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Opinion

SJC stuns real estate bar with 'Cummings' decision



By Edward M. Bloom

In its eagerness to embrace the concept that a liquidated damages clause in a commercial agreement should be upheld, the Supreme Judicial Court recently surprised the real estate bar by ruling that a full acceleration of future rent upon a tenant default under a commercial lease is enforceable.

The July decision of *Cummings Properties, LLC v. National Communications Corp.*, 449 Mass 490 (2007), undercuts the real estate bar's long-held belief that full acceleration of rent upon a tenant's default constitutes a penalty and is therefore unenforceable.

In reaching its decision, the SJC both ignored its own prior cases and cited other authorities that do not support its ultimate conclusion.

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In *Cummings*, the tenant had signed a five-year lease for office space in Woburn. The lease contained a provision that, in the event of an uncured default in the payment of rent, the "entire balance of rent which is due hereunder shall become immediately due and payable as liquidated damages."

When the tenant failed to pay its rent for two months, the landlord terminated the lease and brought a complaint for summary process in the Woburn District Court. The judge awarded the landlord possession of the leased premises and damages in excess of \$525,000, which represented the balance of rent due under the lease.

The tenant appealed to the Appellate Division of the District Court Department, which affirmed the lower court's granting of possession of the premises to the landlord but overturned the award of damages, ruling that the full acceleration of rent constituted a penalty pursuant to the case of *Commissioner of Ins. v. Massachusetts Accident Co.*, 310 Mass. 769 (1942).

The landlord appealed the Appellate Division's ruling and the SJC took the case on direct appeal to address the landlord's request that the SJC update its jurisprudence "in light of the near unanimous trend toward upholding liquidated damages clauses in agreements between sophisticated parties, and to adopt a presumption against interpreting such clauses as penalties." *Cummings* at 495.

The SJC agreed that the rule against penalty clauses "has come to seem rather an anachronism, especially in cases in which commercial enterprises are on both sides of the contract," and reinstated the District Court's award of damages for the full amount of future rent due under the lease.

In so doing, the court modified the 65-year-old precedent of *Commissioner of Ins.*, but more importantly, ignored a number of other concepts and precedents that militate against the broad sweep of its ruling.

Full acceleration clauses

enforceable lease provision specifying damages due the landlord as a result of the termination. *Sutton v. Goodman*, 194 Mass. 389, 395 (1907), and *Krasne v. Tedeschi & Grasso*, 436 Mass. 103, 109 (2002).

In light of this common-law rule, commercial real estate lawyers in Massachusetts have typically preserved a landlord's right to damages upon a tenant's default by employing two common provisions.

In one provision, the tenant is required to pay rent monthly, according to the schedule set forth in the lease, for the remainder of the term as though the lease had not been terminated. However, the amount actually paid will be net of amounts received by the landlord from re-letting the premises, after the landlord deducts the un-reimbursed costs of re-letting. And the SJC has made it clear that a landlord has a duty to mitigate its damages once a lease is terminated by reason of a tenant's default. *Krasne*, at 109.

In an alternative provision, the landlord has the option to require the tenant to pay, as liquidated damages, a lump sum equal to the amount by which the aggregate rent due for the remaining lease term exceeds the current fair market rent for the space for the remainder of the term. This amount is then discounted to present value.

This alternative provision is typically referred to as a "partial acceleration clause" that is intended to give the landlord the benefit of its bargain. If the lease rent for the remainder of the term is greater than the fair market rent, under this formula the landlord receives the difference, thus giving him the benefit lost by the tenant's default. If the fair market rent is more than the lease rent, the landlord would receive nothing under this partial acceleration.

In contrast, if a landlord is permitted to fully accelerate rent due under a lease without being required to mitigate damages, the result may constitute a penalty insofar as the damages received are likely to be disproportionate to the damages actually incurred. For this reason, full acceleration clauses have not been typically employed by real estate lawyers.

The SJC has previously upheld liquidated damage clauses in purchase and sale agreements.

In the 1999 case of *Kelly v. Marx*, 428 Mass. 877, the court ruled that a seller was entitled to retain a defaulting buyer's 5 percent deposit. The typical deposit under such agreements ranges between 5 and 10 percent of the purchase price.

By analogy, the use of a full acceleration clause as liquidated damages under a lease would be similar to a seller insisting on a 100 percent deposit under its purchase and sale agreement and then retaining the deposit as liquidated damages. See *Security Safety Corp v. Kuznicki*, 350 Mass. 157 (1966) (liquidated damages providing for penalty of one-third of contract price is unreasonable and unenforceable as a matter of law).

In *Marx*, the court stated that liquidated damages of 5 percent were not grossly disproportionate to the expected damages nor was it unconscionably excessive so as to be defeated as a matter of public policy. In fact, the court warned in that case that "we reiterate our view that [a] term fixing unreasonably large liquidated damages is unenforceable on grounds of public policy as a penalty."

Just as an acceleration of future interest under a defaulted promissory note is deemed a penalty even if the note recites that such acceleration is payable "as liquidated damages and not as a penalty," *A-Z Servicenter, Inc. v. Segall*, 334 Mass. 672 (1956), there is no justification for a landlord to accelerate all future rent due under a defaulted lease and claim that it is simply agreed-to liquidated damages and not a penalty.

While it is true in *Cummings* that the accelerated rent exceeded the landlord's actual damages, as determined by the District Court, by only approximately 6 percent, the court's holding supports the possibility that the landlord under a 10-year lease, employing a liquidated damages clause similar to the lease in *Cummings*, could accelerate over nine years' future rent if the tenant defaulted in the first year of its lease.

In such a case, it is simple to conclude that not only does such an acceleration violate the spirit of landlords' common law duty to mitigate their damages, but also that nine years' future rent (which is not even discounted to its present value) constitutes "unreasonably large liquidated damages [that are] ... unenforceable on grounds of public policy as a penalty."

Marx at 882 n.6.

Cummings not only lacks any dicta warning that the use of full acceleration clauses could be illegal in many instances, but also relies on authorities that do not support its decision. A principal, but not the only, example is the court's citation of comment k. to the Restatement (Second) of Property (Landlord and Tenant) Sect. 2.1 (1977) that "parties may provide in the lease that if the tenant defaults in the payment of rent or fails in some other way to perform his obligations under the lease, the total amount of rent payable during the term of the lease shall immediately become due and payable." *Cummings* at 494.

The court, however, omits the next two sentences of comment k., which clearly modify the sentence it quoted and provide language that contradicts the holdings in *Cummings*. The two sentences read as follows:

"If the acceleration clause is enforced, the landlord cannot terminate the lease for the tenant's default that generated the rent acceleration, nor can the landlord terminate the lease for any other default of the tenant, without reimbursing the tenant for the rent he has paid in advance, less any damages the landlord is entitled to collect from the tenant for such default. If the landlord does terminate the lease before the acceleration clause is enforced, he may not recover rent for the period after the termination."

Real estate lawyers should not rush to include full acceleration clauses in their commercial leases based on *Cummings* because the SJC, if and when it revisits this issue, will most certainly modify and limit the unfortunate, and perhaps unintended, breadth of its holding.

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