Rent Concessions and Illegal Contract Penalties in Texas

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Rent concessions—in theory a foregoing of money—have ironically become a new income source for Texas landlords. Although there is nothing wrong with discounting prices, there is something wrong with reimposing that discount on a breaching tenant. The reimposed rent concession is a penalty that the landlord would not have collected in the routine performance of the contract, and as a penalty, violates one of the oldest edicts in Anglo-American contract law.

This article arose from advice given and brief services rendered to clients in a landlord-tenant matter. Using the facts and documents from that dispute, this article reviews the history of contract penalties and their distinction from liquidated damages, and analyze that rule's application to rent concessions. This analysis demonstrates that rent concessions, when reimposed on the breaching tenant, are clear violations of a centuries-old Anglo-American ban on contract penalties. The article concludes with a short speculation into the reasons that these issues are not being litigated.

I. Rent Concessions and the Breaching Tenant

Like most consumer transactions, rent is subject to market forces, at least in states like Texas that do not regulate residential rent prices. Where the supply of apartments exceeds current demand, landlords have two choices. First, they can collectively establish fixed prices to support the existing rent structure, risking civil suits and criminal prosecution under state and federal competition laws.[1] Second, they can lower the rent. A cynic will contend that landlords mix these solutions, but this article will assume that landlords are choosing only the second option. If Texas landlords—or landlords in specific markets such as the Dallas-Fort Worth

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[1] Examples include the Sherman Act, 15 U.S.C.A. §§ 1-7 (West 1997 & Supp. 2006); the Clayton Act, 15 U.S.C.A. §§ 12-27 (West 1997 & Supp. 2006); and the Texas Free Enterprise and Antitrust Act, TEX. BUS. & COM. CODE §§ 15.20 & 15.21 (Vernon 2002).

Metroplex—are not fixing prices, then rent is controlled by the ongoing dynamic of market forces.

Landlords, and for that matter tenants, care little for this market dynamic. They care instead about personal wealth, which landlords promote by maximizing rent, and tenants by minimizing it. In the past few years, landlords in Texas and no doubt in other states have devised a means of maximizing wealth by using form leases which entice tenants with a monthly discount off the "market rent," with a follow-up clause reimposing that discount if the tenant breaches. Until recently, relying on rent collections at the point of breach was not lucrative. But with the increasing success of debt collection practices,[2] the breaching tenant may well be a new source of income. No data are available to determine what percentage of landlord income is produced in this manner. But the popularity of the practice suggests that it works, both as a strong-arm incentive for tenants to remain, and a potential profit if the tenant does not remain. This article is more than an isolated legal argument that a lease term violates the law. It involves people, and more importantly, people who are partly in the wrong. They have breached an agreement and owe damages. The question is how much.

This fact scenario is supported in the author's records.[3] Names, locations and exact dates are changed to protect confidentiality, but all essential facts are true. Pam Martin is a twenty-six-year old single mother who now lives with her parents. Pam had been sharing an apartment with a co-worker. The apartment complex leased them a two-bedroom apartment for a fourteen-month period on a form prepared by the Texas Apartment Association. The lease's terms included provisions claiming (1) the apartment had a "market rate" of $975 a month, (2) the tenants would receive a "rent concession" that would give them a $200 a month discount, and (3) if the tenants breached, at least any breach involving a move out, the tenants would owe rent of $975 a month for the remaining months in the term, and $200 a month for the months in which the tenants had honored the lease. The lease had other damages provisions such as a reletting fee of $824, late fees, and a possible clean-up charge. Pam and her roommate signed the lease and both initialed each page, purporting to represent that they had read and discussed each of the clauses relating to the discounted rent. Pam's parents co-signed as guarantors.

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[2]Collection company Unifund is an example. *See e.g.*, James McNair, *Bad Debts Very, Very Good for Bill Collector of Last Resort*, CINCINNATI ENQUIRER, Sunday, Nov. 23, 2003, Bus. p. 1 ("But class action lawsuits filed in Texas and Chicago claimed Unifund is chasing outdated debts. In the pending Texas case, two plaintiffs say Unifund brought their credit-card debt, freshened up the delinquency dates by a year and provided them to Experian Information Solutions, one of the nation's three big credit-rating firms.") Unifund's own website provides more examples. *See* http://www.unifund.com/aboutunifund/history.aspx, ("Unifund popularized the concept that long-delinquent distressed debt is regenerative."); http://www.unifund.com/business/debtpurchases.aspx ("We purchase charged-off debt at all stages of default: Newly defaulted; Freshly charged-off; Post-primary; Post-secondary; Post-tertiary and beyond").

[3]Readers will note that this example is limited to rent concessions involving reductions in monthly rent as opposed to up-front concessions of one or more months' rent. The up-front rent waivers are very likely penalties as well because they involve the same windfall for the landlord over the term of the lease. *See e.g.*, Raffel v. Medallion Kitchens of Minnesota, Inc., 1196 WL 675787 (N.D. Ill. 1996) (commercial lease with seven-month reimposable rent concession; denied as a penalty). But the author's documents support only the monthly discount and this article is accordingly limited to that example.

Pam and her roommate moved into the apartment in June, 2004. In October, 2004, Pam's roommate accepted a job in another city and moved out. When Pam asked if she could move into a one bedroom apartment, the landlord refused as was its right. Pam moved out at the beginning of December, 2004, and moved into her parents home with a little under nine months remained on the fourteen-month lease. In January, 2005, Pam's father received a collection letter demanding $10,400. The demand also stated that the delinquent account would be sent to credit-reporting-service Experian, and that it would be posted there for up to seven years and would not be updated until the demand was paid in full. Read literally, this demand stated that even if the landlord was able to find a new tenant, which it did, the reported debt of $10,400 would not be changed. True to this reading, neither the collection company nor the landlord changed the bad credit report when the apartment was relet two months later.

Pam and her parents ignored the letter. Over a year later, Pam's parents were negotiating to buy a new house and their financing was refused when the parents' credit report showed the bad debt for $10,400. The Martins sought legal advice. Letters from their attorney to the collection agency and the landlord reduced the debt from $10,400 to $4,400. This reflected the apartment's reletting, but the landlord continued to impose the $824 reletting fee (which the Martins did not contest) and a $1400 rent concession for a seven-month period (the five months Pam lived there and the two months before reletting).

The collection company also responded to the Martins' demand for damages under the federal Fair Debt Collection Practices Act and similar Texas laws.[4] Specifically, the collection company inquired how an attorney could possibly be making claims on behalf of people who did not pay debts. The answer, of course, is that the Martins had an obligation to pay the landlord's actual damages, but not a penalty. The fact that the Martins might be at fault did not entitle the landlord to a $1400 penalty. This collection agent's view is no doubt one reason that breaching tenants fail to seek legal advice on these consumer debt issues—they see themselves as deadbeats and assume that they owe not only what they would have paid, but the extra damages as well. The collection agent's rhetoric underscored this theme.

After another round of letter negotiations, the collection company abruptly declared the account inactive.[5] Neither the collection company nor the landlord responded to the Martins' request that "inactive" be defined. The Martins are not currently being pursued and will not

[4]These include the federal Fair Debt Collection Practices Act, 15 U.S.C.A. §§ 1692 et seq. (West 1998) (specifically 15 U.S.C. § 1692e (2)(A), (8), & (10)); the Texas Debt Collection Practices Act, TEX. FIN. CODE §§ 392.001 et seq. (Vernon 1998 & Supp. 2006) (specifically § 392.304(8)); and the Texas Deceptive Trade Practices-Consumer Protection Act, TEX. BUS. & COM. CODE §§ 17.41 et seq. (Vernon 2002 & Supp. 2006) (specifically § 17.45(5), § 17.46(b)(7) and § 17.50(a)(3)).

[5]A second letter from the Martins' attorney offered to set off the Martins' debt against their claim for debt-collection damages under state and federal law explained in footnote 4. This offer assumed that the Martins' debt included the two months' rent at $775 a month, plus the $824 reletting fee and other incidental fees, but did not include the rent concession of $1400 for the seven-month period. The collection company responded that it had reclassified the account as "inactive" and that any further communications should be made with the landlord. In a third letter, the Martins' attorney asked that "inactive account" be defined. Would it later become active? Would the debt allegation be removed from the Martins' credit reports? The collection agency did not respond. The landlord had never responded to any of the correspondence and ignored one additional letter.

likely file suit to reduce or clear this debt. Interestingly, significant legal research yielded no litigation on similar issues.[6] Without judicial review, can we conclude that the reimposed rent concession in Pam's lease is an invalid penalty? The answer seems clear but is analyzed in Section II's discussion of the centuries-old penalty ban and Section III's analysis of that ban's application to the rent concession. The reimposed rent discount does not reimburse the landlord for any money it would have received had Pam remained there and paid through the lease's end. Neither does it reflect any other loss, tangible or otherwise, suffered by the landlord. It is nothing more than an incentive to perform, an *ad terrorem* clause that Anglo-American contract law has widely rejected for four centuries.

II. THE PENALTY PROSCRIPTION IN TEXAS LAW

Historians speculate that in pre-Roman legal systems, penalties were the only remedy for breach of contract.[7] The Romans continued this practice and passed it on to nascent legal systems throughout the Empire, including Britannia.[8] As English common law emerged, it rejected the Roman view in favor of the idea that the goal in contract damages is to make the promisee whole—to compensate for the actual loss sustained and reimburse what the promisee would have received had the contract been performed, along with any incidental damages.[9] Penalty damages originated as penal bonds that were forfeited upon breach, but when English

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[6]Multiple searches in Westlaw, Lexis and other databases in the period May-September, 206, using the term "rent concession" alone, and "rent concession w/250 penalty" failed to produce any cases from state or federal courts in Texas regarding rent concessions, either residential or commercial, as penalties. The same searches failed on a national basis as well. The search did reveal an unreported federal decision involving a commercial lease in which the landlord sought to recover a seven-month rent concession worth $81,000 because of a dispute over the payment of the last month's rent in a sixty-one month lease. The court held that "while the contract gives the windfall to the plaintiff, Illinois law takes it away." Raffel v. Medallion Kitchens of Minnesota, Inc., 1196 WL 675787 at *2-*3 (N.D. Ill. 1996).

[7]*See generally* I WILLIAM HERBERT PAGE, PAGE ON THE LAW OF CONTRACTS 2d ed. (1920) 2-5 (hereinafter PAGE); I E. ALLEN FARNSWORTH, FARNSWORTH ON CONTRACTS 3d ed.§ 1.4 (2004) at 11-13 (hereinafter FARNSWORTH). Sir Henry Maine's well-known treatise offers little more on pre-Roman contracts than speculation that prior to the Roman Empire, various jurisdictions' laws of contract were merely rudimentary attempts to resolve disputes among equals because inequals could not have mutually-enforceable agreements. *See* HENRY SUMNER MAINE, ANCIENT LAW (1866)(reprinted by Transaction Publishers, 2002) at 312-14. These accounts of pre-Roman contract law are further supported in non-legal historical references. *See e.g.*, *Contracts*, 15 ENCYC. BRITANNICA 340-41 (2003).

[8]*See generally* William H. Loyd, *Penalties and Forfeitures Before Peachy v. The Duke of Somerset*, 29 HARV. L. REV. 117, 119-25 (1915) (hereinafter *Penalties and Forfeitures*); I FARNSWORTH, *supra* note 7 at 11-16; III FARNSWORTH, *supra* note 7 at 302; II SIR FREDERICK POLLOCK & FREDERIC WILLIAM MAITLAND, HISTORY OF ENGLISH LAW BEFORE THE TIME OF EDWARD I, 2d ed. (1896) (hereinafter POLLOCK & MAITLAND) at 223-25; THEODORE F. T. PLUCKNETT, A CONCISE HISTORY OF THE COMMON LAW 5th ed. (1956) at 633-34, 677-78.

[9]*See generally* RESTATEMENT (SECOND) CONTRACTS §§ 344-56 (1979), especially § 255 (Penalties) and § 356 (Liquidated Damages and Penalties). *See also* III FARNSWORTH, *supra* note 7 at _____.

law banned penalties outright, clauses with the same function appeared as stipulated damages.[10] Because valid liquidated damage clauses also appear as stipulations for payment upon breach, courts had to devise distinctions.[11] In modern American law, those distinctions have become both uniform and universal. The widespread nature of this rule throughout the United States is reflected both in treatises and a number of cases. *Lake River Corporation v. Carborundum Company*[12] may be the best example. There, Judge Posner relied on Illinois law but made the point that it reflected the common American principle that to be enforceable, stipulated damages must be:

> a reasonable estimate at the time of contracting of the likely damages from breach, and the need for estimation at that time must be shown by reference to the likely difficulty of measuring the actual damages from a breach of contract after the breach occurs. If damages would be easy to determine then, or if the estimate greatly exceeds a reasonable upper estimate of what the damage are likely to be, it is a penalty.[13]

The penalty rule does not vary in Texas law. Texas courts applied the rule as early as 1854 in *Durst v. Swift*, an action for damages for defendant's failure to deliver various land titles in several counties in southeast Texas.[14] The contract stipulated the damages and defendant objected that this was a penalty. The trial court disagreed that it was a penalty, and in upholding that decision, the Texas Supreme Court recited the rule, from English and American sources, distinguishing proper liquidated damages from penalties.

> Where the parties, in the agreement, have expressly declared the sum to be intended as a forfeiture, or penalty, and no other intention is to be gathered from the instrument; where it is doubtful whether it was intended as a penalty, or not; and a certain damage, or debt, less than the penalty, is made payable on the face of the instrument; where the agreement was evidently made for the attainment of another object, to which the sum specified is wholly collateral; where the agreement contains several matters of different degrees of importance, and yet the sum is payable for the breach of any, even the least; and where the contract is not under seal, and the damages are capable of being certainly known and estimated in all these cases the sum stipulated has been treated as a penalty.[15]

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[10]*See* III FARNSWORTH, *supra* note 7 at 302; *Penalties and Forfeitures*, *supra* note 7 at 119, 122.

[11]Unlike penalties, liquidated damages are estimates of actual losses that will likely be sustained in breach. The stipulations must be made at the time of contracting, be difficult to measure or prove, and be reasonable. *See infra* notes 13 and 23 and accompanying text.

[12]769 F.2d 1284 (7th Cir. 1985).

[13]*Id.* at 1289-90 (citations omitted).

[14]11 Tex. 273 (1854).

[15]*Id.* at 282.

A last clause in the last sentence is important: ". . . in all these cases the sum stipulated has been treated as a penalty." The factors listed in this paragraph are not cumulative. Any one factor can defeat the fixed damages provision in a contract. *Durst* shows the ready understanding courts had in 1854 of the liquidated damages and penalty distinction. It was developed law, easily imported into Texas's nascent judicial system. *Durst* further shows that in spite of the presumption that stipulated damages are illegal penalties, that liquidated damages are appropriate where, as in that case, "the damages are uncertain, and are not capable of being ascertained by any satisfactory and known rule; . . ."[16]

Texas courts considered the rule several times over the years, but *Stewart v. Basey*[17]—a 1952 case—may provide the best and most current statement. All the more appropriate for this discussion, it involved a rental agreement. Stewart was a commercial landlord in Austin. In 1949, he leased three buildings on Congress Street in Austin to Basey for a stated term of five years. The written lease in fact stated a term spanning six years, although the court resolved the questions without worrying about that discrepancy. The rent was $325 a month and the lease began on January 1, 1949. Basey only paid through November 1 of that year and then moved out. Stewart then sued, seeking to collect on the lease's clause that stipulated $150 damages for each remaining month on the lease. Importantly, the damage provision applied for any breach of the lease.[18] The trial court found that provision to be a penalty, but awarded Stewart $38.50 for damage to a door, and the court of appeals reversed that.[19] In affirming the court of appeals, the Texas Supreme Court examined Texas case law starting with *Durst* and noted the wide agreement on this rule in the United States as reflected in the Restatement of Contracts and leading treatises.[20] The *Stewart* rule summarized Texas law that "to be enforceable as liquidated damages, the damages must be uncertain and the stipulation must be reasonable."[21] A further discussion drawn from Williston adds the element that reasonableness means a good faith effort

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[16]*Id.*

[17]245 S.W.2d 484 (Tex. 1952).

[18]The lease stated: "The failure to pay any monthly installment of rental when such installment is due shall terminate this lease at the option of Lessors. The failure of Lessee to make said payment of payments or the breach of this contract otherwise by him shall render him liable to Lessors, as agreed liquidated damages, the sum of One Hundred Fifty (150) Dollars per month for each and every month of the unexpired term of the lease which shall become due and payable when the option to terminate this lease is exercised or at the time of the breach of this contract otherwise by Lessee if any, and the payment thereof be secured by lien on the property of Lessee in said Store Buildings at said time." *Id.* at 485.

[19]*Id.* at 485.

[20]"Volumes have been written on the question of when a stipulated damage provision of a contract should be enforced as liquidated damages and when enforcement should be denied because it is a penalty provision." *Id.* at 485-86. *See generally id.* at 485-87. In addition to the Restatement of Contracts § 339, the *Stewart* opinion cites 3 WILLISTON ON CONTRACTS (rev. ed.) § 783 at 2204; MCCORMICK ON DAMAGES § 151; and legal encyclopedias. *Id.* at 487.

[21]*Id.* at 486.

to assess otherwise unquantifiable damages.[22] Perhaps more important, *Stewart* states the underlying policy against contract penalties or any remedy that over-compensates for contract breaches.

> The universal rule for measuring damages for the breach of contract is just compensation for the loss or damage actually sustained. By the operation of that rule a party generally should be awarded neither less nor more than his actual damages. A party has no right to have a court enforce a stipulation which violates the principle underlying that rule. In those cases in which courts enforce stipulations of the parties as a measure of damages for the breach of covenants, the principle of just compensation is not abandoned and another principle substituted therefor. What courts really do in these cases is to permit the parties to estimate in advance the amount of damages, provided they adhere to the principle of just compensation.[23]

In summarizing this policy drawn from the Restatement of Contracts, the *Stewart* opinion stated the rule that now controls in this area and may be the most accurate statement of judicial oversight for contractually-stipulated damages.[24]

The court then addressed the lease in front of it and found that the $150 a month stipulation was indeed a penalty because it far exceeded any actual damage the landlord had suffered. The court also upheld the court of appeals' reversal of the $ 38.50 for damages to the door, leaving the landlord with nothing.[25] But what about the landlord's entitlement to rent at $325 a month for the remaining months on the lease? The opinion does not tell us whether the lease had such a covenant and does not recite the relevant law for 1952. We do know that the landlord quickly relet the buildings by the time of trial.[26] We also know, if the opinion reflects the court record, that the landlord did not seek such damages for any time the building was empty, but instead sought only the $150 a month for the five or more years remaining on the lease. That is, the landlord pursued only his remedy under the stipulated damages provision, and it failed because it did not realistically measure any actual damage the landlord had suffered.

Reported Texas decisions have cited *Stewart* at least two dozen times, some invoking the rule, some distinguishing the facts and finding appropriate liquidated damages, but none questioning the rule. Two cases merit short discussion. In 1991 the Texas Supreme Court

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[22] *Id.* at 486, citing to WILLISTON ON CONTRACTS, rev. ed. at 2179.

[23] *Id.* at 486, citing the RESTATEMENT OF CONTRACTS § 339. *Stewart*'s limiting the measure of contract damages to just compensation for the actual loss is consistent with Farnsworth's description of American law generally. *See* III FARNSWORTH, *supra* note 7 at 300-05, especially Jaquith v. Hudson, 5 Mich. 123 (1858), discussed id. at 301.

[24] *See* III FARNSWORTH, *supra* note 7 at 305-08.

[25] *Id.* at 487.

[26] *Id.* at 485.

applied *Stewart*'s bar on contract penalties in *Phillips v. Phillips*.[27] When Harry and Martha Phillips divorced after thirty-two years of marriage, they placed their considerable community property—mostly based on oil and gas holdings—into a limited partnership. Harry was the general partner and Martha was the only limited partner. Harry's duties included the distribution of funds to himself and Martha and various routine reporting and fiduciary duties. The agreement included the following clause that if Harry breached his duties, he would pay liquidated damages of ten times Martha's actual loss.[28] Harry did breach by short-funding the distributions and overcharging for his own expenses. The trial court enforced that clause, but the Tyler court of appeals reversed and the Texas Supreme Court affirmed. Justice Hecht's majority opinion found the ten-time multiplier to be a penalty because it clearly violated Stewart's two-prong rule that liquidated damages be incapable or difficult of estimation, and a good faith assessment of actual damages. To the contrary, the Phillips's agreement linked the ten-time multiplier to an initial determination of actual damages. This, the *Phillips* majority concluded, was on its face an unenforceable penalty.[29]

The *Phillips* dissent, and the majority's rejection of that argument, add an important footnote to the *Stewart* rule. When Martha Phillips sued, Harry had failed to plead his penalty argument as an affirmative defense. Three justices keyed their dissent to what they argued was the clear requirement under Texas procedural rules that matters such as this be affirmatively raised by the defense.[30] The majority rejected this, finding an exception to the requirement of affirmative pleading where the matter in question is illegal and apparent on the face of the plaintiff's claim. As the court stated, "[e]nforcement of a penalty, like enforcement of an illegal contract, violates public policy."[31]

In 2006, the Texas Supreme Court made an important distinction regarding the *Stewart* rule. *Flores v. Millennium Interests, Ltd.* was a certified question from the federal Fifth Circuit Court of Appeals, involving the interpretation of the term "liquidated damages" in a section of the Texas Property Code.[32] Specifically, a seller under certain contracts for deed faces "liquidated damages" of $250 a day for certain violations. The federal appellate court submitted questions regarding this provision's penalty nature and whether it required proof of actual damages. The Texas Supreme Court explained that the Texas Legislature had used the term "liquidated damages" here to mean a penalty, and that it was automatic and did not require proof of actual damages. Summarizing the *Stewart* rule and distinguishing it from the statute in *Flores*, the court stated:

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[27] 820 S.W.2d 785 (Tex. 1991).

[28] *Id.* at 786-87.

[29] *Id.* at 787-89.

[30] *Id.* at 790-92 (Gonzalez dissenting based on Tex. R. Civ. P. 94).

[31] *Id.* at 789-90.

[32] 185 S.W.3d 427 (Tex. 2005), construing TEX. PROP. CODE § 5.077 (Vernon Supp. 2006).

> The term "liquidated damages" ordinarily refers to an acceptable measure of damages that parties stipulate in advance will be assessed in the event of a contract breach. The common law and the Uniform Commercial Code have long recognized a distinction between liquidated damages and penalties. If damages for the prospective breach of a contract are difficult to measure and the stipulated damages are a reasonable estimate of actual damages, then such a provision is valid and enforceable as "liquidated damages;" otherwise it is void as a "penalty."[33]

The court went on to point out that while many Texas statutes reflected this general rule, some statutes used the term "liquidated damages" synonymously with "penalty." In fact, of the twelve Texas statutes mentioning liquidated damages, nine regulate them consistent with the Stewart rule, while three use the term liquidated damages to create a civil penalty such as the one in *Flores* under the Property Code.[34]

In *Flores*, the Texas Supreme Court may have been hasty in labeling these provisions as nothing more than penalties. Although the $250-a-day measure applies regardless of the property's value, this can be characterized as a legislative attempt to award damages for inconvenience and other loss beyond the measured monetary loss, and to do so without the complications of proof at trial. But even if the legislature intended these "liquidated damages" as pure civil penalties, the necessary conclusion is that the law penalizes wrongful conduct. In any event, *Flores* underscores that these few statutory usages of "liquidated damages" as penalties must be distinguished from the centuries-old common law rule barring contract penalties.

As *Flores* pointed out, the law of contracts goes beyond the common law. Contracts have also been regulated by statutes since late medieval England, including one that codified the equity courts' requirement that contract damages be limited to the actual loss sustained.[35] But what about other areas of contract law, where legislatures and uniform codes codified entire subsets of contact law? An exhaustive answer is not feasible here, but one good example appears in the Uniform Commercial Code, and specifically in the Uniform Commercial Code's section 2-718 governing liquidated damages in contracts for the sale of goods.[36] Section 2-718 has no

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[33] 185 S.W. 3d at 431 (citations omitted).

[34] *Id.* at 431. The other two Texas statutes treating "liquidated damages" as a penalty provision are TEX. LABOR CODE § 62.201 (Vernon 2006) (for violations of the minimum wage law), and TEX. AGRIC. CODE § 52.106(d)(1) (Vernon 2004) (allowing a marketing association to "fix as liquidated damages a specific amount to be paid by a member if the member breaches the marketing contract"). *See* 185 S.W.3d at 432 notes 4 & 5.

[35] *See* III FARNSWORTH, *supra* note 7 at 302-03.

[36] Section 2-718 was amended in 2003, with no substantive change regarding consumer contracts but easing the burden of proof for plaintiffs in commercial cases. As of the time of this publication, no states have adopted the amended version. However, this strikeout version, taken from the official text, reflects that the UCC's rule on liquidated damages has been consistent with the common law and did not change with the 2003 amendments. The standard and amended sections read:

> "Damages for breach by either party may be liquidated in the agreement but only at an amount ~~which~~ that is reasonable in the light of the anticipated or actual harm caused by the breach and, in a consumer contract, the difficulties of proof of loss, and the inconvenience or non-feasibility of otherwise obtaining an adequate

application to any discussion of residential leases, but it exemplifies the pervasive ban on penalty damages in Anglo-American contract law.

III. The Reimposed Rent Concessions as Penalty

The Martin lease stated in clause 6 that tenant "will pay $975.00 per month for rent" then in clause 10 that "Resident will receive $200 monthly discount making monthly rental rate $775.00." A lease addendum entitled "Rent Concession and Discount Addendum" read "A monthly recurring concession. The monthly Market Rent amount will be reduced by $200 per month during the initial lease term making the monthly rent amount $775. This rate reduction may or may not be offered on renewal leases." Additional terms both in the lease and the addendum stated that if tenant moved out before the end of the lease, the concessions would be forfeited, and that if the rent was late in any given month, the concession was forfeited for that month, in addition to other late fees specified in the lease. The parties agreed to these terms, evidenced by signatures on the lease and the addendum, and by initials at the bottom of each page of the lease.

Quick conclusions are easily reached here, supporting both sides. On Pam's side, the demand was significantly more than she had been paying in rent. Any thought on her part that she would owe a couple of months' rent after reletting was misplaced. On the landlord's side, Pam had not only signed a lease that spelled out these damages, she had initialed each page. Pam had breached and would now pay the clearly-specified "market rent." Although Pam had no thought of the illegality of penalties, her resistance was well founded. That conclusion is supported by several points that initially seem to favor the landlord, but fail on a cursory legal or economic analysis.

First is the lease language in clause 6 that tenant "will pay $975 a month," modified by the language in clause 10 with the $200 monthly concession, "making the monthly rent $775." So what is the rent—$975 or $775? Keeping in mind that the contract language alone does not determine this,[37] the most pertinent point is that tenant was in fact paying $775 a month. The tenant was attracted to this apartment with an expectation of paying $775 a month, in spite of the

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> remedy. ~~A term fixing unreasonably large liquidated damages is void as a penalty~~. <u>Section 2-719 determines the enforceability of a term that limits but does not liquidate damages</u>."

Amended art. 2-718, 1 U.L.A. Master Ed. (2004) at 549. Official Comment 2 to the 2003 version states in part: "Under original Section 2-718, a party seeking to enforce a liquidated damages term had to demonstrate the difficulty of proving the loss and the inconvenience or nonfeasibility of obtaining an adequate remedy. These requirements have been eliminated in commercial contracts but are retained in consumer contracts." In other words, the 2003 insertion of "and, in a consumer contract" was intended to ease the burden of proof for plaintiffs in commercial contracts who were on a more even footing with the breaching defendant, but retain the higher burden for sellers in consumer contracts. Official Comment 3 explains that the penultimate sentence was stricken for redundancy. *See id.* *See also* Tex. Bus. & Com. Code § 2.718 (Vernon 1994).

[37] *Stewart*, 245 S.W.2d at 486.

language that the rent would be $975 a month in the event of breach.[38]

A second point is the landlord's measure of damages. If tenant remains in the apartment for the duration of the lease, landlord would collect fourteen installments of $775 and no more, other than perhaps incidental fees at move-out. The $200 monthly rent concession, adding up to $2800 for the fourteen-month term of the lease, is not a part of the performance of this contract. The landlord collects that $2800 concession only if tenant breaches. When tenant moves out early, the landlord's out-of-pocket loss of rent is measured from a $775 base.

A third point, tying into the second, is the penalty/liquidated damages distinction. Under American law in general and Texas law in particular, the test is *Stewart*'s requirement that liquidated damages provisions be for uncertain losses and the stipulation must be reasonable.[39] The rent concession fails quickly here because the landlord's actual damages are readily ascertainable. The loss is the amount of rent the tenant would have paid, plus actual bills such as utilities, plus various liquidated fees for reletting and cleaning.[40] Whatever argument that can be made for the rent concession as a damage provision, it is not a measure of any loss suffered by the landlord.[41]

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[38]Closely related and undeserving of separate enumeration is the argument that the parties had an agreement. This argument has initial validity. However the lease's terms can be characterized as rent or penalties, the contract is clear on the underlying point—tenants agreed to pay an extra $2800 in the event of early termination of the fourteen-month lease. This conclusion is reached with no regard for law or history, but many consumers apparently believe it. But as with other illegal aspects of contractual agreements, courts ignore penalty clauses. The fact that the parties have agreed is irrelevant. Had the parties not agreed, it would not be a contracted-for penalty. If this argument had any validity, then courts and legislatures would lack power to impose terms on contracting parties, or to declare public policy in regard to contracts. The opposite is true, and that truth extends far outside the single point of contract penalties. *E.g.*, *Stewart*, 245 S.W.2d at 486 ("Regardless of which line of cases is followed, the courts will not be bound by the language of the parties."). *See generally* II FARNSWORTH, *supra* note 7 at §§5.1-5.9, pp. 1-100.

[39]*Stewart*, 245 S.W.2d at 486.

[40]Most of these contactually-specified damages are uncontroversial, though they may be onerous to the breaching tenant. Other than the rent concession, the other fees are assessments of actual loss to the landlord. Ordinary rent, utilities, repair and clean-up are out-of-pocket losses to the lessor. The reletting fee is not necessarily an measured out-of-pocket loss, but is a valid assessment of liquidated damages. The costs of reletting the premises include advertising and the salaries of employees who answer the phone and show the apartment. Large apartment complexes with continual turnover will bear these costs in any event, merely to promote full occupancy, and without regard to how many tenants left early. While breaching tenants may increase the work for employees, they likely have little impact on the advertising costs for large apartment complexes. Nevertheless, it is fair to spread those costs to the tenants who leave early. The costs, of course, will vary from breach to breach, and while $824 may seem high, it is an assessment of an actual cost to the lessor. As long as courts find it reasonable, it is appropriate liquidated damages under *Stewart*.

[41]Two arguments for the rent concession as liquidated damages come to mind, and both are flawed. The first is that the rent concession is liquidated damages for an unoccupied apartment and the accompanying blight. It is doubtful that the law imposes a duty on tenants to remain in a residence on that basis and there is no precedent to support this. To the extent that this duty-to-occupy has any validity, Pam's form lease did not address this issue. To the contrary, the lease allowed the tenant to abandon the apartment and live elsewhere as long as the rent was paid. The second argument for the rent concession as liquidated damages is that the $200 monthly concession is a late fee.

A fourth point goes to the underlying policy behind the centuries-old ban on contract penalties. The lease's penalty clause entitles the landlord to all $2800 whether the tenant moves out one month early or eleven months early. The value of the contract to the landlord increases by $2800 in the event of breach. Admittedly, landlords often do not collect from breaching tenants and the extra $2800 may be nothing more than a paper victory. But that paper victory can be powerful in the hands of aggressive collection agencies and credit reporting services. Although there are no demographic studies describing the victims of contract penalties, the practice is best targeted at middle class consumers who wish to protect their credit. The author's anecdotal collection of leases in the preparation of this article supports the idea that apartments leasing to a broad middle income group use this practice of rent concessions.

A final point that ostensibly supports the landlord raises a deeper economic analysis. It can be analogized to a question of perspective—is the glass-half-empty or half-full. The landlord may argue that the rent concession is not a penalty at all, but is instead a bonus. That is, the lease does not impose a penalty for moving out early. It does the opposite. It rewards the tenant for not moving out. Instead of a penalty for breach, tenant merely loses the bonus.

Avery Katz is a law-and-economics specialist, and more important for this discussion, teaches contracts to law students at Columbia. He poses a similar problem to his students. First he asks them whether one can guarantee prompt performance from a building contractor by providing that late performance will result in a 20% cut in the price. The students correctly answer that such a penalty would be voidable if the party's actual damages did not reasonably support the 20% claim. Katz then asks them about cutting the price by 20%, and providing a 20% bonus for on-time performance. He reports that students usually see that simply cutting the price and re-labeling the penalty as a bonus cannot operate as an all-purpose method of evading the penalty doctrine. Katz points out, however, that the question can be more complicated because bonuses as such are legitimate and play valid roles in contract law. He proposes that the distinction between contract bonuses and penalties lies in their function, much as Judge Posner distinguishes between penalties and valid liquidated damages.[42] A true bonus, Katz says, rewards the performing party beyond the contract's fixed consideration for routine performance.[43]

In support of this, Pam's lease states that the concession is forfeited, for that month only, if the rent is late. That provision, however, is in addition to a standard liquidated damages provision regarding late rent that imposes a late fee of $50 and $5 a day until the rent is paid. Assuming no ambiguity here, is the extra $200 an additional late fee or merely part of the rent? As discussed in the prior paragraph, the rent is $775 a month except in the event of breach. The breach, in this case a nominal breach for late rent, kicks in $200 additional rent, and does so in addition to the lease's provision for a typical liquidated fee for late rent. Again, it appears to be a penalty for breach.

[42]*See Lake River*, 769 F.2d at 1289-93.

[43]Email and telephone discussions with Avery Katz, July 28, 2006. Professor Katz further explains that in using market value to distinguish a bonus from a penalty, he would be careful to obtain objective measures outside the parties' viewpoints. Thus, in Pam's case he would accept neither the lease's $975 "market rate" nor the parties' actual $775 transaction rate, but instead would measure market value from a sufficiently large number of similar rentals where the terms did not include the rent concession or other bonus/penalty provisions. Katz points out that a problem occurs even with this objective measure if all sellers in a given market recast their penalties as bonuses; there, he would use the parties' actual transaction price to measure market value. *Id.* No public data is available as to how many apartment complexes in Texas use the Texas Apartment Association's form lease with the rent concession

Even with this explanation, distinguishing a bonus from a penalty can be difficult. It is especially difficult in ad hoc contracts drawn from scratch, such as an artist's agreement to paint a portrait or a builder's agreement to construct a unique home. It becomes easier in open market consumer contracts. In that setting, the bonus/penalty distinction can be made by comparison of the contract's terms to similar agreements in a broader market. In other words, if Pam Martin's landlord claims that the $200 concession is a bonus for an apartment renting for $975, what would that apartment bring in a wider market sample? If the market value is $975 as the landlord maintains, then the $200 concession is a bonus for Pam. If the market value is $775, then Pam has not received a bonus but instead faces a $200 penalty for breach.

This brings up a related point in Pam Martin's lease, which used the term "market rent." Specifically, the Rent Concession and Discount Addendum states that "[t]he monthly Market Rent amount will be reduced by $200 during the initial lease term making the monthly rent amount $775."[44] The lease does not otherwise define the term "market rent," and that term cannot be found in dictionaries, including those focused on economics.

Consulting economics dictionaries and treatises does not advance the analysis much further. For economists, the terms "value" and "worth" are not precise terms of art. Economics references, if they define these terms at all, do not provide consistent meanings.[45] Instead, the terms are generic and mean what the speaker wants them to mean, reminiscent of Lewis Carroll's approach to meaning. With "value" and "worth" having no fixed meaning, what meaning should be given a contract in which the parties agree that (1) the market rent is $975 a month, (2) but tenant will pay only $775 a month, unless (3) tenant breaches, in which case tenant will pay $975 a month?

If a landlord believes an apartment is worth $1000 but nobody is willing to pay that, then the landlord's valuation is at best a subjective one; it may be accurate as to the apartment's value to him, but not for prospective tenants in the market place. On the other hand, if a tenant believes she should pay only $500 for an apartment but no landlord will rent at that price, then the tenant is wrong at least as to her sense of market value. Although both landlord and tenant in this example may validly claim that their disparate value settings are accurate for them, those conclusions have little meaning outside their subjective views. This approach to value is often called "intrinsic value."[46] The more objective approach is "exchange value," determined by what

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clause. To the extent that use is widespread, the measure of market value in Pam's case is $775.

[44] *Rent Concession and Discount Addendum* at 1, on file with author.

[45] *See generally* DAVID W. PEARCE, ED., THE MIT DICTIONARY OF MODERN ECONOMICS 4th ed. (1992) (hereinafter MIT DICTIONARY), *passim*; WEST'S LAW AND COMMERCIAL DICTIONARY IN FIVE LANGUAGES (1985) (hereinafter WEST'S LAW AND COMMERCIAL DICTIONARY), *passim*; PETER NEWMAN, ED., THE PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW (1998) *passim*. Interestingly, the West reference does provide definitions for "market value" and related terms. The apparent reason for the more precise definition there is that "market value" is a legal term. *See* WEST'S LAW AND COMMERCIAL DICTIONARY at Vol. K-Z, pp. 726-27 (discussing definitions of "value").

[46] *See* MIT Dictionary, *supra* note 45 at 446-47 (discussing definitions of "value"); WEST'S LAW AND COMMERCIAL DICTIONARY, *supra* note 45 at Vol. K-Z, pp. 726-27 (discussing definitions of "value").

the good or service brings in the marketplace.[47] Although data are unavailable to show which meaning of value is more often used to measure damages, there will likely be little argument that exchange value is appropriate for most contract damages. Exchange value is determined when the buyer and seller agree on a price. Of course, that value setting is true only for that one buyer and seller. Aggregate value is determined by a collection of transactions.

If we assume that the lease's reference to "market rent" refers to the average rental amount for similar apartments in a given geographic market, this raises an interesting question. Can we believe that the landlord willingly rents an apartment to Pam for $775 if it will readily rent for $975? One argument is that the landlord has the option of renting at a lower price and may do so for reasons other than maximizing profit. Such motives may occur with individual landlords renting single apartments, but are far less likely in large apartment complexes managed by an agent rather than the owner. The not-interested-in-profits motive can also be tested by measuring the frequency of rent concessions. How often does the landlord grant one? No data are available on this, but it is significant that the rent-concession language is printed on a form lease prepared by the Texas Apartment Association. As noted above, the author's inquiry resulted in numerous instances of leases with rent discounts, all reimposable under the terms of the lease.

It is highly unlikely that Pam's landlord made a concession only for Pam or a few other tenants. The practice appears to be widespread, and there are two plausible reasons for the practice—puffery and penalties. As for puffery, rent concessions are a handy marketing pitch. "This apartment is worth $1000 a month, and if you move in this month, you'll pay only $800." A more familiar example is the car dealer who advertises the "list price" as $20,000 but sells the car for $16,000. This differs from the Martin facts if the car sale does not involve the buyer's agreement to pay the list price in the event of breach, but the puffery is the same for both the landlord and the car dealer. In both cases the puffery, as such, is legal. The penalty function is illegal. Neither the lease nor the car dealer's purchase agreement can require the higher amount—the market rent or the car's list price—upon breach.

Reliable data is available to support these market determinations in specific cases. The market value of rental properties can be determined at any given time with data from apartment rentals in a defined area. That is not to say that rent-concession penalties can be validated by market data. To the contrary, they remain penalties because they do not reflect the landlord's actual losses. But if courts or legislatures choose to view the rent concessions as bonuses rather than penalties, the burden should rest on the landlord to prove market value when seeking damages higher than the rent being paid by the tenant.

IV. WHY THESE CASES ARE NOT LITIGATED

It is unlikely the Martins will bring an action to reduce or clear this debt. For Pam and any number of tenants, there are several reasons why this issue does not find its way to court. One reason is embarrassment from being in the wrong. As the collection company urged both in its correspondence to Pam's father and to the Martins' attorney, Pam breached an agreement.

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[47] *Id.*

She signed a fourteen-month lease and moved out after five. Even without the rent-concession penalty and with the credit for reletting after two months, Pam owed the landlord about $2400. This includes two months' rent at $775, a liquidated reletting fee of $824 and other fees related to the move-out. What Pam should not owe is an extra $2800 for the reimposed "market rent" on the full fourteen months, or even a $1400 reimposed rent concession for the seven months she lived there.

A second reason these penalties are not litigated is the tenant's belief that the law allows the penalty, or their disbelief that a corporate landlord would categorically pursue an illegal remedy. Tenants may not imagine that the written contract could include illegal elements. Whatever grousing tenants may do regarding landlords, there is something persuasive about a printed lease, not to mention the collection agency's demand letter. For Pam, the landlord's demand is consistent with the contract's language. The tenant's misplaced faith is reinforced by the near-total lack of public education on consumer issues.

A third disincentive for consumer lawsuits is the relatively small gain in the face of bigger losses. However valid this article's analysis, its implementation requires a court finding that the contract is illegal. To the extent that trial courts make literal rather than policy-oriented decisions, the consumer's relief will more likely come from an appellate court. If the Martins were to lose a lawsuit, they would owe not only the full damages but attorney fees as well. On the other hand, if the Martins win the lawsuit, their damages under state and federal law are only a few thousand dollars at best. This negative cost-benefit analysis increases when the landlord (or seller in the larger setting) drops the claim in the face of an attorney's letter, as Pam's landlord did. In Pam's case, she would be taking on litigation to erase a debt that is not being pursued at the moment, with little to win in damages. But the fact that the landlord momentarily drops the claim does not mean that Pam and her parents are off the hook. The collection business has become lucrative, with collectors now talking of "regenerating" old debts.[48]

This third disincentive for tenant litigation—relatively low return with high risk—should not be read as an argument that the damage calculation should change. Current laws provide a reasonable penalty and attorney fees for consumer credit violations. This point is made only to explain a likely reason for the non-litigation of common wrongs against tenants. These disincentives do not mean that the potential litigation against reimposed discounts lacks merit. To the contrary, reimposable discount provisions have become common. The setting is ideal for a class action with both plaintiff and defendant classes.

If landlords are misusing rent concessions as penalties and the tenant's litigation remedy is problematic, why not resolve this legislatively? Statutes banning *ad terrorem* remedies are not likely feasible. Because of the significant gray area between valid liquidated damages and penalties, it would be difficult to draft legislation that would bar these penalties without circumventing legitimate remedies. A possible solution is to draft the statute generally, barring the recovery of contract damages beyond those actually suffered, or beyond reasonable estimates of liquidated damages. But that principle is already the law. Moreover, a principle this broad would require case specific resolution, that is, litigation. The best remedy is the one in place for four centuries—a broad common law rule echoed in specific statutes such as UCC 2-718, and

[48] *See supra* note 3.

with statutory exceptions where fines are appropriate.[49]

All this assumes the judicial and legislative review would support the no-penalty principle. What if they do not? In the current wave of anti-consumer reform, courts and legislatures could validate the use of reimposed rent concessions in spite of their irrelevance to any loss by the seller, and in spite of the *Stewart v. Basey* precedent. Not even the economists who argue for party autonomy and the availability of negotiated penalties push for that; instead they argue merely that penalties are valid in certain agreements between parties of somewhat equal sophistication and bargaining strength.[50] But statutes or court rulings endorsing consumer penalties in adhesion contracts is a possibility, and arguments can be made for it. One is that penalties have an *ad terrorem* function that promotes contract compliance. So does debtor's prison, or Shakespeare's pound of flesh. How far are we willing to go?

Admittedly incarceration is a harsher penalty than Pam $2800 rent concession. The question, then, is whether allowing consumer penalties achieves the right balance. In weighing the merits, consider that consumer penalties not only do the good of promoting contract compliance, but work the bad of giving the seller a motive to induce breach or create circumstances where breach is likely. Landlords may argue that they are not motivated to induce breach because contract compliance is preferable to penalties that may not be collected. But with credit reporting services at work, middle-class consumers have little choice but to pay if they wish to maintain their credit. Consider also the tenant who is forced into breach by circumstance. Here the tenant is exercising the efficient breach endorsed by Anglo-American

[49]For a discussion of UCC 2-718, *see supra* note 36. For examples of statutory exceptions to the penalty rule, *see supra* notes 32-34 and accompanying text.

[50]For a convenient summary of the scholarly analyses of contract penalties, *see* Avery W. Katz, *Remedies for Breach of Contract Under the CISG*, 25 INT'L REV. L. & ECON. 378, 386-87 (2005). Professor Katz's discussion cites to articles for and against "supracompensatory damages" in both domestic and international commercial settings, with little if any application to consumer sales. These articles include Charles J. Goetz & Robert E. Scott, *Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes of an Enforcement Model and a Theory of Efficient Breach*, 77 COLUM. L. REV. 544 (1977) (hereinafter *Liquidated Damages, Penalties and the Just Compensation Principle*); Samuel A. Rea, Jr., *Efficiency Implications of Penalties and Liquidated Damages*, 13 J.LEGAL STUD. 147 (1984); Philippe Aghion and Patrick Bolton, *Contracts as Barriers to Entry*, 77 AM. ECON. REV. 388 (1987); Tai-Yeong Chung, *On the Social Optimality of Liquidated Damages Clauses: An Economic Analysis*, 8 J. L. ECON. & ORG. 280 (1992); Aaron S. Edlin and Alan Schwartz, *Optimal Penalties in Contracts*, 78 CHI.-KENT L. REV. 33 (2003); Alan Schwartz, *The Myth That Promises Prefer Supracompensatory Remedies: An Analysis of Contracting for Damages Measures*, 100 YALE L. J. 369 (1990); Aaron S. Edlin, *Cadillac Contracts and Up-Front Payments: Efficient Investment Under Expectation Damages*, 12 J. L. ECON. & ORG. 98 (1996; Aaron S. Edlin and Stefan Reichelstein, *Holdups, Standard Breach, and Optimal Investment*, 86 AM. ECON. REV. 478 (1996); Eric Maskin and Jean Tirole, *Unforeseen Contingencies and Incomplete Contracts*, 66 REV. ECON. STUD. 83 (1999); Avery W. Katz, The Option Element in Contracting, 90 Va. L. Rev. 2187 (2004); Robert E. Scott and George G. Triantis, *Embedded Options and the Case Against Compensation in Contract Law*, 104 COLUM L. REV. 1428 (2004). *See also* articles listed at III FARNSWORTH, *supra* note 7 at 303, n. 8. For an article addressing adhesion issues in consumer contracts but not including penalties, *see* "Boilerplate" Foundations of Market Contracts Symposium, 104 MICH. L. REV. 821-1246 (2006)(generally discussing adhesion agreements with no focused discussion of penalty damages).

law for several hundred years. Penalties undermine that.[51]

The gain resulting from reimposed rent concessions is at the expense of an increasing consumer debt load. It produces ill effects both on the broad economy and on the individual tenants unwise or unlucky enough to breach. These ill effects are being exaggerated because these disputes are not being litigated. This echoes to a time centuries ago when breaching parties with lesser leverage had to reimburse the seller significantly more that the actual loss. Late medieval England changed that, and the rule awaits enforcement.

[51]For a discussion of efficient breaches, *see Lake River*, 769 F.2d at 1289, *See also Liquidated Damages, Penalties and the Just Compensation Principle*, *supra* note 50.