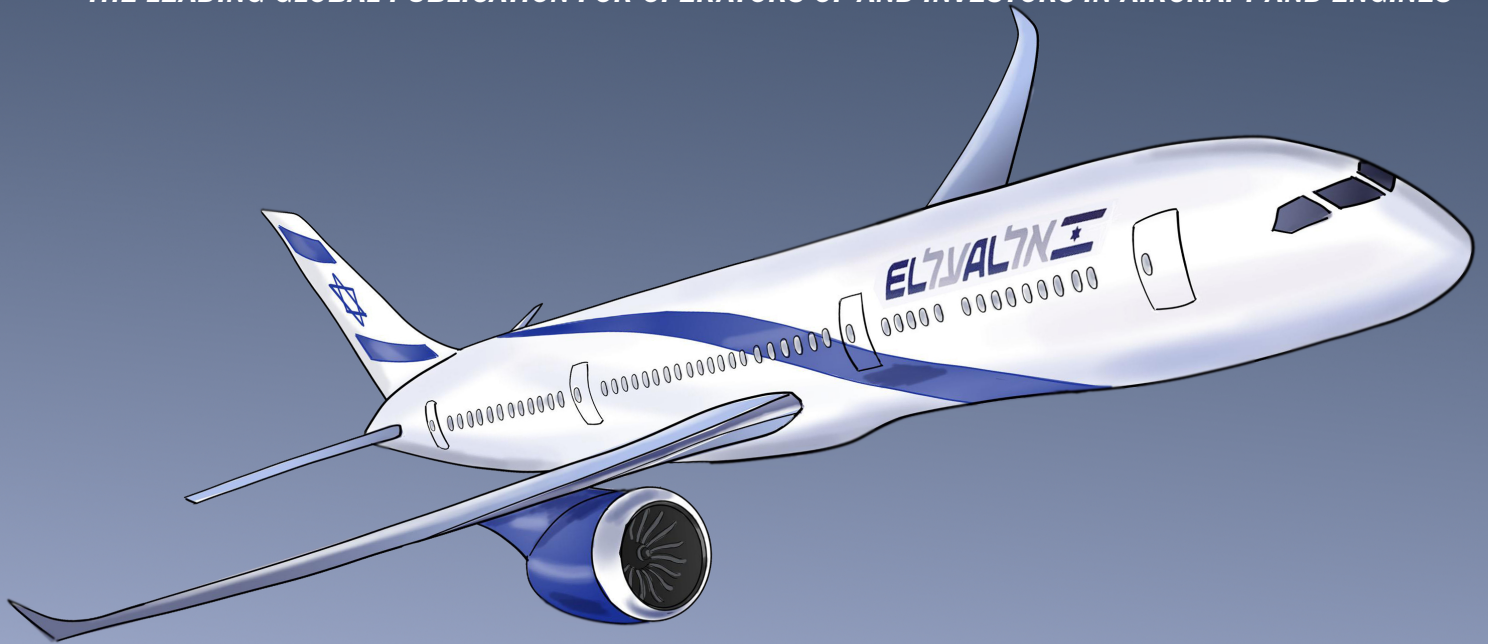
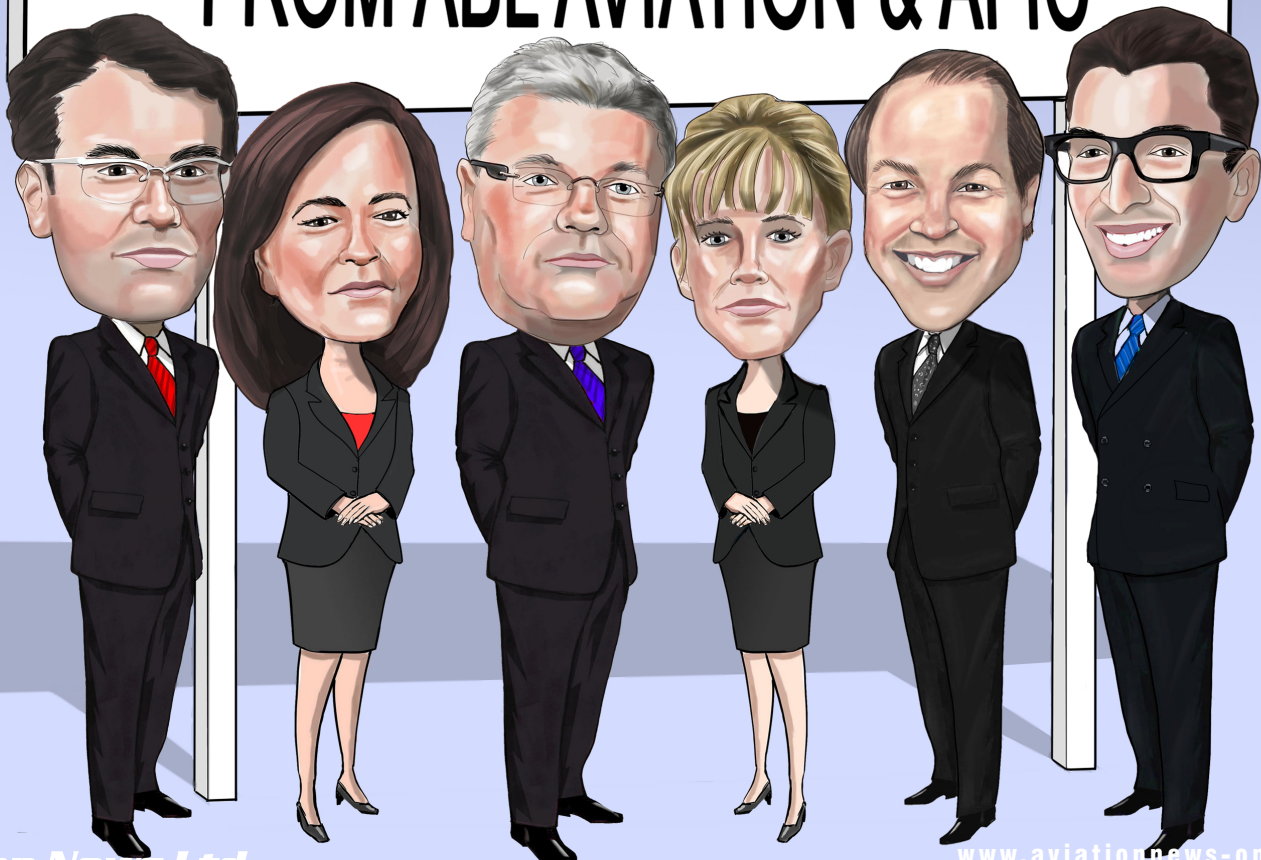


# **Airline Economics**

THE LEADING GLOBAL PUBLICATION FOR OPERATORS OF AND INVESTORS IN AIRCRAFT AND ENGINES



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# Stipulated Loss Value Damages Provisions Grounded in US Court

A recent United States court decision arising out of the bankruptcy of Republic Airways serves as a reminder that liquidated damages provisions in aircraft leases are subject to challenge and may ultimately be deemed unenforceable if not tied to anticipated harm from default.

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**I**n a February 14, 2019 decision with potentially significant consequences for aircraft lessors and lessees, a New York bankruptcy court found the liquidated damages provisions in aircraft leases based on the agreed stipulated loss values of the aircraft unenforceable penalties because they were untethered from the anticipated harm caused by default. The obligations under related guarantees issued by the lessee's parent company were likewise unenforceable.







## BACKGROUND

In February 2016, Republic Airways Holdings and its two operating airline subsidiaries commenced bankruptcy proceedings in New York. Republic's operating subsidiaries offered flights through code-share agreements with United Airlines, Delta Air Lines, and American Airlines Group. During the bankruptcy case, Republic's operating airlines rejected leases for out-of-favor aircraft, including seven with a single lessor nearing the end of their terms.

As is common in aircraft leases, the rejected leases provided for liquidated damages upon an event of default, including for early termination of the lease, calculated by reference to stipulated loss value (SLV) schedules attached to each lease. Specifically, each lease provided that, in the event of a default, the lessor may elect to recover accrued and unpaid rent for the aircraft plus liquidated damages "for loss of bargain and not as a penalty" according to one of three formulas: (i) the difference between the present value of rent reserved for the remainder of the lease and the aircraft's fair market rental value for the remainder of the lease; (ii) SLV minus the aircraft's fair market sale value; or (iii) SLV minus the aircraft's fair market rental value for the remainder of the lease.

The SLV amounts were calculated to protect the lessor against declines in the residual value of the aircraft over

the lease terms by ensuring that the lessor received its desired return on its investment in the aircraft in the event the leases ended early. In addition to calculating liquidated damages, the SLVs also were used to set (i) the amount of insurance Republic was required to maintain on the aircraft, (ii) the amount of Republic's early purchase option for the aircraft, and (iii) the amount that the lessor must receive in the event the aircraft were sold to a third party before the end of the lease term. But under the leases, the lessor, not Republic, bore the risk that the aircraft would be worth less than anticipated at the end of the lease term, as Republic's only obligations under the leases were to pay monthly rent and return the aircraft at the end of the leases.

The lessor filed claims against the lessee and parent guarantor asserting rejection damages in the aggregate amount of approximately US\$55 million based on the second option in the liquidated damages provision—SLV minus fair market sales value. Republic objected to the claims, arguing that the liquidated damages were unenforceable penalties and the lessor's damages should be limited to its actual damages resulting from the termination of the leases, which Republic calculated were only US\$5.7 million, or approximately 10% of the lessor's asserted claim. Republic argued that the claims against the parent guarantor were equally unenforceable.

**"The bankruptcy court concluded that the liquidated damages provisions were unenforceable under Section 2A-504 of the New York Uniform Commercial Code (UCC),"**

## THE BANKRUPTCY COURT'S DECISION

The bankruptcy court concluded that the liquidated damages provisions were unenforceable under Section 2A-504 of the New York Uniform Commercial Code (UCC), which provides that damages "may be liquidated in a 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."

In determining whether liquidated damages are "reasonable," the court held that (i) "reasonableness must be judged at the time of contract formation," and (ii) courts must "give due consideration to the nature of the contract and the attendant circumstances," including the sophistication of the parties.



The court also explained that certain types of liquidated damages formulations are inherently unreasonable, such as those that are “formulated as a penalty,” because damages that are “invariant to the gravity of the breach” are the “hallmark of an unenforceable penalty rather than a bona fide effort to quantify actual damages.” In that regard, the court noted that static SLV formulations in equipment leases that do not change sufficiently over time are unenforceable.

With respect to the liquidated damages provisions in the Republic leases, the court found them unreasonable because they allowed “for the unconditional transfer of residual value risk, or market risk, [to the lessee] only upon default, without a cognizable connection to any anticipated harm caused by the default itself.” The court explained that “while the [UCC] may permit some form of indemnification for risk to residual value, such indemnification can only cover damages or loss to the residual value that is linked to default, rather than by uncorrelated market forces,” and the lessor presented no evidence showing that the SLV-based liquidated damages were a proxy for actual damages, as even the lessor’s expert witness agreed that they were not intended to liquidate damages stemming from a default.

The bankruptcy court likewise held that the guarantees were unenforceable as against public policy. Even though the guarantees included provisions purporting to waive all defences, the

court found that “as a matter of public policy, parties may not waive defences to liquidated damages clauses.” The court acknowledged “the importance guarantees play in the realm of leasing and equipment financing,” but held that “these values cannot overcome the long-expressed mandate that precludes parties from contracting to something privately that is disallowed by public policy and explicit statute.”

The lessor appealed the bankruptcy court’s decision, but the parties settled shortly thereafter, and the court’s decision is now final.

### LESSONS LEARNED

Liquidated damages clauses based on SLVs are commonly used in equipment finance leases to shift the risk of a decline in market value to the lessee in the event of default. Lessors and aircraft financiers should be aware that this sort of provision may not be enforceable, and that guarantees will not protect lessors against that risk. This is particularly true in U.S. bankruptcy courts, where judges take into account equitable considerations.

The Republic court, however, did not hold that such provisions are per se invalid. Thus, while there is no silver bullet, there are certain steps that a lessor can take to minimize the risk that US courts will find such clauses unenforceable. First, a liquidated damages provision that shifts the residual

value risk to the lessee during the lease term is more likely to be enforceable if the lease obligates the lessee to provide some protection for the lessor at the end of the lease term against the aircraft’s loss of value. Second, parties should structure liquidated damages clauses to bear a reasonable relationship to expected loss at the time of contracting. While that may not ensure a fixed rate of return for the lessor, it may be better to contract for a reasonable recovery than to leave the calculation of damages to the courts. Third, the parties should ensure that liquidated damages do not remain static, but rather decrease over time to remain commensurate with the lessee’s remaining obligations. For instance, in the Republic case, the court found significant that the disparity between the amount of unpaid rent toward the end of the lease term and the amount of liquidated damages under the leases was substantial—in one case a multiple of 115 times greater.

Parties can also attempt to contract under favorable law. In the United States, state law governs the enforceability of liquidated damages provisions and guarantees, so lessors should consider precedent in the state selected in choice of law provisions.

In sum, following Republic, aircraft lessors should review and consider revising liquidated damages clauses in leases governed by United States law to increase the likelihood that such provisions will be enforceable.