Republic Airways: Crash Landing for SLV Damages

by

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AS ARLENE GELMAN AND EDDIE GROSS HAVE SO ABLY DISCUSSED in the Spring 2019 issue of the *Journal of Equipment Lease Financing*, Valentine's Day 2019 was a massacre for equipment lessors that have utilized the stipulated loss value (SLV) table to establish liquidated damages for an event of default under a true lease. The U.S. Bankruptcy Court for the Southern District of New York, in a published decision, *In re Republic Airways Holdings Inc.*, 2019 WL 630336, ruled that use of the SLV to establish liquidated damages "violate public policy and constitute unenforceable penalties in violation of" UCC section 2A-504.

The judge dealt another body blow to the equipment finance industry by ruling that the parent guaranty—even though it contained a hell or high water clause—was not enforceable against the guarantor, because it would have required the guarantor to be responsible for the very damages the court had just ruled were an unenforceable penalty.

This article will not repeat the cogent arguments in the *JELF* article. And you probably are asking yourself, "Do I really need to read another article about *Republic Airways?*" The answer is yes. As the EMT technicians say to a bleeding victim, "Stay with me!" Because the decision, flawed as it was, *inadvertently may have reached the correct result* in that fact-intensive case.

Some Background

The decision arose from rejection of seven aircraft leases by the bankrupt airline and the lessee's challenge to the lessor's claim for damages. The lessor used the agreed-upon SLV amount in submitting its claim. The lessee countered that the proper measure of damages was the present value of the rent for the remaining lease term. To hold otherwise, the lessee argued, would make the lessee responsible for the difference between the residual value and the actual value when the planes were returned.

And the court agreed. The court compared the SLV to the rent during the final month of the lease term, and found that the former was roughly 50 times the latter and hence constituted an unenforceable penalty. The judge erroneously cited UCC section 2A-532 to the effect that a lessor's damages may include impairment of the residual value only if caused by the default of the lessee.

The judge also dismissed the lessor's claim that the high SLV reflected a bargained-for allocation of risk to the lessee. The lessor argued that it had contracted to receive a 4% annual rate of return on its investment in the lease and the equipment, but that argument boomeranged (as we will see later).

A Flawed Decision

The *Republic Airways* decision can be criticized on several grounds. First, its refusal to enforce the guaranty is contrary to a long line of federal and New York decisions that have applied New York law to enforce unconditional guaranties. Second, it failed to recognize that the leases gave the lessee credit for the fair market value of the aircraft upon return. Third, the court calculated the lessor's damages *at the time when the lessee rejected the lease*, ignoring UCC section 2A-504, which provides that damages "may be liquidated in the lease agreement *but only at an amount or by a formula that is reasonable in light of the then [i.e., at the outset of the lease term] anticipated harm caused by the default*" (emphasis added).

The Official Comment to section 2A-504 also observes that "stipulated damage schedules are also common [but] will be [enforceable] in the context of each case by applying a standard of reasonableness *in light of the harm anticipated when the formula was agreed to*" (emphasis added).

A fourth error in the decision of the Bankruptcy Court was its misinterpretation of UCC section 2A-532 ("the lessor may recover…for any loss of or damage to the lessor's residual interest in the goods *caused by the default of the lessee*") (emphasis added). The lessor properly argued that its premature need to remarket the aircraft—at a time when aircraft values were depressed—was "caused by" the lessee's default. The court simply dismissed this compelling argument in a

conclusory footnote.

But there was another argument that the court overlooked. Notwithstanding the parties' agreement that "the Amended Leases are 'true leases' governed by Article 2A of the New York Uniform Commercial Code" (opinion, footnote 6), *the leases may not have been true leases and hence Article 2A may not have been the applicable law*.

Say What?

Roughly 12 years after the leases commenced, the opinion relates that the parties restructured the original leases, reducing the basic rent but leaving the SLVs "always equal to the amount that provides Lessor with a four percent return on the Aircraft purchase." The SLVs were "identical to those in the Original Leases—notwithstanding…the reduction in the residual value of the Aircraft" since the Original Leases were entered into. A leopard cannot change its spots, but the restructuring may have boomeranged, causing a change from a true lease to a lease intended for security.

None of this is to suggest that SLVs high enough to ensure a percentage return on the lessor's investment necessarily will destroy true lease treatment. But commentators have written that a rent structure that recovers the lessor's entire investment is consistent with a loan rather than a lease. And under Revenue Ruling 55-540, the Internal Revenue Service announced that, if the "rental" payments materially exceed the current fair rental value, it "may be indicative that the payments include an element other than compensation for the use of the property." So the "overlooked argument" postulated above may not be so far-fetched.

And what if the court had ruled that the agreements were not true leases? In that event, the lessor's damages would have been evaluated under principles applicable to secured loans where the borrower is in bankruptcy proceedings and the fair market value of the "collateral" is less than the outstanding "debt." Because the aircraft had been returned to the "secured lender" (thereby satisfying the secured portion of the claim), the remaining "principal" of the "loan" (after deducting the fair market value of the aircraft "collateral") would have been a general unsecured claim, satisfied (once the Plan of Reorganization had been confirmed) along with all other unsecured creditors, from the entire pool of cash remaining after all higher priority claims had been satisfied. In contrast, damages in a true lease typically would consist of return of the leased equipment (UCC 2A-532) plus the PV of the remaining rent, minus the PV of either the "market rent" (where the goods are located) or the rent under a "substantially similar" re-lease for the remaining lease term.[1] *So arguably the decision reached the correct result, even if its reasoning was flawed.*

Now What?

First, lessors should create a default value formula, comprised of 1) the PV of the remaining rent, 2) enforcement, remarketing and restoration costs, and 3) damages from premature termination. Those damages consist of a) the agreed-upon residual value of the equipment during each monthly rent period minus b) the fair market rental value of the equipment under UCC Sections 2A-527 and -528. The lessee would acknowledge that the monthly rentals were established upon

the lessor's reliance that the lessee would perform its obligations and that if an EOD occurred prior to the lease expiration date, then the lessor would suffer additional harm (arising from the lessee's default) from having to remarket the equipment earlier than the bargained-for expiration date. This element must provide that the premature termination damages element essentially would be zero if an EOD occurs during the final month of the lease term.

Second, the hell or high water clause in the lease should refer expressly to premature termination damages and require the lessee to acknowledge that, at the time that the lease was entered into, the premature termination damages formula is a reasonable means of calculating the lessor's damages caused by the lessee's default, and hence premature remarketing of the leased goods.

Finally, any guaranty of the lease not only should contain the usual hell or high water and waiver of defenses clauses, but also acknowledge that the premature termination damages formula is a reasonable means of calculating the lessor's damages caused by the lessee's default.

The *Republic Airways* decision may have signaled the death knell for use of SLV as liquidated damages in a default context. But it provided a road map for lessors to construct an enforceable EOD damages formula—if lessors are careful to preserve that the lease is a true lease.

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