New York Law Journal

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An ALM Publication

JANUARY 20, 2021

A Double Attorney Fees Clause Is Held Not a Penalty, But What's Next?

In 'Loughlin v. Meghji', the court held that a provision of a commercial contract requiring the payment of double the amount of attorney fees expended by the "substantially prevailing party" in a litigation between the contracting parties is not an unenforceable penalty. While some may believe that this particular provision is, in fact, a penalty, the court's mode of analysis in reaching that result is the more important takeaway for commercial lawyers.

By Michael P. Regan

The Appellate Division, Second Department held in *Loughlin v. Meghji*, 186 A.D.3d 1633, on Sept. 30, 2020, that a provision of a commercial contract requiring the payment of double the amount of attorney fees expended by the "substantially prevailing party" in a litigation between the contracting parties is not an unenforceable penalty. While some may believe that this particular provision is, in fact, a penalty, the court's mode of analysis in reaching that result is the more important takeaway for commercial lawyers.

Instead of focusing on the more traditional factual inquiries in determining the enforceability of such provisions, the court in *Loughlin* invoked the simpler rule that sophisticated commercial parties should be held to the terms of the contract that they signed onto. It remains to be seen

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whether *Loughlin* signals a growing shift in how New York courts treat such provisions in commercial contracts, and whether this new approach knows any boundaries.

The decision in *Loughlin* does not discuss Court of Appeals' opinion in *Equitable Lumber v. IPA Land Dev.*, 38 N.Y.2d 516 (1976), which is often cited in this context. In *Equitable Lumber*, the Court of Appeals scrutinized the enforceability of a contractual provision establishing 30% as a reasonable attorneys' fee to be paid in connection with any enforcement and collection efforts by the seller under the parties' contract, and noted that courts routinely address the enforceability of similar clauses providing for attorney fees in a liquidated amount. See *Equitable Lumber*, at 522-24.

The court remitted for the resolution of traditional fact inquiries concerning the enforceability of a liquidated damages provision, to wit: (a) was a 30% fee reasonable in the light of the damages to be anticipated by a party in the seller's position, or, alternatively, (b) was the fee commensurate with the actual arrangement agreed upon by this plaintiff and its attorney? See id. at 524. Further, the court directed the lower court to determine "whether the amount stipulated was unreasonably large or grossly disproportionate to the damages which the [seller] was likely to suffer" in the event it did not rely on the liquidated damages clause and, if so, indicated that the provision should be voided as a penalty. Id.

Recent decisions from the Commercial Division, New York County, have followed the analysis set forth in *Equitable Lumber*. For example, in *Julius Silvert v. Open Kitchen 17*, 2019 NY Slip Op 30394(U) (Sup. Ct. N.Y. Co.), Justice Cohen, citing *Equitable Lumber*, declined to enforce, on summary judgment, a contractual provision setting the amount of attorney fees at 33.33% of the balance due under the parties' credit agreement. See *Julius Silvert*, at pp. 3-6.

The court held, inter alia, that "[f] ixing attorney's fees at an arbitrary percentage of an unknown amount … acts as a kind of liquidated damages provision, one which may constitute an unenforceable penalty." Id. at p. 4. In contrast to *Loughlin*, Justice Cohen declined to award attorney fees based solely "on the face of the [parties' agreement]," and held that more information is required to determine whether such a payment for legal fees is fair and reasonable. Id. at pp. 5-6.

Likewise, in *Maina v. Rapid Funding NYC*, 2014 NY Slip Op 30952(U) (Sup. Ct. N.Y. Co.), Justice Sherwood held that a provision contained in a promissory note, entitling the lender to a payment of attorney fees in the amount of 20% of the principal and interest then due on the note, is an unenforceable penalty. See *Maina*, at *5, citing *Equitable Lumber*. The court reasoned that a party is only entitled to such an attorney fees award "if it demonstrates that the quality and quantity of the legal services rendered were such to warrant, on a quantum meruit basis, that full percentage [provided for in the contract]." Id.

In contrast to *Equitable Lumber* and its progeny, the decision in *Loughlin* eschews the traditional method of analyzing the enforceability of a contractual provision requiring a payment of attorney fees based on a fixed, pre-determined percentage of fees incurred—in this case, a whopping 200% of such fees. Instead, the court principally relies on the Court of Appeals' holding in *Vermont Teddy Bear Co. v. 538 Madison Realty Co.*, 1 N.Y.3d 470 (2004), which emphasizes the importance of enforcing commercial contracts according to their terms, especially in the context of real-estate transactions. See *Vermont Teddy Bear Co.*, at 475. But *Vermont Teddy Bear* dealt with the notice requirements of a commercial lease, not the enforceability of a liquidated damages provision—let alone in the context of awarding attorney fees. Further, a provision which requires a payment based on a multiple of future, undetermined attorney fees, does not create the kind of "commercial certainty" that the court was seeking to achieve in *Vermont Teddy Bear*.

Further, the decision in *Loughlin* cites to the court's prior decision in *White Plains Plaza Realty v. Town Sports Int'l*, 79 A.D.3d 1025 (2d Dept. 2010), another commercial-lease dispute, in which the contract provided for holdover rent at 200% of ordinary, monthly rent. But whereas a multiple of holdover rent can be easily identified and calculated, a multiple of future attorney fees, yet to be incurred, is a more nebulous construct that has been recognized to be "particularly susceptible to abuse[.]" *Julius Silvert*, at p. 5.

The decision in *Loughlin* may be indicative of an increasing judicial reluctance to interfere with the bargain struck by commercial parties. But under the mode of analysis

utilized in *Loughlin*, it is unclear what restrictions the court would impose on even more extreme variations of such a clause, if any. For instance, would a clause entitling the "substantially prevailing party" to a payment of 500% of incurred litigation fees be enforceable as between commercial parties? Under the principle that commercial parties must adhere to the agreement they struck, at all costs, the bounds of such a provision seem endless. And as set forth in *Equitable Lumber* and its progeny, good reasons exist to impose limits on the use of such provisions. Indeed, provisions like the one in *Loughlin* dramatically alter the "American Rule," employ the courts in creating financial windfalls to commercial parties, and act as a deterrent against the filing and prosecution of important claims.

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