TIPPING THE scales

Stipulate — and Lose?
The Danger of Relying on Casualty Values

BY STEPHEN T. WHELAN

A recent Bankruptcy Court oral decision has cast doubt on using casualty values in a default context. Stephen Whelan provides background on this turn of events and offers an improved solution for lessors to calculate damages and stipulated loss values.

STEPHEN T. WHELAN
Partner, Blank Rome

It used to be so easy. Lessors would attach schedules of casualty values and early termination values to an equipment lease agreement. These values typically were expressed as a percentage of the lessor's cost of the items of equipment suffering a casualty or for which the lessee was terminating the lease in advance of the scheduled expiration date. Both parties would agree on these schedules, which seldom arose in practice because casualties were infrequent and the parties often would negotiate for a new lease of upgraded or substitute equipment to avoid paying the full termination value. But a recent oral decision by a Bankruptcy Court judge in the District of Delaware has cast doubt on the use of casualty values in a default context.

The Legal Background

A lessor's remedies upon an event of default (by the lessee) usually include past due rent, present value of remaining rentals, damages for loss or reduction of anticipated tax benefits, damages for any loss or reduction in the lessor's residual interest in the equipment and enforcement expenses, such as legal and repossession costs.

These remedies are reflected in UCC §2A-504, which provides 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*."

The official comment to §2A-504 observes a common liquidated formula includes the sum of the above five elements "less the net proceeds of disposition (whether by sale or re-lease) of the leased goods," and mentions a common formula "utilizes a periodic depreciation allocation as a credit" in lieu of the actual net proceeds of disposition.

The comment also notes "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*." Once again, reasonableness is determined when the lease begins, rather than at the time of default.

Lessors: Don't Get Sloppy or Greedy

This dry recitation of business custom and commercial law is necessary background for a debate currently raging among equipment finance lawyers: is a table of stipulated loss values an appropriate measure of damages if the lessee defaults prior to the lease expiration date? The answer is yes — if the lessor doesn't get sloppy or greedy.

Montgomery Ward Holding, a 2003 3rd U.S. Circuit Court of Appeals decision,[1] which denied the lessor's claim for casualty value damages, demonstrates what can happen when the casualty value is unreasonable under the circumstances of the deal. The remedies section called for the defaulting lessee to pay all accrued and unpaid rent plus the then-current casualty value. But, in a default situation, rather than a casualty, if the equipment is returned to the lessor then a reduction for the actual net resale proceeds of remarketing the equipment should be made. Many leases which adopt this approach give the lessor the option to retain the equipment and hope for a better resale market later on. In that case, the lessee typically receives a credit for the fair market value of the equipment at that time.

The lease in this case did not contain any kind of offset. In effect, the lessor was compelling the lessee to pay an amount as if the equipment had been destroyed — but the lessor had the ability to remarket the equip-

This dry recitation of business custom and commercial law is necessary background for a debate currently raging among equipment finance lawyers: is a table of stipulated loss values an appropriate measure of damages if the lessee defaults prior to the lease expiration date? The answer is yes — if the lessor doesn't get sloppy or greedy.

1 326 F.3d 383

ment and realize additional proceeds. The lease also contained another flaw. The casualty value table was calculated only on an annual basis rather than the monthly basis on which rentals were paid. This produced an odd result. If a casualty (or default) occurred during the final month of the three-year term, then the lessee would be obligated to pay $3,067,460 — for equipment which cost $6,070,923.

This amount would make sense if the equipment was destroyed and the lessor was deprived of the opportunity to remarket the leased property and realize its anticipated residual value. But this was a default scenario, in which the goods were returned to the lessor (presumably, in good condition), which was able to remarket the equipment. Faced with these two flaws, the court ruled, under Illinois law governing the lease, using the casualty value numbers constituted an impermissible penalty, rather than a formula which was "reasonable in light of the then anticipated harm caused by the default." The court also rejected the lessor's contention that the parties were commercial entities entitled to make their own bargain and declared that "Illinois continues to invalidate damages provisions [that fail the reasonableness test] even if both parties are economically sophisticated."

More Bad News

In 1998, the same 3rd Circuit applied New York law to reject another liquidated damages clause, even though the remedies section of the lease contained an offset for the fair market rental value or the fair market sales value.[2] Under New York law, a damages formula will be upheld "if the amount liquidated bears a reasonable proportion to the probable loss *and* the amount of actual loss is incapable or difficult of precise estimation."

Much like the *Montgomery Ward* decision, the *TWA* court interpreted the termination value in the aircraft lease to constitute an impermissible shifting of the "risk of a market drop in the aircraft's value." The court observed, when TWA defaulted in 1992, "the airline industry was severely depressed" and the termination value would impose upon TWA substantial liquidated damages, even after deducting the fair market sales or rental value. And, like its *Montgomery Ward* decision, the court, in striking down the liquidated damages clause, rejected the lessor's argument that the parties were sophisticated commercial parties.

Here is the Good News

Both of these decisions failed to distinguish between the unlikely event of a default which occurs during the final month of the lease with the equipment returned in good condition versus the typical default situation which occurs with a substantial remaining term and, most likely, during difficult economic times. In the former case, the lessor is in position to remarket the equipment promptly and realize its residual value *at the time the lessor originally anticipated having to perform such remarketing*. In that situation, unless the lease agreement (such as a TRAC lease) expressly contemplated a lessee guaranty of some or all of the anticipated residual value, the lessor's damages should not include any element of residual value, but appropriately would include lessee compensation for excessive wear and tear.

In the latter case, the lessor did not bargain for having to remarket the equipment in depressed times and years before the lease expiration date — especially if the lessee does not return the leased property promptly. In that situation, it would be appropriate for the lessor's damages to include *the disadvantageous time element to which the lessor has been exposed by reason of the lessee's default*. That is why both of the 3rd Circuit decisions are flawed.

2 In re *Trans World Airlines, Inc.*, 145 F.3d 124

Better news arises from a 2016 U.S. District Court decision.[3] On one hand, the court recognized the New York rule announced in *TWA*, liquidated damages must bear a reasonable relation to the probable loss, and the amount of actual loss must be incapable or difficult to estimate precisely. On the other hand, even though the lessor and lessee agreed the liquidated damages clause constituted an unenforceable penalty, the court enforced the guaranty of the lessee's obligations because the guaranty contained a customary, ironclad, "hell or high water" guaranty.

This brings us to the oral opinion announced in the bankruptcy proceedings for Tidewater and its affiliates, which were lessees of offshore energy exploration vessels. Although the judge, relying on *Montgomery Ward* and *TWA*, ruled the stipulated loss values in those leases constituted an unenforceable penalty, he did not rule on whether the *Invar* decision would support enforceability of the hell or high water guaranties provided by the parent, Tidewater. He also reportedly encouraged the parties to settle their claims (which they did), and noted it was possible (as the lessors alleged) the lessors' provable, actual damages might exceed the stipulated loss amounts.

Years ago, many lessors created a table of *default values* designed to approximate actual damages in case a lessee defaulted and promptly returned the equipment in good condition. Those values typically included an element for loss of profit on the busted transaction, but did not credit the lessee for any resale value of the equipment since, after all, any such proceeds would be in respect of the lessor's residual interest in the equipment and did not represent an element of value belonging to the lessee. A well-written remedies section also should include an additional damages amount for equipment not returned promptly and in good condition.

What Can Lessors Do?

Years ago, many lessors created a table of *default values* designed to approximate actual damages in case a lessee defaulted and promptly returned the equipment in good condition. Those values typically included an element for loss of profit on the busted transaction, but did not credit the lessee for any resale value of the equipment since, after all, any such proceeds would be in respect of the lessor's residual interest in the equipment and did not represent an element of value belonging to the lessee. A well-written remedies section also should include an additional damages amount for equipment not returned promptly and in good condition. Lessors should consider this approach, rather than continuing to rely on casualty values as a proxy for damages calculation or stipulated loss values in all instances. m

STEPHEN T. WHELAN is a partner in the New York office of law firm Blank Rome LLP and a former member of the ELFA Board of Directors (2013-2016). He can be reached at *swhelan@blankrome.com*.

3 *Field Point Circle Holding Co. v. Invar International Holding*, 644 Fed. Appx. 10.