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Stipulated Loss Value Provisions Used for Damages Purposes Held to Be Unenforceable as a Penalty by the U.S. Bankruptcy Court for the Southern District of New York

By James Heiser, Richard F. Klein, Stephen R. Tetro II, and Franklin H. Top III*

The U.S. Bankruptcy Court for the Southern District of New York held that liquidated damages provisions calculating damages based upon stipulated loss value schedules designed to provide the lessor/owner participant with a return on investment of four percent violated New York public policy and were unenforceable as penalties. The authors of this article discuss the decision, which is the subject of an appeal.

In the recent decision *In re Republic Airways Holdings Inc.*,[1] the U.S. Bankruptcy Court for the Southern District of New York held that liquidated damages provisions calculating damages based upon stipulated loss value ("SLV") schedules designed to provide the lessor/owner participant with a return on investment of four percent (and not as a proxy for actual damages) violated New York public policy and were unenforceable as penalties. The obligations under the related guarantees were likewise held unenforceable because the underlying obligations under the leases were unenforceable.

BACKGROUND

The dispute related to a number of substantially similar aircraft leases ("Leases"), along with corresponding guarantees ("Guarantees"), with a debtor ("Lessee") affiliated with Republic Airways Holding Inc. ("RAH"). The Guarantees were issued by RAH prior to the bankruptcy proceedings,

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

unconditionally guaranteed the obligations of the Lessee under the Leases, and purported to waive all defenses and otherwise make the obligations thereunder "unassailable."

The Leases provided for damages upon an event of default. As is typical for aircraft leases of this type, damages were calculated with reference to a stipulated loss value schedule attached to each Lease.[2]

Generally speaking, the value of the remaining payments due on a Lease or the sales value of the aircraft was deducted from the stipulated loss value to arrive at the applicable liquidated damages amount. The SLVs adjusted from month to month in order to account for monthly payments of basic rent and tax benefits and to provide a four percent return on investment to the lessor under the Leases ("Lessor"). Notably, the court pointed out that no evidence was presented showing the calculations based on SLV were a proxy for actual damages.

On February 25, 2016, RAH, the Lessee and other RAH affiliates (collectively, "Debtors") filed petitions for bankruptcy. Each of the Leases was rejected in the bankruptcy proceedings. The Lessor filed seven proofs of claim against the Lessee, asserting damages resulting from the rejection of the Leases, and seven proofs of claim against RAH on the Guarantees (one for each aircraft and Lease at issue) in the aggregate amount of $55,000,000 based on one of the methods of calculation set forth in footnote 2 of the SLV schedules.

The Debtors filed an objection to each of the claims, asserting that the rejection damages should instead be calculated using actual damages because the liquidated damages based on the SLV schedules violated public policy. The Debtors also asserted that the claims based on the Guarantees ought to suffer the same fate.

The Lessor argued that the clauses were proper, that voiding the clauses would violate the parties' freedom to contract (which, they argued, was particularly problematic given the sophistication of the parties), that these were commercial finance leases and thus should be subjected to a different standard for the reasonableness of the damages clauses, and that the Guarantees were ironclad.

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[2] The provision at issue was described by the court as follows: Upon a default, "the Lessor could demand payment of unpaid Basic Rent (*e.g.* overdue monthly rental obligations), . . . plus one of the following: (i) the amount . . . by which (x) the [SLV] . . . exceeds (y) the [discounted present value of the] aggregate Fair Market Rental Value . . . of the Aircraft for the remainder of the [lease term] . . . , (ii) the amount . . . by which (x) the [SLV] . . . exceeds (y) the Fair Market Sales Value . . . of the Aircraft as of such date, or. . . ." *Republic Airways*, *id*. The third possible remedy has been excluded from the quote due to its irrelevance to the decision.

THE COURT'S DECISION

The court determined, and the parties agreed, that the contract was governed by Article 2A of the Uniform Commercial Code ("UCC") as adopted in New York and that the issue of the enforceability of the liquidated damages provision was governed by Section 2A-504 thereof. Section 2A-504 provides in pertinent part that "[d]amages payable by either party for default . . . 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. . . ."

To gauge the reasonableness of the damages calculations, the court employed the following analysis.

First, the court noted that the reasonableness of the liquidated damages provision must be determined as of the time of contract formation.

Second, the court found that "when analyzing the reasonableness of a liquidated damages amount, a court must give due consideration to the nature of the contract and the attendant circumstances."[3] The court cautioned, however, that while the nature of the contract and the sophistication of the parties may shed light on the harms anticipated at the time the contract was entered into, these factors were not dispositive.

Third, the court stated that a liquidated damages provision violates New York public policy when it is formulated as a penalty, *i.e.,* if the relevant damages provision is not proportionate to the anticipated probable harm.

Finally, the court noted that certain types of formulations are inherently unreasonable. Damages that are "'invariant to the gravity of the breach' have been called a 'hallmark of an unenforceable penalty rather than a bona fide effort to quantify actual damages, as is permissible in a liquidated damages provision.'"[4] As an example, the court noted that static SLV formulations (or those which do not greatly change over time) are deemed unenforceable.

The court found that the calculations based on SLV schedules and the "Residual Value Risk Transfer" executed in connection with the Leases were designed to protect the Lessor's investment in the aircraft and to ensure a four

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[3] Citing *Wilmington Tr. Co. v. Aerovias de Mexico, S.A. de C.V.*, 893 F. Supp. 215, 218 (S.D.N.Y. 1995); *JMD Holding Corp. v. Cong. Fin. Corp.*, 4 N.Y.3d 373, 380, 795 N.Y.S.2d 502, 828 N.E.2d 604 (2005); and *Oscar de la Renta, Ltd. v. Mulberry Thai Silks, Inc.*, No. 08 Civ. 4341 (RJS) (S.D.N.Y. Apr. 17, 2009).

[4] *Republic Airways*, *supra* note 1, citing *In re Montgomery Ward Holding Corp.*, 326 F.3d 383, 390 (3d Cir. 2003); and *In re Nw. Airlines Corp.*, 393 B.R. 352, 356–57 (Bankr. S.D.N.Y. 2008).

percent return. In this case, even the Lessor's expert agreed that the SLV obligations did not purport to liquidate damages stemming from a default or even attempt to mimic them. The court compared the calculations based on SLV with the remaining amount of basic rent then unpaid, and found that "a very large disparity exists between the cost of the remaining performance and the SLVs."[5] While the Lessor asserted liquidated damages of $55.7 million, the undiscounted total of the remaining rent was only $12.585 million.

With no causal link between the manner in which damages were anticipated to be calculated and the damages suffered as a result of the default, the court found that the SLV liquidated damages provisions were unenforceable as a penalty.[6] "The Court's conclusion that the liquidated damages clauses operate as a penalty dovetails with the spirit of traditional liquidated damages clause—*i.e.,* liquidated damages arising out of a breach of contract, not as a mechanism for generalized risk transfer."[7]

The court next turned to the enforceability of the Guarantees by RAH. It rejected the Debtors' argument that the bankruptcy court could use its equitable powers to void the Guarantees. The court noted that although there was strong policy in New York to enforce guarantees, there were exceptions.

Ultimately the court determined that because the underlying obligation of the Lessor to pay damages based on the SLV schedules was unenforceable as a penalty as against public policy, the obligations under the Guarantees were likewise unenforceable as against public policy.

CONCLUSION

The decision of the bankruptcy court is the subject of an appeal. While the court did not find fault with the myriad of other uses of SLV schedules contained in the Leases (*i.e.,* loss of the aircraft or the early return thereof), when the SLV schedules intersect with the UCC mandates on damages upon an

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[5] *Republic Airways, supra* note 1.

[6] Citing *In re TransWorld Airlines*, 145 F.3d 124, 134–135 (3d. Cir. 1998); *Wells Fargo Equip. Fin., Inc. v. Woods at Newtown, LLC*, (S.D.N.Y. Sept. 23, 2011); *CIT Grp./Equip. Fin., Inc. v. Shapiro*, 09 Civ. 409 (JPO) (S.D.N.Y. Mar. 29, 2013); Ian Shrank & Samuel Yin, *Liquidated Damages in Commercial Leases of Personalty—the Proper Analysis*, 64 Bus. Law. 757 (2009), analogizing similar provisions as an "insurance policy." Further, the court distinguished other occasions in which SLV might be used, for example in connection with aircraft loss, value protection in connection with an early termination, or value protection in connection with a third-party lease. The difference, the court held, was that upon default a specific statute—Article 2A of the Uniform Commercial Code—requires that the amount be reasonable.

[7] *Republic Airways, supra* note 1.

event of default, according the court such schedules, as well as the liquidated damages calculations based thereon, must reasonably relate to the expected damages caused by the default.

Parties that finance aircraft leases, or other leases containing similar provisions, therefore must be cognizant of the fact that these and similar formulations of damages may not be enforceable in the event of a default under the applicable financing arrangement.