TENANTS PROJECT

May 29, 2017

Analysis of *Kline v. Southgate* & *Walton v. Gaffey*

I. <u>Introduction</u>

On May 19, 2017, the Iowa Supreme Court issued rulings in *Kline v. Southgate Property Management*, no. 15-1350 (Iowa 2017) and *Walton v. Gaffey*, no. 15-1348 (Iowa 2017). These are companion cases with *Kline* as the lead and the only significant difference between the decisions being the treatment of their respective carpet cleaning provisions. Both cases are class actions under the Iowa Uniform Residential Landlord Tenant Act ("IURLTA") Iowa Code Chapter 562A, that arose in the Johnson County District Court. The Tenants' Project was counsel for both sets of plaintiff-tenants. Both cases were interlocutory appeals, made as of right from the orders certifying classes, and by permission of the Supreme Court with regard to the orders for partial summary & declaratory judgment.

On summary & declaratory judgment the district court found several lease provisions to be prohibited under 562A.11 and certified class pursuant to the Court of Appeals' decision in *Staley v. Barkalow*, 834 N.W.2d 873 (Iowa Ct. App. 2013). The Supreme Court, acting unanimously, partially affirmed and partially reversed the district court ruling and remanded for further proceedings.

II. Inclusion, Enforcement, Monetary & Punitive Damages

In *Staley v. Barkalow*, 834 N.W.2d 873 (Iowa Ct. App. 2013) the Court of Appeals, ruling on a similar landlord tenant class action brought by the Tenants' Project, held that tenants had a right to a legal lease, free from illegal provisions and that under Iowa Code §562A.11 if a lease provision was prohibited that a landlord could be subject to punitive damages if they knowingly included it in a lease, even if they did not enforce the provision. This ruling was hotly contested by some landlords and in *Kline* and *Walton*, the defendant landlords, supported by several Iowa landlord associations, urged the Supreme Court to overrule *Staley*.

Section 562A.11(2) provides that punitive damages can be imposed if a landlord "willfully uses" a rental agreement containing provisions known to be illegal. In *Kline* & *Walton*, the landlords argued that without enforcement of the illegal provisions and without actual damages that the landlord had not "used" the provision. Thus, absent both enforcement and actual damages tenants not only have no right to punitive damages, but have suffered no injury and have no standing, even through a declaratory judgment action, to challenge illegal lease provisions.

The Supreme Court noted that the IURLTA was a remedial statute and, "[s]tanding alone, the defense of unenforceability will not accomplish excision of prohibited provisions from residential rental agreements." *Kline*, page 17. The *Kline* Court held that while the phrase "uses" in 562A.11(2) includes enforcement, "…we believe it also encompasses the separate egregious act of inserting such a provision in a rental agreement with knowledge that it is prohibited." *Kline*, page 17. Thus, "...we conclude section 562A.11(2) authorizes a claim for damages against a landlord, even in

the absence of an attempt to enforce a prohibited provision." *Kline*, page 17. And in addition, held the *Kline* Court, §562A.11(2), "…permits a recovery of not more than three months' periodic rent even if no actual damages are pled and proved." *Kline*, page 18.

The Supreme Court in *Kline* therefore vindicated tenants' rights to a legal lease, free from illegal provisions and also found that tenants have standing to challenge illegal lease provisions. While the court's focus was on punitive damages, the ruling also makes it clear that tenants have standing to seek a declaratory judgment with regard to the legality of lease provisions.

The Supreme Court in *Kline* did not alter the high standard imposed in *Caruso v. Apts. Downtown,* no. 14-1783 (Iowa 2016), for the "knowing" use of prohibited provisions necessary to impose punitive damages. The *Caruso* Court ruled that the tenant must show that the landlord had actual knowledge that the provisions were prohibited. *Caruso* at 13. Actual knowledge can be established by circumstantial evidence only in rare cases. *Caruso* at 13.

PRACTICE TIPS:

(1) Landlords should carefully review their leases and remove all illegal provisions.

(2) Landlords that do not have actual knowledge that their lease provisions are prohibited are not subject to punitive damages.

III. Actual versus Liquidated Damages

In *Kline* and *Walton*, the tenants argued and the district court ruled that under the IURLTA only actual damages were permitted. The landlords argued that unless the IURLTA specifically required actual damages that liquidated damages were permitted. The Supreme Court held that other than the types of provisions prohibited in §562A.11, including waiver of rights established by the IURLTA, that, "...landlords and tenants are free to form residential rental contracts consistent with chapter 562A and the principles of law and equity supplementing it." *Kline*, page 22. The Supreme Court held that unless actual damages were specifically required by the IURLTA that residential leases could contain liquidated damage provisions. *Kline*, page 22. The Supreme Court emphasized however, that liquidated damage provisions could be overturned if they were, "...unconscionable under section 562A.7 or unenforceable penalties under any other principle of law or equity supplementing the Act." *Kline*, page 22-23.

PRACTICE TIPS:

(1) While the Supreme Court has found that liquidated damage provisions are permitted in residential leases, landlord must be careful not to impose liquidated damages in situations where the IURLTA requires actual damages.

(2) Landlords still may not impose outright fines or penalties on tenants or set the liquidated damages so high above actual damages that they constitute a penalty. See *Rohlin Constr. Co. v. City of Hinton*, 476 N.W.2d 78 (Iowa 1991),

> 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."

Rohlin, 476 N.W.2d at 80.

(3) Liquidated damages must also not be unconscionable under §562A.7.

(4) Landlords need to remember that once liquidated damages are provided in a lease, that their recovery is limited to the amount of liquidated damages set, even if actual damages are higher. A lease provision that provides for liquidated damages plus any additional actual damages is unenforceable as a penalty provision. See *Lefemine v. Baron*, 573. So. 2nd 326 (Fl. 1991) (option to choose either liquidated damages or to sue for actual damages indicates an intent to penalize and negates the intent to liquidate damages.)

(5) Landlords are free to require actual damages in leases and if so need not be concerned about violating specific provisions of the IURLTA, imposing penalties or fines, setting unreasonably high liquidated damages, having unconscionable lease provisions, or setting liquidated damages that result in a loss because they are less than actual damages.

IV. Exculpatory Provision and Disclaimer

The landlord's lease in *Kline* provided that if possession could not be given at the beginning of the tenancy that rent would abate, "…and the rebated rent shall be accepted by Tenant as full settlement of all damages." *Kline*, page 23. The Supreme Court affirmed the district court's ruling that this provision was prohibited under §562A.11(d) as an illegal exculpatory provision because it clearly limited the landlord's liability. The provision was not saved by including the disclaimer, "'…[s]ubject to other remedies at law' as it otherwise clearly purports to attempt to limit [landlord’s] liability

and the tenants' remedy for damages sustained..." *Kline*, page 23.

PRACTICE TIPS:

(1) Landlords should be careful not to use any exculpatory or other provisions limiting liability in leases.

(2) Lease provisions that are otherwise prohibited are not saved by disclaimer provisions.

V. <u>Carpet Cleaning Provisions in *Kline* & *Walton*</u>

In *De Stefano v. Apts. Downtown*, Inc., 879 N.W.2d 155 (Iowa 2016) the Supreme court held that a lease provision that provided for an automatic deduction from the security deposit for carpet cleaning was prohibited under the IURLTA.   In *Kline*, the Supreme Court held that the landlord's carpet cleaning provision which merely set, "…a benchmark for the condition of the carpet—a clean carpet—at the commencement of each tenancy from which subsequent assessments of ordinary wear and tear can be measured," without providing for deduction from the security deposit was not prohibited under the IURLTA and reversed the district court's finding that the landlord's carpet cleaning provision was prohibited. *Kline*, page 25. The *Kline* Court noted that any deduction for cleaning from the security deposit would require the landlord to prove that, "…cleaning was reasonably necessary '[t]o restore the dwelling unit to its condition at the commencement of the tenancy, ordinary wear and tear excepted.'" *Kline*, page 26, citing Iowa Code § 562A.12(3)(a)(2).

On the other hand in *Walton*, the Supreme Court noted that the landlord's lease provided for an automatic deduction from the security deposit for carpet cleaning.

Walton, page 12. The Supreme Court found that this provision was prohibited because, "[i]t authorizes the landlord to undertake professional carpet cleaning and deduct the cost from the security deposit without regard to whether the cleaning is necessary to restore the carpet to its condition at the commencement of the tenancy." *Walton*, page 12.

PRACTICE TIPS:

(1) Landlords should continue to follow *De Stefano* and not make automatic carpet cleaning deductions from the security deposit.

(2) Landlords should not deduct from the security deposit any amounts for cleaning due to ordinary wear and tear.

VI. Required Check-in Inspection

The landlord's lease contained a provision that required tenants to complete and return an inspection checklist within three days after the occupancy began. *Kline*, page 5. If the checklist was not returned, the lease provided that, "…Tenant shall be presumed as acknowledging that there are no defects or damages in the Dwelling Unit." *Kline*, page 5. The district court found that this provision was prohibited and the Supreme Court reversed, holding that the provision was merely, "...a procedural device to promote documentation of the condition of the dwelling at the outset of the landlord–tenant relationship." *Kline*, page 27. The *Kline* Court found that the failure to complete the checklist did not constitute a waiver of the tenant's rights, and rather than operating as a presumption merely, "…might well have evidentiary significance in the event [the landlord] claims the tenant caused damage to the dwelling…" *Kline*, page 27.

PRACTICE TIP: Landlords may require check-in inspection lists, but should be cautious about imposing an automatic presumption of damage merely based on the failure to timely provide the completed check-in.

VIII. Class Certification

Under Iowa R. Civ. P. 1.264(2) the district court is required to make specific factual findings in order to certify a class. In *Kline*, the Supreme Court reversed certification on the grounds that these required findings had not been made, but stated, "[o]ur ruling should not be understood, however, as a determination that the grounds for certification of a class cannot be established in this case." *Kline*, page 28.

IX. Conclusion

In *De Stefano* and *Caruso* and now in *Kline* and *Walton*, the Supreme Court has completed the most sweeping review of landlord tenant law since the passage of the IURLTA. The Court has responded to the concerns of both landlords and tenants and we now have a clearer idea of its attitudes regarding the landlord tenant relationship.

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