Landmark Decision For Lessors

Lessors receive support for enforcing late charges from New Jersey's highest court.

In a case of great significance to the equipment leasing industry, on June 30, 1999, the New Jersey Supreme Court issued a unanimous ruling overturning the Appellate Division's near-disastrous 1998 decision in MetLife Capital Financial Corporation v. Washington Avenue Associates. In a well-written and comprehensive opinion, the Court upheld a creditor's ability to impose small, fixed-percentage late charges negotiated by sophisticated commercial parties, so long as the charges are "reasonable" under the "totality of the circumstances," as determined by "normal industry customs and standards" or they otherwise fall within a range expressly authorized by statute in similar contexts.

The Court also upheld a lender's ability to increase the interest rate on a loan while the debtor is in default, so long as the default rate is reasonable. Most significantly, the Court clearly asserted that:

• Late charges and default interest freely negotiated by sophisticated commercial parties should always be presumed reasonable.
• The debtor must bear the full burden of proving such charges unreasonable within industry or statutory standards.
• The debtor must otherwise prove the existence of fraud, duress or unconscionability in the transaction.

The decision should have far-reaching positive impact nationally on a lessor's ability to charge and collect "late fees" and default rates of interest.

Trial Court Ruling
The plaintiff, MetLife, made a $1.5 million dollar loan to Washington Avenue Associates, secured by a mortgage on commercial property in Belleville, New Jersey. Washington Avenue signed a four-year promissory note providing for 48 equal monthly payments, with interest at 9.55 percent per annum and a final balloon payment due at the end of the four-year term. The note also provided for a late fee equal to 5 percent of any delinquent payment. In addition to the late fee, in the event of a declaration of default under the note, the interest rate on the unpaid principal balance would increase to a "default rate" equal to the greater of 15 percent per annum or 5 percent per annum in excess of Chase Manhattan Bank's prime rate.

Although Washington Avenue eventually made all 48 installment payments, 40 of them were delinquent, and it failed to make the balloon payment at maturity. MetLife declared the loan in default and commenced a foreclosure action.

At trial, the court held that the creditor, MetLife, bore the burden of proving the enforceability of the late fee and the default interest provisions of the note as "stipulated" or "liquidated" damages clauses, and concluded that the 5 percent late fee represented reasonable liquidated damages. Although the court considered the applicable 15 percent default rate in the promissory note an unenforceable penalty, it concluded that a default rate of 12.55 percent (or 3 percent above the contract rate of 9.55 percent) would be reasonably related to MetLife's actual damages. It therefore judicially rewrote that provision to reduce the default interest rate from 15 percent to 12.55 percent.

Appellate Ruling
Washington Avenue appealed the trial court's decision, challenging the court's enforcement of the late fees and the default interest rate (even at the reduced rate). The Appellate Division reversed the trial court and concluded that both the 5 percent late fee and the court-imposed default interest rate of 12.55 percent constituted unenforceable penalties. It vacated the trial court's judgment of foreclosure, and remanded the matter to permit MetLife to present proof of the actual damages from Washington Avenue's late payments and defaults.

The Appellate Division's ruling caused a torrent of concern and consternation throughout the commercial finance industry. Seemingly overnight, lessors across the country were hit with class action lawsuits from a "cottage industry" of plaintiffs' counsel looking to cash in on the unfriendly environment. MetLife appealed the Appellate Division's decision to the New Jersey Supreme Court, supported by numerous amicus briefs from real estate and commercial finance trade groups and organizations from around the U.S.

If sustained, the Appellate Division's ruling would have made it all but impossible for a lessor to collect late charges in New Jersey, even in the most routine cases. Each time a lessor sought to collect late charges in court, it would have to prove that (1) the late charge was reasonably related to the anticipated or actual damages that it would suffer due to the delay in payment, and (2) such damages were difficult to establish. This "Alice-in-Wonderland" logic meant that a lessor would be forced to prove that its fixed late charge was "reasonably related" to something that was itself impossible (or
extremely difficult) to predict or measure at the time the lease was entered into (i.e., its anticipated or actual damages in the event the lessee is late in making a payment). The requirement would have defeated the entire purpose of establishing stipulated or liquidated damages in an equipment lease whenever damages are difficult to determine.

Supreme Court Ruling
Fortunately for equipment lessors and other commercial creditors, the Supreme Court held in favor of MetLife. Its thoroughly researched opinion is a definitive dissertation on modern contract analysis and the current state of the law on stipulated damages and late charges, and should help shield lessors in individual actions and class action strike-suits alike. The highlights of the Court’s ruling are as follows:

1. Parties in a commercial transaction must be given more latitude on their contractual estimate of damages from default when those damages were uncertain at the time they entered the contract, the test eventually being the reasonableness of the stipulated damages clause “under the totality of the circumstances.”

2. Liquidated damages provisions in a commercial contract between sophisticated parties are presumptively reasonable. The party challenging the clause bears the burden of proving its unreasonableness. Provisions for a small percentage late fee or default interest are more properly characterized as “variable pricing provisions”—an alternate pricing term for the use of money—rather than as liquidated damages. These charges are part of the debtor’s cost of doing business in acquiring a commercial loan (or other type of credit) for which it did not pay as agreed. Therefore, the charges must be proved unreasonable.

3. An appropriate method of assessing the reasonableness of late charges is to look at the amounts of late charges permitted by statute (generally 4 percent to 5 percent fixed late charges under various state and federal mortgage, banking and consumer finance statutes), and the range of charges commonly used throughout the creditor’s industry. The 5 percent rate in the MetLife case was not an unusually large percentage, nor did it explicitly evidence “coercive intent” to cause the debtor sufficient pain to create an incentive to pay the debt.

4. The Court viewed the 5 percent fixed late charge in the MetLife note as having been negotiated between “sophisticated commercial entities” and therefore as, in these circumstances, a reasonable and valid measure of liquidated damages. The 12.55 percent default rate imposed by the trial court was a reasonable estimate of the “potential” costs of administering a defaulted loan, and reasonably represented the “potential” difference between the contract interest rate and the rate MetLife might have to pay securing a commercial loan to replace the lost funds. (The Court gave examples of excessive late charges, including fees equal to 10 percent of the payment due or six months’ additional interest, or imposing a late fee measured by the entire principal balance for a single past due installment. Its examples of excessive default interest included rates ranging from 8.5 percent to 15 percent over the non-default rate. The 15 percent default rate in the MetLife note originally provided for a 6.45 percent increase over the 9.55 percent non-default rate, which was later reduced to a 3 percent increase with the 12.55 percent rate approved by the trial court.)

5. Late charges and default interest provisions constitute a practical solution to the problem of pricing loans and other forms of credit according to anticipated rather than actual performance, and to the difficulty allocating and determining the costs and damages of late payments and default. Moreover, considerations of judicial economy and freedom of contract favor enforcement of stipulated damages clauses.

6. The “reasonableness” test in assessing the enforceability of liquidated damages clauses rather than an “unconscionability” standard provides an adequate safeguard for creditors and better protection for debtors.

The principles pronounced in the Court’s decision should make it easier for lessors and commercial lenders to enforce late charges and default interest in transactions throughout the U.S. Lessors should nevertheless analyze and monitor the overall costs of processing late payments and defaults, as well as the late fees and default rates they charge compared to industry standards, to ensure that they conform to the guidelines articulated by the Court in the MetLife case.

ELT thanks Michael A. Leichtling, Esq. and Raymond W. Dusch, Esq., Parker Chapin Flattau & Klimpl, LLP, New York City, for this article. For further information, contact them at (212) 704-6000.