



Republic Airways: Will Courts Ever Enforce Stipulated Loss Value Claims in Aircraft Leases?

By Daniel J. Carragher

With a global drop in demand and reduction of flight schedules by 90 percent or more in the wake of the COVID-19 pandemic, we could be braced for another wave of insolvency proceedings as passenger airlines, charter operators, and helicopter operators face incredibly difficult decisions about rationalizing fleet size and managing ongoing lease costs. At some point, paying rent on stored aircraft ceases to be a viable option, and airlines and other operators will either default or file for Chapter 11 protection and reject leases.

Rejection of leases in bankruptcy is a powerful tool. The standard for approving rejection is a lenient business judgement standard, and aircraft lease rejection motions typically are allowed unless they drastically modify provisions for insurance, return locations, or pairing of engines with airframes or impair the lessors' rights to recover their property. Rejection also sets a narrow period of time, typically 30 days, for the affected lessor to file a proof of claim for damages arising from the rejection of the lease.

The typical measure of damages in bankruptcy, however, allows a lessor to recover accrued and unpaid rent as of the petition date, plus the actual damages for loss of future rent. The test begins with a calculation of contractually obligated base rent for the remainder of the lease term. From that amount, the fair rental value of the aircraft is deducted to arrive at net rental losses. The resulting damages are discounted to present value back to the petition date so that claims of all creditors are treated comparably. Other actual damages that can be claimed include return condition deficiencies and missing parts.

Unlike claims under real estate leases, there is no cap on the amount of prospective damages that an aircraft lessor can claim. The only reason for disallowance is if the claim is unenforceable under applicable state law for a reason other than because the "claim is contingent or unmaturing."¹ Thus, if the lease provision is enforceable under state law, a bankruptcy claim based on that provision is not subject to disallowance.²

Under a typical aircraft lease, the lessor can claim amounts due under a liquidated damages clause plus any additional damages under any separate tax indemnity

agreement. Using a formula approach designated at the inception of the lease, the lessor may be entitled to damages above and beyond the common view of what constitutes actual damages in bankruptcy cases. The refusal of the court in *In re Republic Airways Holdings Inc.*³ to enforce such a stipulated loss value (SLV) provision is the focus of this article.

Background of U.C.C. Article 2A

U.C.C. Article 2A was first promulgated in 1987 to codify a separate set of rules for personal property leases with a focus on freedom of contract.⁴ The subject matter was deemed sufficiently different from sales (Article 2) and secured transactions (Article 9) to warrant its own body of law. Aircraft leases and pricing models were developed long before Article 2A was promulgated, and the use of SLV or termination value schedules as the basis to calculate liquidated damages was long established. Indeed, creating a statutory framework to recognize and validate preexisting practices was one of the driving forces behind Article 2A.⁵

Some states enacted Article 2A soon after it was released, while others waited several years. New York enacted Article 2A in 1994, and Connecticut waited until 2002. The delay in universal enactment meant that challenges to liquidated damages clauses continued to be evaluated under more restrictive common law standards. As a result, the case law under Article 2A is still in developing. Even after state adoption of Article 2A, many litigants and courts continued to look to the common law and never focused on the potentially different outcome under Article 2A.⁶

Treatment of Liquidated Damages: A Comparison of Common Law and U.C.C. Articles 2 and 2A

Common Law

Under the traditional common law view of liquidated damages, the anticipated damages for breach must be difficult or impossible to estimate, and the liquidated damages must be a reasonable forecast of the anticipated damages. The burden is on the party challenging the enforceability of a liquidated damages clause.⁷

At common law, liquidated damages clauses were viewed with suspicion by courts, and many reported cases have refused to enforce them.

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[B]ecause the goal of contract remedies is compensation, not punishment, if the purpose or effect of a provision stipulating damages is to punish the nonperformance of a party's obligations under the agreement, or to coerce or secure performance of the agreement through the assessment of an unreasonable sum payable on nonperformance, the provision will not be upheld.⁸

There have been notable bankruptcy court rulings invalidating aircraft lease liquidated damages clauses utilizing the common law approach. In *Interface Group-Nevada, Inc. v. Trans World Airlines, Inc. (TWA)*, the U.S. Court of Appeals for the Third Circuit upheld rulings by the lower courts that invalidated a typical liquidated damages clause in a lease for two Lockheed L-1011s.⁹ The court found that damages were not uncertain or difficult to calculate and that the net termination value claim bore no relationship to the lessor's probable loss in the event of breach. Where the liquidated damages formula provided for an amount that was disproportionate to the lessor's actual loss, the clause was void as a penalty. The court cited what it admitted was an improbable hypothetical of a default by Trans World Airlines (TWA) one month before the end of the lease term, where the remaining rent would be \$100,000 and the net termination value claim after resale of the aircraft would be \$11 million. The lessor admitted that the intent was to shift the risk of a market value decrease to TWA, but the court did not consider that as actual damages to the lessor.

In *In re Northwest Airlines*, the bankruptcy court invalidated liquidated damages clauses in leases of two DC-9s.¹⁰ As in *TWA*, the total remaining rent at the time of rejection was far lower than the amount claimed—\$1.36 million in rent as compared to SLV claims totaling \$15 million—more than 10 times the amount that would have been paid if Northwest had not rejected the leases. Citing Minnesota common law, the court easily concluded that the clause was an unenforceable penalty. Making the case even more difficult for the lessor, the SLVs on the leases in question did not decline over time because they were adapted to the particular facts of the case—that is, to the fact that Northwest had invested nearly \$6 million in the aircraft and was entitled to share in 50 percent of the sale proceeds, casualty loss proceeds, or static SLVs stated in the leases.

U.C.C. Article 2

U.C.C. section 2-718(1) governs liquidated damages in contracts involving sales of goods. It provides:

Damages for breach by either party may be liquidated in the agreement but only at an amount which is reasonable in the light of the anticipated or actual harm caused by the breach, the

difficulties of proof of loss, and the inconvenience or nonfeasibility of otherwise obtaining an adequate remedy. A term fixing unreasonably large liquidated damages is void as a penalty.¹¹

Section 2-718(1) first carries forward the common law requirement that damages must be difficult to quantify. If a contract concerns readily available goods for which there is a market external to the contract, a liquidated damages clause may not meet the “difficult to quantify” standard.

Second, liquidated damages must be reasonable in light of anticipated *or* actual harm. This element of section 2-718(1) was a departure from the common law, in which the majority rule focused only on anticipated harm and deemed actual harm irrelevant. Most courts have read this requirement to mean that a liquidated damages clause will be enforced if it meets either one of the tests (anticipated or actual).¹² Many attempts to avoid liquidated damages clauses focus on actual, rather than anticipated, damages, and the benefit of hindsight often figures prominently in such cases. Under the majority approach, the courts will not take a second look at actual damages as long as the liquidated damages were reasonable in light of the damages that the parties anticipated when they entered into the contract.

Third, clauses that impose a penalty are unenforceable. If the liquidated damages clause operates to coerce performance or penalize, rather than compensate, for a breach, the clause will be considered a penalty.

U.C.C. Article 2A

The applicable provision in Article 2A is section 2A-504(1):

Damages 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.¹³

The drafters of Article 2A removed some of the key limitations on the enforceability of liquidated damages clauses under common law and under section 2-718(1). Their purpose was to recognize the common desire of parties to a lease to agree in advance to a formula for establishing the amount due at any point in time for breach of the lease.¹⁴

Under the traditional common law view of liquidated damages, the anticipated damages for breach must be difficult or impossible to estimate, and the liquidated damages must be a reasonable forecast of the anticipated damages. Under Article 2A, there is no requirement that

damages be uncertain or difficult to quantify. Article 2A also eliminated the proportionality requirement and the requirement of inconvenience or nonfeasibility of otherwise obtaining an adequate remedy.¹⁵

Of key importance to the enforcement of SLV provisions in aircraft leases, the text of Article 2A itself and the official comment allow loss or damage to the lessor's residual interest to be a permissible element of damages that may be liquidated in the lease agreement as long as the formula for calculating liquidated damages is reasonable in light of the then anticipated harm. The example in the official comment describes the essential elements of a typical liquidated damages provision in an aircraft lease: "A liquidated damages formula that is common in leasing practice provides that the sum of lease payments past due, accelerated future lease payments, and the lessor's estimated residual interest, less the net proceeds of disposition (whether by sale or re-lease) of the leased goods is the lessor's damages."¹⁶

This provides a seemingly firm foundation for the enforcement of a typical SLV or termination value claim. As will be seen below, however, transferring residual risk to the lessee upon default has been held to be unreasonable and punitive under Article 2A.

The Republic Airways Decision

When Republic Airways (Republic) filed for Chapter 11 protection in February 2016, its business plan called for retiring its fleet of smaller regional aircraft, including its ERJ-145s. Seven of the ERJ-145s were leased to Republic's affiliate Shuttle America (successor to Chautauqua Airlines, Inc.) by ALF VI, Inc. as owner participant (Residco), which was the successor to the original owner participant. After rejection, Residco filed proofs of claim seeking over \$55 million in rejection damages.¹⁷ The aggregate SLVs at the time of rejection were \$61.1 million, and the fair market sales value credit applied by Residco was only \$6.56 million, or only 10.7 percent of the anticipated residual values built into the leases in 2002.

The original 2002 leases for the aircraft contained SLV provisions that specified the amount of liquidated damages to be paid by the lessee in the event that the leases were terminated before the end of the 18-year basic terms. The SLV schedule stepped down over time, and the SLV tables were designed to capture not only losses due to lease payments on the aircraft but also lost tax benefits accruing with respect to the leases. The SLV schedules took into account the projected residual value of the aircraft at the time of termination and the amounts needed for the lessor to receive a four-percent return on its investment.

The leases were amended and restated in December 2013, and new basic rent schedules were adopted that significantly reduced the amount of the monthly rent payments. However, the SLV schedules remained unchanged from the original leases. Had new appraisals been prepared, the projected residual values would

have been dramatically lower.

The SLV provision allowed the lessor to claim unpaid "Basic Rent" plus, "as liquidated damages for loss of bargain and not as a penalty" and "in lieu of Basic Rent payable" for the remainder of the term, one of three options:

(1) "the amount . . . by which . . . the Stipulated Loss Value computed as of the specified payment date . . . exceeds . . . the aggregate Fair Market Rental Value . . . of the Aircraft for the remainder of the Basic Term[,] after discounting such Fair Market Rental Value to present worth";

(2) the amount . . . by which . . . the Stipulated Loss Value computed as of the [specified] payment date . . . exceeds . . . the Fair Market Sales Value," determined on the basis of an arm's-length transaction between a willing seller and a willing buyer both with full knowledge of the relevant facts, including the actual condition and maintenance status of the aircraft at such time; or

(3) the amount . . . by which . . . the aggregate Basic Rent for the remainder of the Basic Term . . . , discounted . . . to present worth [as of the payment date], exceeds . . . the Fair Market Rental Value . . . of the Aircraft for the remainder of the Basic Term[,] after discounting such Fair Market Rental Value to present worth."¹⁸

Option three is the "actual damages" formula for breach of a true lease as specified in U.C.C. section 2A-528, whereas options one and two allow the lessor to claim SLV less a credit for either the fair rental value during the remaining term (without giving rental credit for residual value after the end of the term) or sales value. Residco elected option two.

Republic challenged the liquidated damages claims as unenforceable penalty claims under Bankruptcy Code section 502(b)(1), U.C.C. section 2A-504(1), and New York common law. First, Republic claimed that the liquidated damages clause was unenforceable because it gave the lessor the choice of actual damages or SLV claims. Second, Republic claimed that the liquidated damages clause was an unenforceable penalty because it was grossly disproportionate to the actual damages. Third, Republic challenged the use of liquidated damages because the probable loss was readily calculable.

The bankruptcy court sided with Republic and reduced Residco's claims to actual damages for lost rent during the remaining term.¹⁹ After reviewing the applicable legal standards before and after Article 2A, the court ruled that the penalty analysis under common law carried over under Article 2A:

Although Section 504 of Article 2A does not explicitly incorporate the common law's consideration of "disproportionality to actual damages," many of the cases cited above compare the damages to "probable harm" rather than actual harm; . . . this concept is consistent with the instruction in Section 504 to examine reasonableness in light of the "anticipated" harm caused by a default.²⁰

The court also held that *TWA* is still good law and an important tool by which to assess the enforceability of liquidated damages clauses.

[T]he reasonableness requirement was part of the common law test predating Article 2A and remains part of the test today. Accordingly, the Court sees no reason why it would not consider prior case law on the reasonableness of liquidated damages, including the *TWA* decision, to be relevant and useful precedent, even if ignoring other case law on now discarded elements like the difficulty of estimation.²¹

The bankruptcy court predictably compared the amount of the SLV claims to the remaining basic rent and found the claims to be a multiple of the future rent liability. The court also found that the SLV damages would rise to 104 times the remaining rent if Shuttle America defaulted with one month remaining in the term of the amended leases. However, the court's principal reason for rejecting the claims was that the transfer of residual risk to the lessee, only upon default, is an unenforceable penalty. In the court's view, the liquidated damages are inherently unreasonable unless the claim amount is tied to the anticipated harm *caused* by the default. Because the SLV claim is never triggered if the lessee pays its rent through the end of the term, the potential for such a large liability could only be seen as a punitive measure to compel performance and not one to compensate the lessor for losses caused by a default.

The bankruptcy court could have tailored its ruling to some of the bad facts presented. For example, the court could have focused solely on the disconnect between anticipated residual values at the time the leases were amended and restated in 2013 and the failure of the parties to update the SLV tables to take into account the dramatic decline in current and projected market values. Under that approach, the liquidated damages clause could have been viewed as a penalty and invalidated on the facts of the case without reaching the issue of whether any transfer of residual risk would be prohibited. A similar approach has been used in other contexts where, for example, a truck lessor intentionally used a price for the leased trucks that was well above market value as the basis for the SLV amounts in its leases. Because that price was intended to be, and was,

punitively high, the clause was unenforceable.²²

By considering the original leases and the amended leases and finding that both ran afoul of Article 2A's reasonableness requirements, the *Republic Airways* court cast considerable doubt on whether typical aircraft lease SLV provisions will ever be enforceable.²³

Recommendations and Conclusion

There is no bright line separating an agreement to pay a reasonable measure of damages from an unenforceable penalty clause.²⁴ The *Republic Airways* court deemed an SLV clause to be a penalty, whereas other courts have accepted SLV clauses in aircraft leases as reasonable and enforceable.²⁵

So, how does a lessor convince a court to enforce a liquidated damages clause and avoid having the court treat the clause as a penalty and refuse enforcement? The issues will be resolved as a matter of law without considering extrinsic evidence, so the factual underpinnings for the arguments should be included in the lease. Beyond stating that the liquidated damages clause is not a penalty, the interrelationship of the SLV clause and the timing and amount of basic rent can be explained in the lease so that, but for the lessee's agreement to assume unanticipated residual risk upon an early termination or default, the other pricing terms would not be available to the lessee. A reviewing court will need to take those factors into account in assessing reasonableness. Adverse consequences to the lessor upon early termination should be recited, such as the potential inability to draw on a residual value guaranty or potential loss of the aircraft to foreclosure if the lessee does not perform for the entire term. Lessors may also consider requesting separate lessee or affiliate residual value guarantees if such agreements can be reconciled with the parties' economic, accounting, and tax objectives.

Republic Airways can be distinguished on its facts because the continuation of the 2002 SLV tables in the 2013 amended leases presented a dramatic case of a remedy untethered from the anticipated losses at the time. However, the decision contains a broad prohibition on transfer or residual risk to the lessee if that shift occurs only after default.

Article 2A expressly permits the parties to address loss of residual value in a liquidated damages clause in a true lease. The challenge remains how best to demonstrate that the liquidated damages amount is reasonable for the purposes of U.C.C. section 2A-504(1) and section 502 of the Bankruptcy Code.

Endnotes

1. 11 U.S.C. § 502(b)(1).
2. In a Chapter 7 liquidation, claims for fines, penalties or multiple, exemplary or punitive damages are allowable but are subordinated to claims of other creditors. *Id.* § 726(a)(4).
3. 598 B.R. 118 (Bankr. S.D.N.Y. 2019).

4. U.C.C. § 2A-102 official cmt. (AM. LAW INST. & UNIF. LAW COMM'N 1987).

5. *Id.*

6. TAL Fin. Corp. v. CSC Consulting, Inc., 446 Mass. 422, 431 (2006) (lease of computer hardware, telephone equipment, software, and office furniture); *In re* Nw. Airlines Corp., 393 B.R. 352, 356 (Bankr. S.D.N.Y. 2008) (aircraft lease); *Holmes v. Gen. Elec. Capital Corp.* (*In re* Holmes), 369 B.R. 708, 736–38 (Bankr. M.D. Ga. 2007) (aircraft lease).

7. Honey Dew Assocs., Inc. v. M & K Food Corp., 241 F.3d 23, 37 (1st Cir. 2001); Wells Fargo Bank Northwest v. TAC Int'l Airline, 315 F. Supp. 2d 347, 350 (S.D.N.Y. 2003) (enforcing a liquidated damages clause under Article 2A equal to the rent for the remainder of the lease term less the fair market rental value of the aircraft, discounted to the payment date).

8. 24 RICHARD A. LORD, WILLISTON ON CONTRACTS § 65:1 (4th ed. 2019).

9. Interface Group-Nevada, Inc. v. Trans World Airlines, Inc., 145 F.3d 124, 133–36 (3d Cir. 1998).

10. *In re* Nw. Airlines Corp., 393 B.R. 352 (Bankr. S.D.N.Y. 2008).

11. U.C.C. § 2-718(1).

12. ANDERSON, DAMAGES UNDER THE UNIFORM COMMERCIAL CODE § 13:10 (2003).

13. U.C.C. § 2A-504(1).

14. *Id.* § 2A-504 official cmt.

15. “This section does not incorporate two other tests that under sales law determine enforceability of liquidated damages, i.e., difficulties of proof of loss and inconvenience or nonfeasibility of otherwise obtaining an adequate remedy. The ability to liquidate damages is critical to modern leasing practice; given the parties’ freedom to contract at common law, the policy behind retaining these two additional requirements here was thought to be outweighed. . . . By deleting the reference to unreasonably large liquidated damages the parties are free to negotiate a formula, restrained by the rule of reasonableness in this section.” *Id.*

16. U.C.C. § 2A-504.

17. Residco also filed guarantee claims against parent company Republic Airways Holdings Inc. for the same amounts.

18. *In re* Republic Airways Holdings Inc., 565 B.R. 710, 713–14 (Bankr. S.D.N.Y. 2017).

19. *In re* Republic Airways Holdings Inc., 598 B.R. 118 (Bankr. S.D.N.Y. 2019).

20. *Id.* at 132.

21. *Id.* at 131.

22. *Ryder Truck Rental, Inc. v. Maalt, LP*, 2017 WL 9806934 (N.D. Tex. Dec. 13, 2017). After invalidating the liquidated damages clause, the court awarded the lessor its lost profit on the transaction, which is an alternative remedy to the recovery of the remaining rent under U.C.C. § 2A-528(2).

23. The *Republic Airways* court also rejected Residco’s claims for the full amount under unconditional guarantees of the lease claims by Republic Airways Holdings, the parent of the lessee, thus cutting off a potential structural solution of the issues arising under Article 2A. In the court’s view, reading the guarantees to require payment of amounts that were unenforceable under the leases would violate public policy. *Republic Airways*, 598 B.R. at 143–48. Shortly after the court’s decision was issued, the parties reached a stipulated settlement under which Residco’s claims were allowed for \$20 million as compared to the \$55 million sought in the rejection damages claims.

24. TAL Fin. Corp. v. CSC Consulting, Inc., 446 Mass. 422, 431 (2006).

25. *See, e.g., In re* Holmes, 369 B.R. 708, 736–38 (Bankr. M.D. Ga. 2007).