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## **New York Bankruptcy Court Holds Aircraft Leases' Liquidated Damages Provisions and Related Guarantees To Be Unenforceable Under New York Law**

### **Introduction**

In a recent decision arising out of the Republic Airways bankruptcy, Judge Sean Lane of the United States Bankruptcy Court for the Southern District of New York held that the liquidated damages provisions of certain aircraft leases were improper penalties and, thus, “unenforceable as against public policy” under Article 2A the New York Uniform Commercial Code. *In re Republic Airways Holdings Inc.*, 2019 WL 630336 (Bankr. S.D.N.Y. Feb. 14, 2019). Following extensive analysis and review of applicable law, Judge Lane also determined that unconditional guarantees provided in respect of such liquidated damages were unenforceable as “public policy defenses may not be waived under a guaranty.” Judge Lane’s interpretation and application of Article 2A serve as a reminder that liquidated damages provisions should bear a reasonable link to anticipated losses in the event of a default.

### **Background**

In February 2016, Republic Airways Holdings Inc. and certain of its affiliates filed for chapter 11 relief in the Southern District of New York.

During the cases, the Debtors rejected several aircraft leases. Each relevant lease provided that, in the event of a default, the lessor could 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 fair market rental value for the remainder of the lease; (ii) a “stipulated loss value” (“SLV”) *minus* the fair market sale value of the aircraft; or (iii) SLV *minus* the present value of the fair market rental value of the aircraft for the remainder of the lease. Each lease included a schedule which set forth SLVs. SLVs were calculated for each month of a lease, with the first month equal to the purchase cost of the applicable aircraft and all subsequent months equal to an amount that, subject to certain adjustments, was intended to ensure that the lessor would receive a 4% return on the original cost of the aircraft.

After the Debtors rejected the leases, the lessor filed claims against each of the lessee and the guarantor, in the aggregate amount of \$55 million based on SLV. The Debtors objected, arguing that, among other things, the rejection and guarantee claims should be limited to actual damages. The Debtors maintained that (i) actual losses arising from rejection were readily calculable and totaled just \$5.7 million—approximately

10% of the lessor's asserted claim amount, (ii) the liquidated damages provisions, including the SLVs, violated public policy because, among other things, they allowed for the unconditional transfer of market risk to the lessee upon an event of default and were untethered from actual damages, and (iii) a guarantee of an unenforceable contract provision is itself unenforceable. The lessor argued that voiding such liquidated damages provisions would "violate the parties' freedom to contract," particularly given the sophistication of the parties and complex nature of the commercial finance leases involved. *Id.* at \*7. The lessor also asserted that, under New York law, unconditional guarantees are "irrevocable" and "ironclad" and, therefore, any defenses—including those based on public policy—had been waived. *Id.*

### **The Bankruptcy Court's Decision**

As an initial matter, the parties agreed that the leases were "true leases" and, therefore, governed by Article 2A of the New York Commercial Code, which permits liquidated damages "only at an amount or by a formula that is reasonable in light of the then anticipated harm caused by the default . . ." N.Y. U.C.C. Law § 2-A-504(1). Because the New York Commercial Code does not define the term "reasonable," Judge Lane looked to applicable case law for guidance.<sup>1</sup> Following extensive review of the law, he drew the following conclusions regarding the reasonableness requirement of Article 2A: (i) "reasonableness must be judged at the time of contract formation," (ii) due consideration must be given to the "nature of the contract and the attendant circumstances"—including the sophistication of the parties—but these considerations are not dispositive on the question of reasonableness, (iii) clauses formulated as penalties violate New York public policy and are inherently not "reasonable in light of the then anticipated harm caused by the default," and (iv) courts have identified certain formulations as inherently unreasonable, including, for example, "static liquidation values" that do not decline over the term of the lease. *Id.* at \*10-11.

Applying these principles, the Court concluded that the SLVs violated Article 2A's reasonableness requirement. The SLVs were not designed to liquidate damages stemming from a default or to otherwise serve as a proxy for anticipated harm caused by a default. The Court explained that the provisions "effectuated a transfer of all market risk, or residual value, including any risk of idiosyncratic depreciation or damage to a particular [a]ircraft" to the lessee. *Id.* at \*12. As a result, the lessee always bore the full risk of any loss of market or rental value over the course of a lease, in the event of a default. Absent a default,

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<sup>1</sup> Prior to the enactment of Article 2A in 1995, liquidated damages provisions were governed by common law which provided that, to be enforceable, the provisions "'must specify a liquidated amount which is reasonable in light of the anticipated probable harm, and actual damages must be difficult to ascertain as of the time the parties entered into the contract.'" *Id.* at \*8. While the lessor argued that case law on the meaning of "reasonable" prior to 1995 was inapplicable given the passage of Article 2A, Judge Lane concluded that, because the reasonableness requirement was included in both the common law test and Article 2A, "precedent both before and after the enactment of Article 2A" was applicable on the issue of reasonableness. *Id.* at \*10.

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the lessee assumed no such risk and was merely required to return the applicable aircraft upon a lease's termination (subject to certain maintenance and condition requirements).

Judge Lane found that the unreasonable (and punitive) nature of these provisions was confirmed by the “stark” difference between the SLVs and the remaining rental obligations under the leases. For example, the SLV for one of the aircraft vessels on the last month of the lease was approximately \$5.7 million, while only \$55,000 remained in basic rent obligations—representing a multiple of approximately 104x.

Judge Lane rejected the lessor's argument that the “parties' freedom to contract and liquidate damages as befits their needs and circumstances trumps other circumstances.” *Id.* at \*17. Rather, the Court found that Article 2A and applicable case law require that liquidated damages be based on reasonable estimates of damages arising out of the default as to the aircraft in question.

Turning to the guarantee claims, Judge Lane held that the guarantees were unenforceable “for the same reason as the underlying obligations.” *Id.* at \*22. He noted that the liquidated damages clauses violate public policy and that “public policy defenses may not be waived under a guarantee.” *Id.* at \*21. While Judge Lane recognized “the importance guarantees play in the realm of leasing and equipment financing,” he determined that such values could not “overcome the long-expressed mandate that precludes parties from contracting to something privately that is disallowed by public policy and explicit statute.” *Id.* at \*23.

### **Conclusion**

*Republic Airways Holdings* highlights that (1) risk-shifting stipulated damages provisions in true leases may be challenged and, potentially, deemed unenforceable as against public policy and (2) guarantees will not protect lessors against this risk. This risk exists regardless of the type of true lease at issue or the sophistication of the parties involved.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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