should be prepared to prove a correlation between stipulated damage amounts contained in their leases, particularly with respect to late rental payments (since presumably the losses are quantifiable, as discussed above), and their actual damages. Ironically, the administrative cost incurred in attempting to demonstrate a correlation between actual costs incurred and the stipulated damages may prove so expensive, in and of itself, that it may consume a significant portion of the damages that a lender or landlord is trying to recoup.

Liquidated damages clauses have, to a large extent, survived the scrutiny of the courts and have, in general, gone unchallenged by borrowers and tenants alike, thereby establishing the industry standards so often accepted in mortgage and lease documents. As a result, many lenders and landlords have perhaps been lulled into a false sense of security in assuming that their liquidated damages clauses are valid.

The Metlife holding serves as a wake-up call for both lenders and landlords. The otherwise customary liquidated damages clauses contained in their agreements should no longer be assumed to be valid. In light of the Metlife holding, tenants and borrowers, or, at least those whose documents are governed by New Jersey law, should now no longer blindly assume the validity of liquidated damages clauses. Moreover, they will be able to challenge them on an after-the-fact basis and, after an initial showing, shift the burden of proving (or burden of going forward to show) the reasonableness of the stipulated damage amounts to the lenders and landlords. As the lender in *Metlife* learned, meeting that burden may not be so easy. As noted above, the New Jersey Supreme Court has recently granted the lender's petition for certification and will hear the Metlife case — stay tuned. ■

LOAN TERMS TABLE

_____, 19____
 Borrower: _____
 Original Principal Amount: \$ _____ Loan No.: _____
 Note Rate: _____% Servicing No.: _____
 Monthly Payment Amount: \$ _____ Borrower's TIN: _____
 Amortization Commencement Date: _____ 1, 19____ Maturity Date: _____ 1, _____
 Lockout Period: Beginning on the date of this Note and ending on [4 Months Prior to Maturity Date].
 Specified U.S. Treasury Security: _____% U.S. Treasury Security due _____, _____

PROMISSORY NOTE

FOR VALUE RECEIVED, the borrower described in the Loan Terms Table set forth above (the "Borrower") promises to pay to the order of NATIONSBANK, N.A., a national banking association, its successors and assigns (the "Lender"), the Original Principal Amount (as outstanding from time to time, the "Principal Amount") under the terms and conditions of this promissory note (the "Note") and in accordance with the loan agreement of even date herewith by and between the Borrower and the Lender (the "Loan Agreement"). This Note is secured by a deed of trust, mortgage or deed to secure debt of even date on certain property of the Borrower (the "Security Instrument") and other agreements by and between the Borrower and the Lender. The Loan Terms Table is a part of this Note and all terms used in this Note which are defined in the Loan Terms Table shall have the meaning set forth therein. Except as expressly provided otherwise in this Note, the defined terms in the Loan Documents (as defined in the Loan Agreement) are used herein with the same meaning. All of the terms, definitions, conditions and covenants of the Loan Documents are expressly made a part of this Note by reference in the same manner and with the same effect as if set forth herein at length. Any holder of this Note is entitled to the benefits of and remedies provided in the Loan Documents. Any Event of Default under any of the Loan Documents is an Event of Default under the terms of this Note.

1. Interest. The outstanding Principal Amount of the loan evidenced by this Note (the "Loan") shall bear interest at a fixed rate per annum equal to the Note Rate. Interest shall be computed based on the daily rate produced assuming a 360 day year, multiplied by the actual number of days elapsed. Except as otherwise set forth in this Note, interest shall be paid in arrears.

2. Principal and Interest Payments. The Principal Amount and interest thereon shall be payable at the Lender's offices in Charlotte, North Carolina, or at such other place as the Lender may designate in writing. An initial payment is due on the date hereof for prepaid interest through and including the last day of the month in which this Note is executed. Thereafter, except as may be adjusted in accordance with the immediately following sentence, payment shall be made in consecutive monthly installments of principal and interest in an amount equal to the Monthly Payment Amount on the first day of each month beginning on the Amortization Commencement Date (each a "Scheduled Payment Date"), until the entire indebtedness evidenced hereby is fully paid, except that any remaining indebtedness, if not sooner paid, shall be due and payable on the Maturity Date. Following any partial prepayment occurring solely as a result of the application of insurance proceeds or condemnation awards pursuant to the terms of the Loan Agreement, the Lender may, in its sole discretion, adjust the Monthly Payment Amount to give effect to any such partial prepayment, provided, however, that in no event will any such adjustment result in any such installment becoming due and payable on any date after the Maturity Date.

3. Late Charges. In the event any payment of interest or principal is not received prior to the 10th day after the same is due (or such greater period, if any, required by applicable law), the Borrower will pay to the Lender a late charge of four percent (4%) of the amount of the overdue payment. This provision for late charges shall not be deemed to extend the time for payment or be a "grace period" or "cure period" that gives the Borrower a right to cure a Default Condition. Imposition of late charges is not contingent upon the giving of any notice or lapse of any cure period provided for in the Loan Documents.

COMMERCIAL LEASE LAW INSIDER

JANUARY 1997

The Practical, Plain-English Monthly Newsletter for Owners, Managers, Attorneys, and Other Real Estate Professionals

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Avoid Late Rent with 'Early Bird' Incentive for Tardy Tenants

If you've got a lot of small office tenants or mom-and-pop retailers in your office building or shopping center, chances are several are chronically late with their rent. Late rent can put a strain on your building's or center's operations—it can make it tougher for you to pay your bills on time. Theoretically, you can solve this problem by simply getting rid of your tardy tenants.

But there's an easier—and more practical—solution you can use with tenants you want to keep. When a tenant renews its lease, offer it an "early bird" rent payment incentive, suggests Vena Jones-Cox, president of Real Estate Investors Association of Cincinnati, Inc., a nonprofit educational association. With this incentive, the tenant gets a "prepayment discount" on its monthly minimum rent if it pays the rent before it's due—say, before the first of the month. You can structure the incentive so it costs you nothing: Simply raise the renewal rent to an amount that's slightly more than you would have charged for the space if the tenant had paid its rent on time. Then offer the tenant a discount that brings the rent down to the amount you would have charged, Jones-Cox advises.

We'll show you how to set up the early bird incentive, and give you a Model Lease Clause to help you do that (see p. 3).

Give Tenant Incentive to Pay Rent Early

Alan Alexander, senior vice president of Woodmont Managements, Inc. in Belmont, Calif., has successfully used this "early bird" rent incentive with several renewing tenants that frequently paid their rent late. Traditionally, owners use late fees to induce their tenants into paying rent on time. But the early bird strategy works differently—it encourages the tenant to pay rent early, explains Alexander. To take advantage of the discount, a tenant whose finances are tight may opt to pay the rent first rather than last, after its other bills, explains Alexander.

For example, Alexander recently offered a solo attorney tenant an early bird incentive when the tenant renewed his lease. The attorney was a good tenant in every way except paying his rent on time. He often left the rent until last when he juggled his bills. Since the renewal, the attorney tenant has taken advantage of the early bird incentive—and Alexander has one less late rent payment to worry about each month.

(continued on p. 2)

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Subscriptions: *Commercial Lease Law Insider* (ISSN 0736-0517) is published monthly. Subscription rate: \$254 for 12 monthly issues. Address all correspondence to: Brownstone Publishers, Inc., 149 Fifth Ave., New York, NY 10010-6801. Tel.: 1-800-643-8095 or (212) 473-8200; fax: (212) 473-8786; e-mail: comlease@aol.com

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'EARLY BIRD' INCENTIVE (continued from p. 1)

Is the Incentive Worth the Trouble?

Several experts *CLLI* spoke with questioned whether the early bird incentive is worth the trouble. While it sounds like an interesting idea in theory, it may be hard to handle administratively, warns Charles Pitcock, associate general counsel of Forest City Enterprises, Inc., in Cleveland. For example, you won't be able to predict what your rental income will be each month. Also, many owners simply don't care if the rent is a couple of days late, adds Stuart D. Byron, counsel at the New York City law firm of Tenzer Greenblatt LLP.

But Alexander responds that all owners as a matter of policy should strive to collect rent on time. Otherwise, a minor late rent problem with a few tenants could snowball into a major financial problem for you involving many tenants.

There's another potential problem with the "early bird" incentive. There's a risk that you'll inadvertently accept a check for the discounted amount and then discover that the tenant wasn't entitled to the discount, says Byron. Then the tenant might argue that you gave up your right to collect the higher rent by accepting its check, he explains.

Last but not least, your other tenants may object if they get wind of this rent incentive.

Set Incentive that Doesn't Lower Property Value

If you decide the "early bird" incentive is worthwhile for your building or center, keep a tight rein on when you give this incentive—and how much it is. If you offer the incentive to too many tenants or if the rent breaks you give are too big, you may hurt the value of your building or center, explains Richard F. Muhlebach, president of TRF Management Corporation in Bellevue, Wash. Every dollar you shave off the rent stream decreases the value of your property by roughly \$10, explains Muhlebach. And a lower property value will make it tougher if you later decide to sell or finance your building or center.

The best way to avoid a lower property value is by doing the following:

Set pre-discounted rent at high end of market. Set the tenant's rent—before the discount—at an amount that's at the high end of market rent, suggests Jones-Cox. Then, if the tenant takes advantage of the discount, it's still paying roughly fair market rent—not below market—for the space, she explains.

Don't give too big a discount. Try to keep the discount as small as possible, but still big enough to induce a tenant to pay early, explains Alexander. He usually tries to keep the discount between \$50 and \$200 in his market. The exact amount will differ from tenant to tenant based on the specifics of the deal, such as the tenant, the space, and the amount of rent.

Don't offer incentive to too many tenants. Be selective about offering discounts. Otherwise, the discounts—and the administrative hassle—can really add up. Giving one tenant a \$50 break per month will cost you only \$600 per year if the tenant takes advantage of it each month. Giving that same break to 20 tenants will cost you \$12,000 if it's used by all 20 tenants each month, explains Muhlebach.

Alexander has offered the early bird incentive only when renewing the lease of a chronically late-paying but otherwise good tenant. But you could also consider using it with a new tenant that looks like it might have trouble paying on time—say, with a tenant that has a late-rent payment history, adds Alexander.

Will Tenants Accept This?

Alexander has had no trouble getting a tenant to accept the higher rent with an early bird rent incentive. When facing the renewing tenant, simply say that it must either accept the rent and incentive combination or you won't renew the lease, he suggests. And when dealing with a new tenant with a shaky rent-payment history, say to the tenant, "Ordinarily, I wouldn't take you in my building or center, but I might try you on this basis," suggests Alexander.

Plug Potential Loopholes in Incentive

If you decide to offer the early bird incentive to a tenant, make sure your lease renewal gives you the optimum protection.

Require receipt of rent before set date. Simply requiring the tenant to pay its rent before the due date isn't good enough. The tenant may mail the rent before the due date, but you may still get the rent late. Instead, say in the lease that you must get the rent on or before a certain date—for example, on or before the last business day of the month [Clause, par. b(i)]. You may also want to set a specific deadline for the tenant to mail the rent—say, on or before the 24th day of the preceding month.

Postal problems aren't your fault. What if the tenant insists it mailed the check in plenty of time, but you didn't get it before the early bird payment date? You and the tenant could wind up in a fierce dispute. To avoid this, say that the tenant doesn't

get the prepayment discount if the check doesn't reach you in time no matter what the reason—including a glitch at the post office [Clause, par. c].

No discount if check bounces.

It's also important to say that the tenant loses the discount if the check bounces, says Jones-Cox [Clause, par. b(ii)].

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MODEL LEASE CLAUSE

Offer Discount to Tenant for Early Rent Payment

The following lease clause was drafted with the help of Vena Jones-Cox, New York attorney Stuart D. Byron, and California property manager Alan Alexander. It offers the tenant an "early bird" incentive—called a "prepayment discount" in the lease—for paying the rent early. You can use this clause in a lease renewal with a tenant that has a history of late rent payments.

Paragraph a of the clause offers the tenant a prepayment discount if the tenant pays its rent early, provided that the tenant doesn't owe back rent and isn't in default of the lease. Paragraph b bars any prepayment

discount, and requires the tenant to repay any prepayment discount it has taken, if you don't get the rent check on or before the last business day of the immediately preceding month or if the tenant's check bounces. And paragraph c says that the tenant has no excuse, including poor mail delivery, if the rent arrives too late for the prepayment rent discount.

Check with your lawyer about using this clause in your lease renewal—or even in a lease with a new tenant that has a shaky history of paying rent.

MINIMUM RENT EARLY PAYMENT INCENTIVE

- a. **Prepayment Discount.** As an incentive to Landlord to *[insert one: enter into/renew]* the Lease and as an incentive to Tenant to make full and timely Minimum Rent payments before the first day of the month in which such Minimum Rent payment is due, Tenant may deduct a prepayment discount in the amount of *[insert \$ amount]* ("Prepayment Discount") from the Minimum Rent due for the then current month, provided Tenant is not delinquent in the payment of Minimum Rent, Additional Rent, or any other amounts owed to Landlord pursuant to the Lease or otherwise in default of the Lease at the time it makes such payment of Minimum Rent less Prepayment Discount.
- b. **No Discount if Unpaid Rent or Default.** However, Tenant shall not be entitled to such Prepayment Discount for a given month and shall immediately owe any Prepayment Discount it has deducted from Minimum Rent for such month (along with any other unpaid Minimum Rent, Additional Rent, late fees, interest, and other amounts owed to Landlord pursuant to the Lease) if:
 - (i) The Minimum Rent less Prepayment Discount is not received by Landlord on or before the last business day of the immediately preceding month; or
 - (ii) Tenant's check for payment of Minimum Rent less Prepayment Discount is dishonored for any reason by Tenant's bank.
- c. **No Excuse for Delay.** Landlord's failure to receive the Minimum Rent for any reason whatsoever, including, without limitation, a delay in mail delivery, will not excuse Tenant from compliance with the obligations in this Clause.

'EARLY BIRD' INCENTIVE (continued from p. 3)

Not applicable if tenant delinquent or in default. Here's another possible loophole: What if your tenant's rent is, say, one month in arrears. And the tenant makes the next month's payment early. Don't let the tenant take advantage of the discount if it's delinquent in its rent or other charges due you at the time it pays the early-bird rent, says Alexander. It's also a good idea to hinge the discount on the tenant not being in default of the lease, adds Alexander [Clause, par. a].

The tenant may demand that you first notify it of the default even if there's no notification requirement for that default in the lease. Otherwise, it may not know that it's ineligible for the discount, says Byron.

PRACTICAL POINTER: Leave the late fees in your lease in place. The early bird incentive doesn't replace them, it merely supplements them. But check with your attorney that your late fee amount combined with the rent before the early bird discount won't cause you legal problems. If you set the rent before the early bird discount too high—at an above-mar-

ket rate—courts in some states may find that the rent in effect includes a late fee. Then, if you impose a late fee too, you've crossed the line and are charging the tenant an illegal penalty. You'll minimize the potential problems if you make sure the rent before the discount isn't above market.

Tenant must keep deal confidential. Many leases will require the tenant to keep the lease terms confidential. If your lease or renewal doesn't have a blanket confidentiality requirement, make sure you require the tenant to keep the terms of this early bird incentive confidential. Otherwise, you may have every other tenant in your building or center demanding a rent discount if they pay their rent early.

Clause is an incentive for you to sign lease. Be sure to say that the early bird program is an incentive for you to sign—or renew—the lease with the tenant, suggests Alexander. In other words, if the tenant hadn't accepted this program, you might not have agreed to rent the space to it or renew the lease in the first place [Clause, par. a]. This language lets a court know that the tenant understood the impor-

tance of this clause to you—and the tenant can't later argue that the clause was "unconscionable," says Alexander.

Consider Two Other Provisions

Here are two additional ideas that could help you structure the rent incentive to your advantage:

Applying discount. You may not want to let the tenant deduct the discount from the minimum rent. Instead, you may want to have the discounts accumulate, and then let the tenant eventually apply them:

- As free rent at the end of the lease;
- As an open credit toward operating expenses or CAM costs—including overtime HVAC; or
- Toward a purchase option.

Decide whether eligibility is temporary or permanent. You may not want to offer this incentive to the tenant for the entire lease term or renewal term but just long enough to get the tenant on track. If you decide to offer the incentive to the tenant for, say, only one year, make sure you spell this out in the lease. ▲

NEW LAW

Take Advantage of Depreciation Change for Owner-Made Tenant Improvements

A recent amendment to the Internal Revenue Code may give you more flexibility when negotiating leases for your office building or shopping center. In many situations, the amendment makes it more attractive from a tax standpoint for you to agree to make and pay for tenant improvements as a concession to the tenant.

The amendment—which is part of the "Small Business Job Protection Act of 1996"—covers only tenant improvements "irrevocably disposed of or abandoned" by an

owner after June 12, 1996. Here's a brief overview and some helpful tips on taking advantage of the amendment. Since parts of the amendment are unclear or open to differing interpretations, be sure to talk with your attorney and your accountant before taking any steps.

Before: 39-Year Depreciation Period

Before the amendment, the Internal Revenue Service (IRS) required owners of commercial property to

depreciate the cost of a tenant improvement they paid for over a period of 39 years. It didn't matter when the lease ended or if the tenant improvement was removed at the end of the lease, says David E. Kahan, counsel in the New York City office of the law firm of Roberts & Holland LLP. But many leases are much shorter than 39 years. So you may have ended up having to depreciate these improvements long after they'd been removed from the space.

Keeping Current PROPERTY

Keeping Current—Property offers a look at selected recent cases, rulings and regulations, literature and legislation. The editors of *Probate & Property* welcome any suggestions and contributions from readers.

CASES

• **BROKER LIABILITY: No fraud among professionals.**

A multiple listing indicated that seller was the "sole owner" although the listing broker knew otherwise. A broker/purchaser contracted to buy the property with "good and merchantable title." When the seller was unable to deliver the necessary title, broker/purchaser sued the seller and the listing broker. *Richard Brown Auction & Real Estate v. Brown*, 583 So.2d 1313 (Ala. 1991), upholds a judgment for lost profits against the seller but reverses a fraud judgment against the listing broker. The court distinguished earlier cases finding fraud liability against listing brokers because those cases did not involve a knowledgeable, professional buyer with access to public records.

• **CONCURRENT ESTATES: Notes from entireties property are held by entireties.** In a case certified from the U.S. Court of Appeals for the Fourth Circuit, *Pitts v. United States*, 408 S.E.2d 901 (Va. 1991), treats notes as entireties property when received in exchange for real property held in tenancy by the entireties, even though the notes contain no language of survivorship. The holding invalidates an IRS levy against the husband's interest in the notes.

• **CONVEYANCING: Escrow agent cannot capture cash for itself.** Under a land installment sales contract, a bank was designated as escrow agent for payments. When buyer made an \$11,000 payment on the contract, the bank applied the entire payment to the buyer's other debts to the bank. The sales contract was foreclosed as a result of the missed payment. *A.G.A. Inc. v. First Nat'l Bank*, 474 N.W.2d 655 (Neb. 1991), upheld summary judgment for the buyer in a suit against the bank for the misapplied payment and prejudgment interest.

• **ESTATES IN LAND: Limiting effect of Reverter Act.** The Devou family donated a large park overlooking the Ohio River to Covington, Kentucky. A number of conditions were enforceable by a right of entry. A 1960 Kentucky statute declared rights of entry invalid unless a

declaration of restriction was recorded by 1965. After the time for recording passed, the city filed suit to void every condition except those limiting the property to park use. *Unknown Heirs of Devou v. City of Covington*, 815 S.W.2d 406 (Ky. App. 1991), concluded that the statute removed the right of entry but did not remove the restrictions. The property remained dedicated to the restrictions unless a particular condition had ceased to be "convenient and comfortable."

✱ • **LANDLORD AND TENANT: Late fee is illegal penalty.** A lease of federally subsidized housing provided a late fee of \$5 six days after the rent was due plus \$1 for each late day thereafter. The lease described the charge as "liquidated damages." *Highgate Assoc., Ltd. v. Merryfield*, 597 A.2d 1280 (Vt. 1991), holds the charge unenforceable as a penalty.

• **LANDLORD AND TENANT: Hotel exemption from warranty presents fact question.** The Franklin Hotel, which rented rooms on a weekly basis to occupants with no other fixed address, claimed exemption as a "hotel" from an implied warranty of habitability under the Landlord/Tenant Act. *Baker v. Rushing*, 409 S.E.2d 108 (N.C. App. 1991), reverses summary judgment for the landlord and remands for a trial on whether the Franklin Hotel, called "unfit for human habitation" by a local inspector, is exempt.

• **LANDLORD AND TENANT: Utah joins modern majority on warranty of habitability.** Utah has embraced the implied warranty of habitability in landlord-tenant relationships. *Wade v. Jobe*, 818 P.2d 1006 (Utah 1991), applies the rule to a tenant's counterclaim to landlord's suit for rent. *P.H. Investment v. Oliver*, 818 P.2d 1018 (Utah 1991), reversing *P.H. Investment Co. v. Oliver*, 778 P.2d 11 (Utah App. 1989), annotated in Mar./Apr. 1990, Keeping Current—Property, permits the warranty as a defense to an unlawful detainer action.

• **LAND USE: No exhaustion for due process "taking."** Amendment to city zoning ordinance prevented landowner's proposed retail and warehouse facility while a variance application was pending and after a site plan was approved. The amendment was proposed by a city councilman who lived nearby and was passed, without notice, in a secret executive session. In landowner's suit claiming denial of due process under 42 U.S.C. §1983, *Nasierowski Bros. Inv. Co. v. Sterling Heights, Mich.*, 1991 U.S.App. LEXIS 27663, 60 L.W. 2353 (6th Cir. 11/22/91), finds exhaustion requirements for regulatory taking claims inapplicable to due process claims.

(l) Rights of Superior Lessor. Any rights provided herein for the benefit of any Mortgagees shall apply with equal force and effect for the benefit of any Superior Lessors as if expressly so stated in each instance.

(m) Ownership of Leased Premises. Tenant acknowledges that the Leased Premises are the property of Landlord and that Tenant has only the right to the possession and use thereof upon the terms, covenants and conditions set forth in this Lease and the Second Lease.

(n) Acceptance of Surrender. No surrender to Landlord of this Lease or of the Leased Premises, or any part thereof, or of any interest therein, shall be valid or effective unless agreed to and accepted in writing by Landlord and consented to in writing by any and all Mortgagees of which Tenant has written notice, and no act or omission by Landlord or any representative or agent of Landlord, other than such a written acceptance by Landlord, consented to as aforesaid, shall constitute an acceptance of any such surrender.

(o) No Management Fee. Notwithstanding any contrary provision contained in this Lease, as no on-site management or administrative services are to be provided by Landlord during the term of this Lease, Tenant shall have no obligation or liability to pay to Landlord or any third-party any rent or other sum attributable to the cost of management, administration or other similar services.

30. LATE CHARGES.

(a) Tenant hereby acknowledges that late payment by Tenant to Landlord of rent and other sums due hereunder will cause Landlord to incur costs not contemplated by this Lease, the exact amount of which will be extremely difficult to ascertain. Such costs include, but are not limited to, processing and accounting charges, and late charges which may be imposed on Landlord by the terms of any mortgage covering the Leased Premises. Accordingly, if any installment of rent

or any other sum due from Tenant shall not be received by Landlord or Landlord's designee within fifteen (15) days after the date same is due, Tenant shall pay to Landlord a late charge equal to two percent (2%) of such overdue amount. The parties hereby agree that such late charge represents a fair and reasonable estimate of the costs Landlord will incur by reason of late payment by Tenant. Acceptance of such late charge by Landlord shall in no event constitute a ¹wavier of Tenant's default with respect to such overdue amount, nor prevent Landlord from exercising any of the other rights and remedies granted hereunder.

(b) Except as expressly herein provided, any amount due Landlord not paid when due shall bear interest at the Maximum Rate from the date due. Payment of such interest shall not excuse or cure any default by Tenant under this Lease, provided, however, that interest shall not be payable on late charges incurred by Tenant nor on any amounts upon which late charges are paid by Tenant.

31. DEFINITIONS.

For the purposes of this Lease, the following definitions shall be applicable:

Event of Default - as defined in Section 19(a).

Impositions - as defined in Section 5(b).

Improvements - as defined in Section 1.

Land - as defined in Section 1.

Landlord - as defined in Section 23.

Laws - as defined in Section 2.

Lease Year - any twelve (12) month period during the term of this Lease commencing on the first day of the first full calendar month of the term of this Lease.

Leased Premises - as defined in Section 1.

Maximum Rate - an annual rate of interest equal to the Prime Rate plus two (2%) percent but in no event in excess