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New York Bankruptcy Court Finds That Aircraft Leases' Liquidated Damages Clauses and Guarantees Are Unenforceable

*Arthur J. Steinberg, Christopher T. Buchanan, Jason Huff,
and Scott Davidson**

In Republic Airways Holdings Inc., the bankruptcy court addressed whether the liquidated damages provisions in certain aircraft "true leases" under Article 2A of the New York Uniform Commercial Code were enforceable and, if not, whether they would still be enforceable against the guarantor of the leases. The authors of this article discuss the decision and its cautionary lesson.

Judge Lane of the Bankruptcy Court for the Southern District of New York recently issued an opinion in *Republic Airways Holdings Inc.* addressing whether the liquidated damages provisions in certain aircraft "true leases" under Article 2A of the New York Uniform Commercial Code ("New York UCC") were enforceable and, if not, whether they would still be enforceable against the guarantor of the leases. The court found that the liquidated damages provisions were "unenforceable because they violate Article 2A's requirement that they be reasonable in light of the then anticipated harm from default."¹ The court also concluded that the liquidated damages provision could not be enforced against the guarantor of those obligations.

BACKGROUND

This dispute concerned claims arising from the bankruptcy rejection of certain aircraft leases which contained liquidated damages clauses triggered by the lessee's default. Another debtor guaranteed the lessees' obligations under the

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¹ *In re Republic Airways Holdings Inc.*, Case No. 16-10429 (SHL) (Bankr. S.D.N.Y. Feb. 14, 2019).

leases. The guarantees included various provisions that waived all defenses and “generally establish[ed] the guarantee obligations unassailable under all circumstances.”²

The lessor filed various damage claims against the lessees arising from the rejection of the leases. Claims for the same amounts were filed against the guarantor of the leases. The debtors objected to the claims arguing that the actual losses arising from the rejection of the leases were approximately 10 percent of the liquidated damages amounts claimed. Specifically, the debtors argued that the stipulated loss values used to calculate liquidated damages in the leases improperly transferred the residual loss risk to the lessees on default, and the actual damages caused by the default were significantly less. Accordingly, the liquidated damages provision was an unenforceable penalty and violated New York’s public policy, and any guaranty of this provision would equally be unenforceable. The lessor responded that the liquidated damages clause in the leases was proper and voiding them would violate the parties’ freedom to contract and, under New York law, the guarantees were “irrevocable” and “ironclad” and, therefore, the guarantor waived its rights to any defense based on public policy grounds.³

BANKRUPTCY COURT DECISION

The parties agreed that the leases were “true leases” and, therefore, governed by Article 2A of the New York UCC. Under Article 2A-504(1), “[d]amages payable by either party for default, or any other act or omission, including indemnity for loss or diminution of anticipated tax benefits or loss or damage to lessor’s residual interest, may be liquidated in the lease agreement but only at an amount or by a formula that is reasonable in light of the then anticipated harm caused by the default or other act or omission.”⁴ In looking at what is “reasonable,” in connection with liquidated damages, the court found that (i) “reasonableness must be judged at the time of contract formation;” (ii) courts must “give due consideration to the nature of the contract and the attendant circumstances,” including the sophistication of the parties; and (iii) where a liquidated damages clause is “formulated as a penalty” it will be considered unreasonable and unenforceable under New York law.⁵

Under the leases, the lessor had a choice, upon the lessees’ default, to recover liquidated damages calculated by (a) the actual damages incurred by the lessor

² *Id.*

³ *Id.*

⁴ *Id.*

⁵ *Id.*

(*i.e.*, the difference between the present value of (i) the rent payable under the leases for the remainder of the term and (ii) the fair market rental value of the aircraft for the same time period), or (b) one of two formulas using stipulated loss values (*i.e.*, the amount by which the stipulated loss value exceeds (i) the discounted fair market rental value of the aircraft for the remainder of the term or (ii) the fair market sales value of the aircraft). The stipulated loss values were calculated to provide the lessor with a four percent return on its original costs of the leased aircraft. The court was swayed to invalidate the liquidated damages clauses based on the stipulated loss value formula because the provisions allowed “for the unconditional transfer of residual value risk, or market risk, only upon default, without a cognizable connection to any anticipated harm caused by the default itself.”⁶ Significantly, absent a default, the lessee was only obligated to return the aircraft at lease expiration in the condition required by the leases, and not make any payments due to a decline in residual value. The relevant question for the court was “whether the parties in a true finance lease transaction can allocate risk so that the financing is treated as a debt obligation until the end date of the Leases, and then at the end of the term the Lessor Parties becoming the true economic owners.”⁷ In concluding that the answer was no, the court held that with respect to a true finance lease governed by Article 2A, the liquidated damages must be based on a reasonable estimate of damages arising out of the breach of the lease (*i.e.*, the remaining obligations to be paid by the lessee under the lease), and not as a mechanism for generalized residual risk transfer.⁸ Although the court acknowledged that “no court has *per se* rejected inclusion of residual interest liability in a liquidated damages provision,” it found that under applicable case law, the language of Article 2A “directs that any liquidated damages must be based on reasonable estimates of damages arising out of default as to the aircraft in question.”⁹

The court then turned to the validity of the guarantees, concluding that, like the liquidated damages clause in the leases, the guarantees were also unenforceable as against public policy under New York law.¹⁰ This conclusion was consistent with prior case law that held “as a matter of public policy, parties may not waive defenses to liquidated damages clauses.”¹¹

⁶ *Id.*

⁷ *Id.*

⁸ *Id.*

⁹ *Id.*

¹⁰ *Id.*

¹¹ *Id.*

SUBSEQUENT EVENTS

The lessor appealed the bankruptcy court's decision. An issue left open by the decision was whether the lessor could amend the claims to add fraudulent inducement and breach of representation claims. Subsequently, the parties reached a settlement, whereby the lessor received a \$20 million allowed general unsecured claim in the debtor's bankruptcy case (which was approximately 40 percent of the alleged damages asserted by the lessor arising from the rejection of the leases, but still approximately four times the amount of actual damages as calculated by the debtor). In light of the settlement, the appeal and the request to amend the claims were withdrawn.

CONCLUSION

Any time a court uses a "reasonableness" standard to negate a specific contractual provision, parties are well advised to re-examine their forms to ensure that they will not suffer a similar fate. Here, the cautionary lesson from *Republic Airways* is that a stipulated loss value-based formula used to calculate liquidated damages in an Article 2A true lease may be deemed unenforceable as against public policy, and guarantees do not protect against this risk.