

Aviation - USA

Holdover rent enforceable as liquidated damages in aircraft leases

Contributed by [Katten Muchin Rosenman LLP](#)

February 15 2012

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Introduction

In *Wells Fargo Bank Northwest, NA v US Airways, Inc.*⁽¹⁾ the Supreme Court of New York County, New York – a court of general trial jurisdiction – reaffirmed the enforceability of liquidated damages clauses for holdover rent in aircraft leases that are in addition to damages for failure to comply with return conditions. Such clauses will be upheld if the fixed amount is a reasonable measure of the probable actual damages incurred in the event of a breach and the actual loss is impossible or difficult to determine with precision at the time of lease execution.

The court did not consider the test for lease-liquidated damages promulgated in Section 2-A-504(1) of the New York Uniform Commercial Code, but the common law standards enunciated by the court closely resemble those found in the code. Section 2-A-504(1) of the code provides that lease damages may be liquidated, "but only at an amount or by a formula that is reasonable in light of the then anticipated harm caused by the default or other act or omission".

Facts

The aircraft leases in question included a clause which provided that the lessee would pay the lessor rent of twice the monthly rent amount if the lessee failed to return the aircraft in the required condition after the expiration dates in the leases. The lessee alleged that this holdover rent charge was an unenforceable liquidated damages provision which served as a penalty. The lessee claimed that since the lessor was also seeking actual damages for the cost to repair the aircraft for the failure to meet return conditions, the holdover rent charge constituted double damages for the same injury. The lessee further contended, among other things, that the lessor's damages were easy to predict and the payment of double rent was grossly disproportionate and inappropriate.

The lessor claimed, among other things, that the express terms of the lease gave it a right to claim both holdover rent and actual damages for the failure to meet return conditions. Further, the lessee had waived the right to object to the holdover rent provisions by agreeing to the other terms in the lease, and the amount of holdover rent as liquidated damages was reasonable and proportionate as determined by the parties at the time the leases were executed. In response to the lessor's waiver argument, the lessee alleged that irrespective of the terms of the leases, the law still allows a party to challenge any contractual term that creates an unlawful penalty.

Decision

In reliance upon *LeRoy v Sayers*,⁽²⁾ the court stated that:

- a liquidated damages provision is an estimate made by the parties at the time that the agreement is executed of the level of injuries that a party may suffer if a breach occurs; and
- therefore, the court should consider the surrounding circumstances and the apprehension of the damage that existed in the minds of the parties at the time the contract was entered into.

The court also cited *Central Irrigation Supply v Putnam Country Club Associates, LLC*,⁽³⁾ which provides that:

"A contractual provision for liquidated damages will be upheld only if the amount fixed is a reasonable measure of the probable actual loss in the event of a breach, and the actual loss suffered is impossible or difficult to determine with precision. If however, the amount of actual damages that would be suffered upon a breach is readily ascertainable when the contract is entered, or the amount fixed as liquidated damages is conspicuously disproportionate to the foreseeable losses, the liquidated damages provision is unenforceable as a penalty." (emphasis added)

The common law standard test for lease-liquidated damages that was relied upon by the court in *Wells Fargo Bank* is similar to the standard provided in Section 2A of the New York Uniform Commercial Code, which became effective for lease contracts made on or after June 30 1995, and is therefore inapplicable to any extension, amendment, modification or supplement of a lease made before June 30, 1995, in the absence of an agreement to the contrary.⁽⁴⁾ It must be assumed that the leases in question in *Wells Fargo Bank* were executed before June 30 1995, and hence Section 2-A-504(1) of the code concerning enforceability of lease-liquidated damages was not technically applicable. However, the law as stated in *Wells Fargo Bank* is instructive in that it very closely resembles the standard provided for in Section 2-A-504(1), which states that lease-liquidated damages clauses are enforceable "only in an amount or by formula that is reasonable in light of the then anticipated harm caused by the default or other act or omission" (emphasis added).

The party challenging the effectiveness of a liquidated damages clause has the burden of proving that damages serve as a penalty. The *Wells Fargo Bank* court concluded, in regard to the holdover rent clause, that the lessee had failed to meet its burden that at the time the leases were executed, "the amount of anticipated damages was easily ascertainable, or the liquidated damages amount was grossly disproportionate to the probable loss".⁽⁵⁾ Since the court ruled that the liquidated damages provision was enforceable, it did not reach the parties' arguments in regards to a waiver.⁽⁶⁾

In reaching this decision, the court distinguished *Matter of Trans World Airlines, Inc.*⁽⁷⁾ The court in that case did not consider a holdover rent term; rather, it considered a general liquidated damages clause which provided that upon the occurrence of a lease event of default, the lessor could liquidate damages for an amount equal to unpaid monthly rent due as of the date of the event of default, plus either:

- an amount equal to the relevant termination value specified in the lease minus the aggregate fair market rental value for the remainder of the term as discounted; or
- an amount equal to the relevant termination value specified in the lease minus the fair market sales value of the aircraft.⁽⁸⁾

The court in *Trans World Airlines* concluded that this clause was unenforceable as a penalty because the high termination values as provided for in the lease and the then-existing low aircraft fair market values, once applied to the stated formula, produced damages that "simply have no bearing on [the lessor's] probable loss in the event of a breach".⁽⁹⁾ The *Trans World Airlines* court was unmoved by the arguments that these were clearly negotiated economic terms by sophisticated parties which were designed to protect the lessor's multimillion-dollar investment in the aircraft by shifting the risk of a drop in aircraft values to the lessee upon the occurrence of an event of default. In reaching this conclusion, the court relied upon the New York common law test for liquidated damages clauses as provided for in *LeRoy v Sayers* and in *Pyramid Centres & Co Ltd v Kinney Shoe Corp.*⁽¹⁰⁾

The court in *Wells Fargo Bank* distinguished the holding in *Trans World Airlines* by stating that the liquidated damages clause in question in *Trans World Airlines* was not a holdover rent clause, and that the clause disallowed in that case provided for an:

"amount of a multiple of rent plus an amount equal to the excess of the termination value of the aircraft. In other words, in that case, for the same default, the lessor would be receiving both liquidated damages and additional damages."⁽¹¹⁾(emphasis added)

The court thereafter cited several cases in which contracts that provided for holdover rent and compensatory damages were upheld as appropriate and enforceable.⁽¹²⁾ Furthermore, the court found that other New York courts had enforced liquidated damages clauses for holdover which included multiples of rent.⁽¹³⁾

Comment

Interestingly, the actual amount of the damages sought by the lessor was not determined in *Wells Fargo Bank*, and the court merely denied the lessee's motion for partial summary judgment on its affirmative defence that the holdover rent clause was an unenforceable penalty. The court concluded by stating that should the lessor seek more than the liquidated damages for the same breach (presumably holdover past lease expiration), damages would be limited to the fixed sum in the lease.⁽¹⁴⁾ In reaching this conclusion in the context of a summary judgment motion on an affirmative defence, the court was required to determine that sufficient evidence had been tendered to eliminate any material issues of fact from the case, and that therefore the judgment should be

granted as a matter of law. The court decision does not indicate what evidence may have been tendered to reach the conclusion that the holdover rent term was not a penalty, as it must have done if it were to conduct an analysis to determine that double monthly rent was not conspicuously disproportionate to the foreseeable losses. Whatever the evidence was, it must be assumed that the court concluded that the lessee did not meet its burden on the issue when it denied the lessee's motion for summary judgment.

The court's attempt to distinguish *Trans World Airlines* is somewhat off base. One of the main arguments of the lessee in *Wells Fargo Bank* was that holdover rent and compensatory damages was a double recovery for the same breach of the lease. This argument ran counter to the express terms of the lease, which identified a holdover rent payment obligation as a separate and distinct obligation from compliance with return conditions. Presumably, the lessee alleged that any time there is a double recovery for the same breach, the resulting amount of damages must by law be conspicuously disproportionate to the foreseeable losses. In support of this proposition, the lessee relied upon *Trans World Airlines*. However, the court in *Trans World Airlines* did not consider the issue of double recovery as stated by the *Wells Fargo Bank* court.⁽¹⁵⁾ The *Trans World Airlines* court actually conducted an analysis of whether the liquidated damages formula's use of the stated lease termination value and the then-fair market value of the aircraft produced an amount of damages that "simply [had] no bearing on [the lessor's] probable loss in the event of a breach".⁽¹⁶⁾

What is clear from the court's holding in *Wells Fargo Bank* is that New York courts may look more favourably upon holdover rent clauses than other types of liquidated damages clauses, and that any liquidated damages clause remains subject to challenge based upon the given facts at hand.

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Endnotes

- (1) 2011 WL 6141034 (NY Sup), 2011 NY Slip Op 52188(U), December 1 2011.
- (2) 217 AD2d 63, 69 (1st Dept 1995).
- (3) 57AD3d, 934, 935 (2d Dept 2008).
- (4) See note under NY UCC Section 2-A-101.
- (5) *Wells Fargo Bank*, 2011 WL 6141034 at p3, citing *225 Fifth Ave Retail LLC v 225 5th, LLC*, 78 AD3d 440, 442 (1st Dept 2010).
- (6) *Id.*
- (7) 145 F3d 124 (3d Cir 1998).
- (8) *Trans World Airlines*, 145 F3d at 133.
- (9) *Id.*, at 135.
- (10) 244 AD2d, 625, 633 NYS2d 711, 713 (App Div 1997); "if... the amount fixed is plainly or grossly disproportionate to the probable loss, the provision calls for a penalty and will not be enforced".
- (11) *Wells Fargo Bank*, 2011 WL 6141034 at p 3.
- (12) *Id.* See *Weinberg Properties v Kenner*, 117 AD2d 529 (1st Dept 1986).
- (13) See *White Plains Plaza Realty, LLC v Town Sports International, LLC*, 79 AD3d 1025 (2d Dept 2010).
- (14) *Wells Fargo Bank*, 2011 WL 6141034 at p 3-4.
- (15) *Wells Fargo Bank*, 2011 WL 6141034 at p 3.
- (16) *Trans World Airlines*, 145 F3d at 135.

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