

# Leases

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## CASE LAW DEVELOPMENTS

This survey covers a number of cases decided in 2016 involving disputes between parties to equipment financing transactions or with third parties regarding the transactions or the related equipment. The courts in these surveyed cases considered many of the issues that are fundamental to establishing the respective rights, obligations, interests, and remedies associated with equipment financings. These issues include, among others, whether a transaction documented as a lease creates a true “lease” or a security interest, the rights of assignees of interests under a lease, certainty of payment issues such as waivers of defenses and “hell-or-high water” payment obligations, vicarious liability of a lessor, a lessor’s damages remedies, and options reserved to lessees relating to the leased equipment.

### TRUE LEASE

The characterization of a contract as a “true” lease or a lease that creates a security interest is typically raised by lessees and other parties in the context of bankruptcy or enforcement cases, or priority disputes, for the purpose of achieving greater rights or protections in matters involving the purported lessor of the related equipment.

The characterization analysis in *In re Ajax Integrated, LLC*<sup>1</sup> involved a lease with end-of-term options that required the lessee either to purchase the equipment for a fixed price, or return it to the lessor, at the lessee’s expense, to a location designated by the lessor in the continental United States and in the same condition and appearance as when delivered (reasonable wear and tear excepted), and to pay the full monthly rental from the expiration date until the

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1. 554 B.R. 568 (Bankr. N.D.N.Y. 2016).

equipment was returned.<sup>2</sup> The court relied on “former” N.Y. U.C.C. § 1-201(37), “which provides a two prong ‘Bright-Line Test’ that, if satisfied, calls for the lease to be recharacterized as a secured transaction.”<sup>3</sup> Among other things, the court noted that this statutory test looks to the substance, not the parties’ intent, and if not satisfied, then the court “must apply a contextual analysis that examines the facts and circumstances of the case to determine if a security interest was, in fact, created.”<sup>4</sup> This contextual analysis, referred to as the “economic realities” test, determines, “whether the lessor retains a meaningful residual interest’ at the end of the lease term.”<sup>5</sup>

The first prong of the statutory test was satisfied because the lessee could not terminate the agreement without paying all of the amounts then due in addition to the purchase option price.<sup>6</sup> The court then focused on whether the purchase option price was “nominal” and concluded that the fixed purchase option price of \$16,900 was nominal compared to the expense of returning the equipment to an unknown location in the continental United States, which was estimated by the debtor to be “anywhere from \$10,500 to \$15,000,” in addition to any repair expenses necessary to cause the equipment to be in the “as delivered” condition (reasonable wear and tear excepted).<sup>7</sup> The court also conducted a contextual analysis of the transaction and, based on the totality of the circumstances, reached the same result.<sup>8</sup> As a result, the lessor was deemed to be a secured creditor and was denied any recovery relating to the residual value of the equipment.<sup>9</sup> Although many of the characterization cases turn on the nominality of

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2. *Id.* at 575. The leases also contained early termination options, conditioned upon payment of all amounts then due, all future rent, and the fixed purchase option price. *Id.*

3. *See id.* at 577–78 n.8 (“Since the Agreement was entered into on June 7, 2013, the court looks to former N.Y. U.C.C. § 1-201(37), which is substantively similar to the current law per the current law’s Official Comments.”); *see also* N.Y. U.C.C. § 1-203 (McKinney 2016) (codifying the same bright-line rule test as N.Y. U.C.C. § 1-201(37)).

4. *In re Ajax Integrated*, 554 B.R. at 578.

5. *Id.* (quoting *In re QDS Components, Inc.*, 292 B.R. 313, 333 (Bankr. S.D. Ohio 2002)).

6. *In re Ajax Integrated*, 554 B.R. at 579. As noted above, the early termination option required payment by the lessee of all amounts due upon termination, together with all future rent and the fixed purchase option price, not the “walk away” right that have been consistent with the lease being terminable by the lessee as contemplated in N.Y. U.C.C. § 1-201(37)(b).

7. *Id.* at 581.

8. *Id.* at 582 (citing *In re WorldCom, Inc.*, 339 B.R. 56, 65 (Bankr. S.D.N.Y. 2006)); *see also In re QDS Components, Inc.*, 292 B.R. at 333. The court explained that the “pivotal question” was whether the transaction was structured in such a way that the lessor had an “objectively reasonable expectation that the equipment would be returned at lease expiration.” *In re Ajax Integrated*, 554 B.R. at 582 (citing *In re Ecco Drilling Co.*, 390 B.R. 221, 227 (Bankr. E.D. Tex. 2008)). Among other considerations, the court concluded that the lessor must have known that the lessee would exercise the option; otherwise it would have made little economic sense for the lessor to obligate itself to pay the (back-leveraging) loan balance owed to its lender in an amount equal to the fixed purchase option price. *Id.* The court also deemed noteworthy that “after forty-eight monthly payments, a mere four more to become the owner of three pieces of John Deere Equipment seems more than reasonable and likely.” *Id.*

9. *Id.* at 583. The case also included arguments by the trustee that the lessee took free of the defendants’ interests because the lessee was a “buyer in the ordinary course” when it acquired the equipment pursuant to this secured financing. *Id.* at 583–84. The issue was not fully analyzed or resolved, but it is noteworthy that the trustee was intending to raise the issue as a defense to the defendants’

a purchase option price, this case is rather unique because it considers the nominality using *both* the bright-line test in former section 1-201(37)(a)(iv) (the law in effect when the leases were entered into)<sup>10</sup> and a contextual analysis of the economic realities of the transaction. Also, the court ultimately concluded that the customer was economically compelled to purchase the equipment by comparing the cost to purchase the equipment to the cost of returning it.<sup>11</sup> That analysis is more often described as an economic realities test, not a nominality test.

In *In re Lightning Bolt Leasing, LLC*,<sup>12</sup> the court reached an unexpected result of particular concern for truck and other commercial vehicle lessors. This is a bankruptcy case involving a purported lease that included a Terminal Rental Adjustment Clause, providing for an upward or downward rental adjustment to reflect the difference, if any, between the actual disposition value (i.e., in this case, the amount of the disposition proceeds received by the lessor) and the residual value anticipated by the parties at lease commencement and specified in the lease.<sup>13</sup> The contemplated rental “adjustment” provides for, as applicable, either the Debtor’s payment to the lessor, CIT, of any deficiency if the actual disposition proceeds are less than the anticipated residual value, or the Debtor’s right to receive or retain any excess if the actual proceeds received exceed the anticipated value.<sup>14</sup> All fifty states and the District of Columbia have enacted laws that provide that “for commercial leases of cars, trucks and trailers, the mere presence of a TRAC clause does not destroy true lease status or create a sale or security interest.”<sup>15</sup>

After determining that the lease agreement did not per se create a secured transaction, the court identified the threshold issue, “how the agreement allocates risk of ownership (if a lease) or credit (if a form of loan).”<sup>16</sup> The lessee argued that the lease agreement created a secured transaction because it had the “true ‘upside right’ and ‘downside risk’” after the lease term expired.<sup>17</sup> The court agreed with the lessee, finding that the TRAC provision “effectively divests [CIT] of any real residual interest in the Equipment as the lessee retains no risk associated with the sale or other disposition of the Equipment.”<sup>18</sup>

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claims because it represents another (arguable) vulnerability for purported lessors if the transactions they enter into are recharacterized as secured transactions.

10. *Id.* at 578 (citing former N.Y. U.C.C. § 1-201(37)).

11. *Id.* at 581.

12. No. 3:15-bk-05173-JAF (M.D. Fla. May 25, 2016) (Order Denying Central Truck Finance LLC’s Motion for Summary Judgment and Granting the Debtor’s Motion for Summary Judgment) [hereinafter *In re Lightning Bolt Leasing*] (citing *In re Dena Corp.*, 312 B.R. 162, 169 (Bankr. N.D. Ill. 2004)).

13. *Id.* at 2–3.

14. *Id.* Although there may be various iterations of this adjustment clause in other equipment financings, clauses of this type are most often found in tax-priced commercial truck and other over-the-road vehicle leases having terms consistent with 26 U.S.C. § 7701(h) (2012). Edwin E. Huddleson, *TRAC Vehicle Leasing*, J. EQUIP. LEASING, Fall 2015, at 2.

15. Huddleson, *supra* note 14, at 3.

16. *In re Lightning Bolt Leasing*, *supra* note 12, at 6.

17. *Id.* at 7.

18. *Id.*

Most lessors have assumed that the courts in any state considering the characterization implications of a TRAC provision in a purported lease would invariably follow the pertinent TRAC statute and, unless there were other provisions that were wildly inconsistent with the applicable U.C.C. characterization test (e.g., the lease contained a \$1 purchase option), deem the transaction to constitute a true lease. This presumption that these state TRAC statutes afford a reliable safe harbor from a re-characterization is supported by most of the published cases that have addressed this issue.<sup>19</sup> In that regard, it is noteworthy that a case relied upon by the *Lightning Bolt* court, *In re Zerkle Trucking Co.*, is an outlier because it characterized a TRAC lease as a secured transaction on similar grounds, despite the existence of a TRAC statute.<sup>20</sup> Perhaps the *Lightning Bolt* court would have viewed the “economic realities” differently if the lease was structured as a “split-TRAC,”<sup>21</sup> and the lessor would have retained some of the downside risk, but most lessors would argue that the existence of a TRAC statute alone should have been dispositive in characterizing this TRAC lease as a true lease.

#### RIGHTS OF ASSIGNEES

In *Blanken v. Kentucky Highlands Investment Corp.*,<sup>22</sup> Wells Fargo entered into a lease agreement with the lessee, which allowed the lessee to purchase the leased equipment at the end of the lease term for \$1.<sup>23</sup> In round one of the litigation, the court ruled that this transaction was a “sham lease” and that it was in fact a “secured transaction under the UCC,” making the lessee the economic owner of the equipment.<sup>24</sup> However, the plaintiff alleged that he became the owner of the leased equipment when he received a post-default assignment of Wells Fargo’s security interest in the equipment and subsequently executed an amendment to the lease (the “Second Amendment”), which provided that he became the owner of the equipment.<sup>25</sup> Because the plaintiff believed that he was the true owner of the equipment, he did not file a financing statement to perfect his

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19. See, e.g., *In re HB Logistics, LLC*, 460 B.R. 291, 304–05 (Bankr. N.D. Ala. 2011) (considering the characterization issue under the applicable state law and holding that the subject TRAC lease was a true lease); *Hitchin Post Steak Co. v. Gen. Elec. Capital Corp.*, 436 B.R. 679, 693–95 (Bankr. D. Kan. 2010) (same); *In re Double G Trucking*, 432 B.R. 789, 802 (Bankr. W.D. Ark. 2010) (same), *Morris v. Dealers Leasing, Inc. (In re Beckham)*, 275 B.R. 598, 604 (Bankr. D. Kan. 2002) (same), *aff’d*, *In re Beckham*, No. 02-3035, 2002 WL 31732497, at \*1 (10th Cir. Dec. 6, 2002); *Morris v. U.S. Bancorp Leasing & Fin.*, 278 B.R. 216, 223–24 (Bankr. D. Kan. 2002) (same).

20. See *In re Zerkle Trucking Co.*, 132 B.R. 316, 323 (Bankr. S.D. W. Va. 1991) (holding that the subject TRAC lease was a disguised security interest).

21. A split-TRAC lease is a lease that “gives the owner/lessor an entrepreneurial stake in the residual: that is, a minimum ‘at risk’ stake in the vehicle (e.g., 20 percent of original cost) that is not subject to variation by the TRAC clause[] and a maximum lease term that ensures that the lease does not use up the economic life of the vehicle.” Huddleson, *supra* note 14, at 3.

22. No. 13-47-DLB-HAI, 2016 WL 310363, at \*1 (E.D. Ky. Jan. 25, 2016).

23. *Id.* at \*1.

24. *Id.*; see also *Blanken v. Ky. Highlands Inv. Corp.*, No. 13-47-DLB, 2014 WL 800487, at \*1 (E.D. Ky. Feb. 27, 2014).

25. *Blanken*, 2016 WL 310363, at \*2. Upon the assignment of the lease from the lessor to the plaintiff, the plaintiff and the lessee “executed a Second Amendment to [the] Lease, which amended

interest in the equipment, as permitted by U.C.C. section 9-505.<sup>26</sup> A priority dispute arose when the defendant, an all-assets, perfected secured creditor of the lessee, took possession of the equipment and disposed of it by private sale.<sup>27</sup> Despite the plaintiff's argument that the Second Amendment effected a "strict foreclosure" under section 9-620 of the U.C.C., the court held that there was no evidence of the lessee's "consent to [the] [p]laintiff's acceptance of the [equipment] in satisfaction of its [lease] debt," even though the lessee intended for the plaintiff to become the true owner of the equipment.<sup>28</sup> Accordingly, the court determined that the competing creditor of the lessee prevailed in this priority dispute.<sup>29</sup> This situation demonstrates the significant need to file a protective financing statement against a lessee, whether or not the lessor believes that the agreement is a true lease.

The plaintiff could have made two additional arguments that the court refrained from addressing. First, it appears that the plaintiff, having purchased the lease and Wells Fargo's interest in the equipment, never made the argument that the Second Amendment converted the agreement from a security device to a true lease—which might have enabled him to prevail, as the economic owner of the equipment, over the competing creditor that claimed its interest by reason of the lessee's purported ownership thereof. Second, the plaintiff failed to argue that a multi-step transaction occurred as follows: 1) Wells Fargo assigned the lease and its security interest in the equipment to Mr. Blanken; 2) upon execution of the Second Amendment, the lessee, as economic owner, effectively transferred its ownership interest in the equipment to Mr. Blanken; and 3) Mr. Blanken, as owner of the equipment, then leased it to the lessee. However, each of these arguments would have deprived the lessee's creditor (Kentucky Highlands) of its first priority security interest in the equipment, which had been granted when the lessee was the economic owner of the equipment under what was then a non-true lease and, hence, Mr. Blanken's arguments likely would have been rejected.

## WAIVER OF DEFENSES

Two decisions illustrate conflicting state law interpretations of waiver-of-defenses clauses. In *React Presents, Inc. v. Sillerman*,<sup>30</sup> the guarantor asserted an

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the assigned 'loan documents' to reduce [the lessee's] monthly payments, eliminate [the lessee's] purchase rights, and provide under its terms that [the] [p]laintiff was the owner of the [equipment]." *Id.*

26. *Id.* Wells Fargo had filed a protective financing statement, but Mr. Blanken apparently had not taken an assignment of, or continued, that filing. *Id.* at \*1.

27. *Id.* at \*2.

28. *Id.* at \*4. Under section 9-620 of the U.C.C., "strict foreclosure" . . . permits a secured party to accept collateral in full or partial satisfaction of the debtor's obligation if the following three requirements are met: (1) consent of the debtor, (2) the creditor's acceptance of the collateral in satisfaction of the debt, and (3) a record authenticated after default in which the terms are agreed upon." *Id.* Here, the court held that the transfer of ownership of the equipment did not occur in satisfaction of the debt because the debtor did not explicitly provide consent nor did the amendment to the lease qualify as a "record authenticated after default." *Id.* at \*6.

29. *Id.* at \*7.

30. No. 16-c-3790, 2016 WL 4479569 (N.D. Ill. Aug. 25, 2016).

affirmative fraud-based defense in response to the plaintiff's attempt to enforce both a Guaranty containing a waiver-of-defenses clause and a Reaffirmation of that Guaranty.<sup>31</sup> The court interpreted the Guaranty and Reaffirmation of Guaranty under Illinois law and determined that, read together, they confirmed and ratified the guarantor's reservation of fraud-based defenses.<sup>32</sup> This decision is remarkable because the court went further to find that even if a waiver-of-defenses clause is clear and unambiguous, a "covenant of good faith and fair dealing is implied in every contract, absent express language to the contrary, even when a guaranty waives all defenses."<sup>33</sup>

On the other hand, in *Overseas Private Investment Corporation v. Moyer*,<sup>34</sup> a lender sought summary judgment against two guarantors, asserting that pursuant to the Guaranty agreement, the guarantors unequivocally waived their defenses.<sup>35</sup> Under the Guaranty, the lender's rights and the guarantors' obligations "were made 'absolute, unconditional, irrevocable and continuing.'"<sup>36</sup> The court found that based on "New York law, the only affirmative defenses that are not waived by an absolute and unconditional Guaranty are payment and lack of consideration."<sup>37</sup> In the court's view, this "rule reflects the notion that when parties have expressly allocated risks, the judiciary shall not intrude into their contractual relationship."<sup>38</sup>

#### "HELL-OR-HIGH-WATER" CLAUSES

In *GreatAmerica Financial Services Corp. v. Meisels*,<sup>39</sup> the lessee attempted to reject its acceptance of equipment after it had signed a certificate of acceptance and made fifteen rental payments to the assignee-lessor under an equipment fi-

31. *Id.* at \*1-2.

32. *Id.* at \*4.

33. *Id.* at \*5 (quoting *Fifth Third Bank (Chi.) v. Stocks*, 720 F. Supp. 2d 1008, 1011-12 (N.D. Ill. 2010) (emphasis added by court)). The guarantor expressly waived "every present and future defense (other than the defense of payment in full and fraud based defenses)" in the Guaranty. *Id.* at \*4. However, the plaintiff argued that the Reaffirmation of that Guaranty did not reserve any fraud-based defenses because it stated that "[e]xcept as specifically and expressly modified by this letter agreement, the Guaranty (including any and all provisions thereof) shall not be, and is not, impaired, limited, reduced, compromised or modified by any acts or dealings of the parties prior to the date hereof." *Id.* The court rejected this argument, finding that such ambiguous language must be interpreted in the defendant's favor under Illinois law. *Id.* at \*5.

34. No. 15-CV-8171, 2016 WL 3945694 (S.D.N.Y. July 19, 2016). The guarantors "agreed that their obligation would continue notwithstanding 'any change of circumstances, whether or not foreseeable,' any law, regulation, decree, or judgment now or hereafter in effect that may in any manner affect the payment of any of the Obligations or any of OPIC's rights under the Loan Documents,' or 'any other circumstance that might otherwise constitute a defense available to, or a discharge of, the Borrower, the Guarantor, or any other guarantor or surety.'" *Id.* at \*5.

35. *Id.* at \*4-5.

36. *Id.* at \*5.

37. *Id.* at \*4 (citing *CIT Group/Commercial Servs., Inc. v. Prisco*, 640 F. Supp. 2d 401, 410 (S.D.N.Y. 2009)).

38. *Id.* at \*5 (citing *Citicorp Leasing, Inc. v. United Am. Funding, Inc.*, No. 03 Civ. 1586 WHP, 2005 WL 1847300, at \*4 (S.D.N.Y. Aug. 5, 2005) (quoting *Grumman Allied Indus., Inc. v. Rohr Indus., Inc.*, 748 F.2d 729, 735 (2d Cir. 1984))).

39. No. 15-0933, 2016 WL 5480718 (Iowa Ct. App. Sept. 26, 2016).

nance lease containing both a “hell-or-high-water” clause and a waiver-of-defenses clause.<sup>40</sup> The court noted that the lessee’s “would-be revocation of its acceptance after fifteen months of payments [was] untimely and not an ‘effective rejection.’”<sup>41</sup> The lessee’s action having constituted acceptance, it was required to “fulfill its obligations under the lease in all events.”<sup>42</sup> This decision is noteworthy, not only for upholding “hell-or-high-water” and waiver-of-defenses clauses, but also for rejecting the lessee’s argument that the lease (which had been assigned to GreatAmerica) and the service contract with the original lessor (which had not been assigned) constituted a “unified agreement.”<sup>43</sup>

In *CDK Global, LLC v. Tulley Automotive Group, Inc.*,<sup>44</sup> the lessor (under a so-called “bundled contract”) alleged that the lessee wrongfully terminated the Master Services Agreement (the “MSA”), which provided that the lessor would “deliver equipment in ‘good working order,’ and furnish software and services which would ‘conform to their respective functional and technical specifications.’”<sup>45</sup> Despite the lessor’s argument that the integration clause in the MSA barred the lessee’s fraud in the inducement claim, the court held that the lessor’s representations that its equipment and software would increase the lessee’s business efficiency and reduce costs “concerned matters extrinsic” to the MSA.<sup>46</sup> Surprisingly, the court also denied the lessor’s motion to dismiss the lessee’s claim that the transaction violated the New Jersey Consumer Fraud Act, even though the transaction involved goods and services provided to a business, because the lessor’s acts of advertising its products and services to several different industries “permit[s] an inference that CDK’s DMS products are sold to the public at large.”<sup>47</sup> This decision illustrates the wisdom of including a “hell-or-high-water clause” in a “bundled contract”—and if the customer balks, then including a liquidated damages clause in lieu of other customer remedies.

40. *Id.* at \*1–2.

41. *Id.* at \*4 (citing *In re Rafter Seven Ranches L.P.*, 546 F.3d 1194, 1201–02 (10th Cir. 2008)).

42. *Id.* at \*3.

43. *Id.* (citing *C & J Vantage Leasing Co. v. Wolfe*, 795 N.W.2d 65, 77 (Iowa 2011)). Article 64 of the United Nations Commission on International Trade Law (UNCITRAL) Model Law on Secured Transactions (adopted in Vienna in 2016) takes a different approach: unless otherwise agreed by the debtor and secured creditor, the former can raise “all defences and rights of set-off arising from that contract, or any other contract that was part of the same transaction” (emphasis added). U.N. COMM’N ON INT’L TRADE LAW, UNCITRAL MODEL LAW ON SECURED TRANSACTIONS, U.N. Sales No. E.17.V.1 (2016), [http://www.uncitral.org/pdf/english/texts/security/ML\\_ST\\_E\\_ebook.pdf](http://www.uncitral.org/pdf/english/texts/security/ML_ST_E_ebook.pdf).

44. No. 15-3103, 2016 WL 1718100 (D.N.J. Apr. 29, 2016).

45. *Id.* at \*2. CDK is a developer and seller of dealer management systems or “DMS.” *Id.* at \*1. “[T]he MSA deals primarily with the terms of the lease, installation of software, and CDK’s support services for the software and equipment.” *Id.* at \*4.

46. *Id.* at \*4. Here, the court found an exception to the parol evidence rule for evidence that “is not offered to add or change contract terms but to void the contract altogether.” *Id.* at \*3.

47. *Id.* at \*6. The New Jersey Consumer Fraud Act also covers merchandise that is “expensive, uncommon, or only suited to the needs of a limited clientele.” *Id.* (quoting *Prescription Counter v. AmeriSource Bergen Corp.*, No. 04-5802, 2007 WL 3511301, at \*14 (D.N.J. Nov. 14, 2007)).

## VICARIOUS LIABILITY OF MOTOR VEHICLE AND AIRCRAFT LESSORS

There have been no reported decisions successfully challenging the Graves Amendment<sup>48</sup> since last year's leasing law survey. However, there have been many other noteworthy cases to report. In *Johnke v. Espinal-Quiroz*,<sup>49</sup> involving three consolidated cases relating to a multi-vehicle accident, the plaintiff argued that preemption under the Graves Amendment was not applicable on the basis that defendant Eagle Transport Group, LLC ("Eagle Transport"), the owner and lessor of the semi-trailer involved in the accident, was not "engaged in the trade or business of renting or leasing motor vehicles"<sup>50</sup> because in addition to renting or leasing motor vehicles, such defendant also delivered product to its customers.<sup>51</sup> The court rejected this position and held that "Plaintiffs have not provided any support for [the] notion that a defendant must *only* engage in the business of renting or leasing in order to trigger Graves Amendment preemption."<sup>52</sup> Based on information contained in the plaintiff's complaint and the lease agreement itself, the court found that, as required by 49 U.S.C. § 30106(a)(1), Defendant Eagle Transport was "engaged in the trade or business of renting or leasing motor vehicles."<sup>53</sup>

Another interesting aspect to *Johnke* is the plaintiff's attempted application of the negligence "savings clause" in the Graves Amendment.<sup>54</sup> Plaintiff alleged that the defendant was "directly negligent (e.g., by permitting Defendant Espinal-Quiroz to operate a commercial motor vehicle while legally blind in one eye, for failing to properly maintain the trailer, for failing to inspect the trailer, etc.)."<sup>55</sup> The court held that only claims based on *vicarious* liability are subject to Graves Amendment protection rather than claims based on *direct* liability, such as negligent entrustment and negligence, which are expressly excluded from Graves Amendment protection.<sup>56</sup> The court therefore denied defendant's motion to dismiss based on preemption with respect to the alleged negligent entrustment and negligence.<sup>57</sup>

In *Johnke*, the plaintiff also raised the interesting question of whether a plaintiff can bring a vicarious liability claim (i.e., no allegation of negligence) "against an

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48. 49 U.S.C. § 30106(a) (2012) ("An owner of a motor vehicle that rents or leases the vehicle to a person (or an affiliate of the owner) shall not be liable under the law of any State or political subdivision thereof, by reason of being the owner of the vehicle (or an affiliate of the owner), for harm to persons or property that results or arises out of the use, operation, or possession of the vehicle during the period of the rental or lease, if—(1) the owner (or an affiliate of the owner) is engaged in the trade or business of renting or leasing motor vehicles; and (2) there is no negligence or criminal wrongdoing on the part of the owner (or an affiliate of the owner).").

49. Nos. 14-cv-6992, 14-cv-7364, 14-cv-7917, 2016 WL 454333 (N.D. Ill. Feb. 5, 2016).

50. Under 49 U.S.C. § 30106(a)(1), the owner of the vehicle must be "engaged in the trade or business of renting or leasing motor vehicles." 49 U.S.C. § 30106(a)(1) (2012).

51. *Johnke*, 2016 WL 454333, at \*4.

52. *Id.*

53. *Id.*

54. 49 U.S.C. § 30106(a)(2) requires that "there is no negligence or criminal wrongdoing on the part of the owner (or an affiliate of the owner)." 49 U.S.C. § 30106(a)(2) (2012).

55. *Johnke*, 2016 WL 454333, at \*5.

56. *Id.* at \*5–6.

57. *Id.* at \*6.

owner/lessor by alleging that the owner/lessor was the statutory employer of the lessee, thereby avoiding Graves Amendment preemption.”<sup>58</sup> The court rejected this position and found that “[t]he Graves Amendment was designed to protect rental companies who are sued simply because they own a vehicle that was involved in an accident.”<sup>59</sup> The court further noted that “[a]gency and employer-based theories of liability presuppose a level of involvement by the lessor that goes beyond simply owning the vehicle, thereby putting such claims beyond the scope of the Graves Amendment.”<sup>60</sup>

Finally, in *Johnke*, the plaintiff also sought to hold one of the defendants liable under a theory of agency, namely that the owner of the vehicle can be liable for the acts of others within the scope of their authority.<sup>61</sup> The court held that “[w]hile it is not inconceivable that an owner/lessor might also exercise control over a lessee so as to create an agency relationship, the only relationship presented in Plaintiff’s operative complaints is that Defendant Eagle Transport was a lessor and Defendant Espinal Trucking was a lessee.”<sup>62</sup> The court, therefore, concluded that the plaintiffs had not alleged a plausible claim for agency.<sup>63</sup>

In *Stratton v. Wallace*,<sup>64</sup> one of the co-defendants, Great River Leasing, LLC (“Great River”), sought an interlocutory appeal of a previous decision<sup>65</sup> rendered by the same court to the U.S. Court of Appeals for the Second Circuit on the basis that the Graves Amendment protection was broader than the court found in its previous decision.<sup>66</sup> Great River argued that the Graves Amendment *completely* preempts state-law vicarious liability of owners of motor vehicles in the business of renting or leasing motor vehicles.<sup>67</sup> The court held that Great River “identifies no sign of a ‘clear and manifest’ Congressional purpose to preempt all state-law vicarious liability in the language and structure of the statute.”<sup>68</sup> Indeed, the court pointed out that “the text of the [Graves Amendment] shows Congress intended to save state-law vicarious liability from preemption where there is ‘negligence or criminal wrongdoing on the part of the owner (or an affiliate of the owner).’”<sup>69</sup> The court therefore denied defendant’s motion for an interlocutory appeal.<sup>70</sup>

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58. *Id.* at \*7–8.

59. *Id.* at \*8.

60. *Id.*

61. *Id.* at \*9 (citing *Dolter v. Keene’s Transfer, Inc.*, No. 3:08-cv-262-JPG/DGW, 2008 WL 3010062 (S.D. Ill. Aug. 5, 2008)).

62. *Id.* at \*10.

63. *Id.*

64. No. 11-CV-74-A, 2016 WL 3552147 (W.D.N.Y. Apr. 5, 2016).

65. See *Stratton v. Wallace*, No. 11-CV-74-A (HKS), 2014 WL 3809479, at \*2 (W.D.N.Y. Aug. 1, 2014). In this case, the court held that “the text and structure of [the statute] require ‘both the vehicle’s owner, and the owner’s affiliate . . . to be free from negligence in order for [the statute] to shield Great River from vicarious liability.’” *Stratton*, 2016 WL 3552147, at \*2 (summarizing previous decision).

66. *Stratton*, 2016 WL 3552147, at \*1–2.

67. *Id.* at \*5.

68. *Id.*

69. *Id.* (quoting 49 U.S.C. § 30106(a)(2)).

70. *Id.* at \*6.

In *Escobar v. Nevada Helicopter Leasing LLC*,<sup>71</sup> the case involved an aircraft lessor, rather than a motor vehicle lessor. Accordingly, rather than applying the Graves Amendment, the court analyzed a different federal statute, the Federal Aviation Act (“FAA”).<sup>72</sup> The plaintiffs brought a claim for negligence against Airbus Helicopters SAS, the manufacturer of a helicopter, and Nevada Helicopter Leasing LLC (“Nevada Leasing”), the owner of the helicopter.<sup>73</sup> Nathan Cline was the helicopter pilot and was employed by Helicopter Consultants of Maui, Inc., doing business as Blue Hawaii Helicopters (“Blue Hawaii”), the lessee of the helicopter.<sup>74</sup> On November 10, 2011, Mr. Cline was piloting the helicopter when it crashed on the Island of Molokai, fatally injuring Mr. Cline and all passengers.<sup>75</sup> The estate of Mr. Cline brought suit against the above defendants.<sup>76</sup> Nevada Leasing argued that the state tort law claims are preempted by the Act.<sup>77</sup>

The court held that “[t]he plain language of the . . . the Federal Aviation Act states that owners and lessors of aircraft cannot be held liable for personal injury, death, and property damages unless the secured party, owner, or lessor was ‘in the actual possession or control’ of the aircraft.”<sup>78</sup> The court noted that “[t]he legislative history of the Limitations on Liability provision of the Federal Aviation Act is clear. It was intended to preempt state laws that impose liability on the financiers, owners, and lessors of aircraft who were not in actual possession or control of the aircraft.”<sup>79</sup> The court held that plaintiff had not in fact provided any evidence to establish that Nevada Leasing had actual possession or control over the helicopter after delivery to Blue Hawaii and that instead the helicopter remained in Blue Hawaii’s possession and control until the time of the fatal crash.<sup>80</sup> Additionally, the court pointed out that the underlying lease agreement provided that the helicopter “will at all times be and remain in the possession and control of” the lessee.<sup>81</sup> The lease further provided that the lessee “would be responsible for all maintenance, repairs, and inspections for the Subject Helicopter.”<sup>82</sup> The court therefore found that plaintiff’s state law claims were in fact preempted by the FAA.<sup>83</sup>

## ELECTRONIC CHATTEL PAPER

There have been no reported decisions directly analyzing electronic chattel paper involving equipment leasing under U.C.C. section 9-105.<sup>84</sup> However,

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71. Civ. No. 13-00598-HG-RLP, 2016 WL 3962805 (D. Haw. July 21, 2016).

72. *Id.* at \*5 (applying 49 U.S.C. § 44112 (1994)).

73. *Id.* at \*1.

74. *Id.* at \*2.

75. *Id.* at \*4.

76. *Id.* at \*5.

77. *Id.*

78. *Id.* at \*6 (quoting 49 U.S.C. § 44112(b)) (emphasis in original).

79. *Id.* at \*9.

80. *Id.* at \*11–12.

81. *Id.* at \*4, \*12–13.

82. *Id.* at \*4.

83. *Id.* at \*13.

84. U.C.C. § 9-105 (2013). That section states:

there have been a few noteworthy analogous cases dealing with electronic mortgages, another subset of electronic chattel paper. In *Rivera v. Wells Fargo Bank, N.A.*,<sup>85</sup> the court analyzed a portion of Florida's version of the Uniform Electronic Transactions Act ("UETA")<sup>86</sup> dealing with whether the foreclosing lender (Fannie Mae) had control (i.e., the electronic equivalent of having possession of the original) of the electronic promissory note ("e-note") securing certain real estate.<sup>87</sup> The borrowers argued that the lender did not have control of the e-note and therefore was not authorized to pursue the foreclosure.<sup>88</sup> The court proceeded to analyze the merits of the case under UETA, the language of which is substantially similar to U.C.C. section 9-105.<sup>89</sup> In particular, the court reviewed UETA section 668.50(16)(b), which provides that "[a] person has control of a transferable record if a system employed for evidencing the transfer of interests in the transferable record reliably establishes that person as the person to which the transferable record was issued or transferred."<sup>90</sup> The court found that "[t]he bank's evidence proved that Fannie Mae had control of the e-note by showing that the bank, as Fannie Mae's servicer, employed a system reliably establishing Fannie Mae as the entity to which the e-note was transferred."<sup>91</sup> The court further noted that "the bank's system stored the e-note in such a manner that a single authoritative copy of the e-note exists which is unique, identifiable, and unalterable."<sup>92</sup>

Similarly, in *New York Community Bank v. McClendon*,<sup>93</sup> the court analyzed a portion of the Electronic Signatures in Global and National Commerce Act<sup>94</sup> ("ESIGN") dealing with whether the foreclosing lender had control of the

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Control of Electronic Chattel Paper. (a) [General rule: control of electronic chattel paper.] A secured party has control of *electronic chattel paper* if a system employed for evidencing the transfer of interests in the chattel paper reliably establishes the secured party as the person to which the chattel paper was assigned. (b) [Specific facts giving control.] A system satisfies subsection (a) if the *record* or records comprising the chattel paper are created, stored, and assigned in such a manner that: (1) a single authoritative copy of the *record* or records exists which is unique, identifiable and, except as otherwise provided in paragraphs (4), (5), and (6), unalterable; (2) the authoritative copy identifies the secured party as the assignee of the record or records; (3) the authoritative copy is *communicated* to and maintained by the secured party or its designated custodian; (4) copies or amendments that add or change an identified assignee of the authoritative copy can be made only with the consent of the secured party; (5) each copy of the authoritative copy and any copy of a copy is readily identifiable as a copy that is not the authoritative copy; and (6) any amendment of the authoritative copy is readily identifiable as authorized or unauthorized.

*Id.* (emphasis added).

85. 189 So. 3d 323 (Fla. Dist. Ct. App. 2016).

86. FLA. STAT. § 668.50(16) (2016).

87. *Rivera*, 189 So. 3d at 327.

88. *Id.* at 327–28.

89. *Id.* at 328.

90. *Id.* (quoting FLA. STAT. § 668.50(16)).

91. *Id.* at 329.

92. *Id.*

93. 138 A.D.3d 805 (N.Y. App. Div. 2016).

94. 15 U.S.C. § 7021 (2012).

e-note securing certain real estate.<sup>95</sup> The borrowers here also argued that the lender did not have control of the e-note and therefore lacked standing to pursue the foreclosure.<sup>96</sup> The court proceeded to analyze the merits of the case under ESIGN, which contains identical language to the above UETA provision (and which is substantially similar to U.C.C. section 9-105).

The court quoted the applicable ESIGN language contained in 15 U.S.C. § 7021(b): “A person has control of a transferable record if a system employed for evidencing the transfer of interests in the transferable record reliably establishes that person as the person to which the transferable record was issued or transferred.”<sup>97</sup> The court found that the e-note transfer history demonstrated that the e-note was transferred to the foreclosing lender prior to the foreclosure action, stating that “the transfer history, together with the copy of the e-Note itself, were sufficient ‘to review the terms of the transferable record and to establish the identity of the person [or entity] having control of the transferable record.’”<sup>98</sup>

The above two cases are significant because the referenced language in UETA and ESIGN is nearly word for word the same as the language contained in U.C.C. section 9-105 and should prove helpful when other courts are faced with interpreting “control” of electronic chattel paper under U.C.C. section 9-105. It is noteworthy, however, that while the above court holdings are quite helpful in terms of the resulting decisions, it would have been even more helpful if the courts would have provided more detailed guidance as to precisely how a lender can effectively demonstrate control, including the types of transfer history and the attributes of the underlying systems that would substantiate that the lender does indeed have control of the electronic chattel paper. Until further case law develops, lenders and buyers of such electronic equipment leases will be left to speculate whether such systems do in fact reliably establish the secured party as the person to which the chattel paper was assigned. Nonetheless, the above decisions flowing from other finance industries (i.e., the above decisions do not involve U.C.C. section 9-105 electronic equipment leases) should by analogy provide a big step toward, and a catalyst for, this analysis and development.

Finally, a recent California bankruptcy case, *In re Mayfield*,<sup>99</sup> raised some unfounded concerns regarding electronic chattel paper. Fortunately, the case stood for a very limited proposition that is not relevant to the equipment leasing industry or for that matter electronic contracting generally. The decision simply relates to a local California bankruptcy court procedural rule (LBR 9004-1(c))<sup>100</sup> pursuant to which court pleadings must be signed in wet ink.<sup>101</sup> Counsel for the debtor filed a court petition using DocuSign’s electronic signature service.<sup>102</sup>

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95. *N.Y. Cmty. Bank*, 138 A.D.3d at 806.

96. *Id.* at 805.

97. *Id.* at 806 (quoting 15 U.S.C. § 7021(b)).

98. *Id.* at 807 (quoting 15 U.S.C. § 7021(f)).

99. No. 16-22134-D-7, 2016 WL 3958982 (E.D. Cal. July 13, 2016).

100. United States Bankruptcy Court, Eastern District of California Local Rules of Practice 9004-1(c).

101. *Mayfield*, 2016 WL 3958982, at \*3.

102. *Id.* at \*1.

The court pointed out that LBR 9004-1(c) required that pleadings be signed with original wet-ink signatures.<sup>103</sup> The court also referenced an exception in E-SIGN that provides that E-SIGN “does not apply to ‘court orders or notices or official court documents (including briefs, pleadings and other writings) required to be executed in connection with court proceedings.’”<sup>104</sup> The court further observed that the case at hand did not involve an agreement where the parties had agreed to use electronic signatures, which the court seemed to implicitly concede would be covered by E-SIGN.<sup>105</sup>

## DAMAGES

There were only a few reported cases addressing a lessor’s right to recover liquidated or other damages from a lessee after the occurrence of a default under a personal property lease. It is interesting to note that none of the opinions summarized below include an analysis by the issuing court of the pertinent damages provisions of U.C.C. Article 2A. These decisions emphasize the need for a damages clause to avoid overreaching and to credit the lessee for an appropriate measure of remarketing proceeds.

In the first liquidated damages case, *BA Jacobs Flight Services, LLC v. Rutair Ltd.*,<sup>106</sup> the lessor was pursuing accelerated damages calculated pursuant to one of the remedies provisions in the lease.<sup>107</sup> After recovering possession of and disposing of the leased aircraft, the lessor sought to recover damages from the lessee, including the accelerated rent payments, pursuant to the following lease provision: “Notwithstanding any repossession or other action that Lessor may take, Lessee shall be and remain liable for the full performance of all obligations on the part of Lessees to be performed under the lease and specifically liable for the remaining rent due to Lessor until completion of the lease.”<sup>108</sup> Rutair argued that this acceleration clause was unenforceable because it constituted an illegal penalty.<sup>109</sup> The court cited other liquidated damages cases that had ap-

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103. *Id.* at \*3.

104. *Id.* (quoting 15 U.S.C. § 7003(b)(1)).

105. *Id.*

106. No. 12 C 2625, 2015 WL 8328631 (N.D. Ill. Dec. 8, 2015).

107. This case relates to a decision summarized in our 2016 Survey in which the court granted the lessor partial summary judgment as to the defaulted aircraft lessee’s liability despite the lessee’s argument that the default trigger and related repossession remedy were ambiguous. Edward K. Gross et al., *Leases*, 71 BUS. LAW. 1263, 1276–77 (2016) (citing *BA Jacobs Flight Servs. v. Rutair Ltd.*, No. 12 C 2625, 2015 WL 360758 (N.D. Ill. 2015)). The lessee argued that the pertinent default trigger and repossession and other remedies were ambiguous and should not be enforced. Gross et al., *supra*, at 1277. As noted in the 2016 Survey case summary, the lessee argued that “it was not in default under the lease because a non-payment default would occur pursuant to the pertinent lease provision only if the lessee failed to ‘make any payment of rent’ within the proscribed period, and that lessee had actually made some payments of rent each month.” *Id.* Although the case summarized in the text above was decided in 2015, the opinion was published too late to be covered in our 2016 Survey, so we chose to cover it in this year’s survey.

108. See *BA Jacobs Flight Servs.*, 2015 WL 8328631, at \*2.

109. *Id.*

plied Illinois law,<sup>110</sup> as well as the *Restatement (Second) of Contracts*,<sup>111</sup> concluding that in order for a liquidation of damages to be valid under Illinois law, it “must be a reasonable estimate at the time of contracting of the likely damages from breach, and the need for estimation at that time must be shown by reference to the likely difficulty of measuring the actual damages from a breach of contract after the breach occurs.”<sup>112</sup> The court held that a liquidated damages provision that entitles a lessor to claim the remainder of rent due under a lease as damages irrespective of any repossession or other remedial action taken by the lessor is an unenforceable penalty.<sup>113</sup>

Assuming that this transaction constituted a true lease (as discussed above), it is unclear why the court did not refer to the guidance provided by U.C.C. section 2A-504.<sup>114</sup> However, it is unlikely that section 2A-504 would have produced a different result.<sup>115</sup> In any event, the court did award BA Jacobs what were deemed to be the actual damages it suffered as a result of Rutair’s default

110. *Id.* (citing *Lake River Corp. v. Carborundum Co.*, 769 F.2d 1284, 1289 (7th Cir. 1985); *Grossinger Motorcorp, Inc. v. Am. Nat’l Bank & Trust Co.*, 607 N.E.2d 1337 (Ill. App. Ct. 1992)).

111. *Id.* at \*3; see RESTATEMENT (SECOND) OF CONTRACTS § 356(1) (AM. LAW INST. 1981) (“Damages for breach by either party may be liquidated in the agreement but only at an amount that is reasonable in the light of the anticipated or actual loss caused by the breach and the difficulties of proof of loss. A term fixing unreasonably large liquidated damages is unenforceable on grounds of public policy as a penalty.”).

112. *BA Jacobs Flight Servs.*, 2015 WL 8328631, at \*2 (quoting *Lake River Corp.*, 769 F.2d at 1289).

113. *Id.* at \*2–3. The court reasoned that the losses to the lessor resulting from the lessee’s breach were easily calculable and that acceleration of rent irrespective of the lessor’s enforcement of other remedies did not approximate the actual damages. Once the aircraft was sold, the lessor no longer had the carrying costs of the equipment and in the court’s view recovering all of the monthly rent payments would have been a windfall for the lessor. *Id.* at \*3.

114. U.C.C. section 2A-504(1), which has been codified in Illinois, states:

Damages payable by either party for default, or any other act or omission, including indemnity for loss or diminution of anticipated tax benefits or loss or damage to lessor’s residual interest, 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 or other act or omission.

U.C.C. § 2A-504(1) (2016); see also 810 ILL. COMP. STAT. ANN. 5/2A-504 (West 2016). Unlike the referenced *Restatement* and case law cited in the opinion, U.C.C. section 2A-504(1) does not require that the loss be difficult to prove, nor does it mention that unreasonably large liquidated damages are unenforceable as a matter of public policy because they constitute a penalty.

115. The acceleration formula in this case failed to discount the accelerated amounts to their present value and to afford the lessee a mitigation credit to reflect the lessor’s recovery of the leased equipment, and the resulting windfall to the lessor would have caused the damages provision also to fail the “reasonableness” requirement in section 2A-504. Note that a quick search did not yield any reported cases considering the enforceability of liquidated damages provisions under Illinois’ version of U.C.C. section 2A-504. See, for example, *In re Snelson*, 305 B.R. 255 (Bankr. N.D. Tex. 2003), in which the court applied section 2A-504 as then adopted in New Jersey and considered the discounting and mitigation aspects of the subject liquidated damages formula to be meaningful when deeming it to be enforceable. It is also interesting to note that there was no discussion in the opinion regarding BA Jacobs’ right to seek another remedy provided under Article 2A to determine the appropriate damage amount, given the unenforceability of the acceleration remedy in what we assume was a true lease. See U.C.C. § 2A-504(2) (2011) (stating, “[i]f the lease agreement provides for liquidation of damages, and such provision does not comply with subsection (1), or such provision is an exclusive or limited remedy that circumstances cause to fail of its essential purpose, remedy may be had as provided in this Article”); see also *id.* § 2A-528(1) (outlining the U.C.C.’s rent acceleration remedy).

under the lease, calculated to include the aggregate rent payments that were due by Rutair from the date the aircraft was recovered by BA Jacobs up to the date the aircraft was ultimately sold.<sup>116</sup>

By contrast, the court in *Xerox Corp. v. AC Square, Inc.*<sup>117</sup> awarded the plaintiff both acceleration-type damages and the right to recover the equipment, without requiring any mitigation credit, under seven “product lease contracts” and one “product maintenance contract.”<sup>118</sup> However, despite referring to seven of the contracts as “lease agreements” and the related equipment as “leased equipment,” the *Xerox* court also did not consider the applicable provisions of U.C.C. Article 2A, U.C.C. Article 9<sup>119</sup> (if a non-true lease), or any other commercial or contract laws regarding liquidated damages, when it determined the appropriate remedies.<sup>120</sup>

*PNC Equipment Finance, LLC v. MDM Golf, LLC*<sup>121</sup> involved another liquidated damages claim by a lessor. Similar to the *Xerox* case, the court was “required to conduct an inquiry in order to ascertain the amount of the damages with reasonable certainty.”<sup>122</sup> The lessor claimed damages equal to the deficiencies remaining after the lessor recovered and sold the leased equipment and applied the net disposition proceeds against the stipulated loss value and other amounts due under the leases.<sup>123</sup> Without analysis regarding the laws pertinent to the lessor’s damages claim, the court entered a default judgment against the lessee and guarantor for the full amounts demanded, including interest at the statutory rate, and reasonable attorney’s fees and costs relating to the collection of the payments.<sup>124</sup>

The court in *BLB Aviation South Carolina, LLC v. Jet Linx Aviation, LLC*<sup>125</sup> denied an aircraft lessor’s claim for damages despite finding that the lessee breached its obligations under two different agreements relating to the return of the leased aircraft.<sup>126</sup> The two issues presented were (1) whether the appro-

116. See *BA Jacobs Flight Servs., LLC v. Rutair Ltd.*, No. 12 C 2625, 2017 WL 277913, at \*4 (N.D. Ill. Jan. 20, 2017).

117. *Xerox Corp. v. AC Square, Inc.*, No. 15-cv-04816-DMR, 2016 WL 5898652 (N.D. Cal. 2016).

118. *Id.* at \*1.

119. Assuming that each of the seven leases were true “leases” under California law, section 10504 of the California Commercial Code should govern the calculation of liquidated damages. If the seven leases were not true “leases,” section 1671 of the California Commercial Code and relevant case law should control.

120. *Xerox Corp.*, 2016 WL 5898652, at \*5–8. Also, unlike the court in the *BA Jacobs* case, the recommended remedies did not take into account the possibility of economic waste that might have resulted if the plaintiff both recovered the accelerated rent and had an opportunity to sell or re-lease the equipment and retain any disposition proceeds without crediting the proceeds or other mitigation amount against the lessee’s obligation. *BA Jacobs Flight Servs.*, 2017 WL 277913, at \*3. When considering the court’s approach to determining the appropriate damage amount, note that this was a default judgment and the defendant did not appear so as to raise defenses to the claim.

121. No. 1:14-cv-509, 2016 WL 3453657 (S.D. Ohio June 20, 2016).

122. *Id.* at \*1 (quoting *Osbeck v. Golfside Auto Sales, Inc.*, No. 07-14004, 2010 WL 2572713 (E.D. Mich. June 23, 2010)).

123. *Id.* at \*2.

124. *Id.* at \*3.

125. 808 F.3d 389 (8th Cir. 2015). Although this case was decided in 2015, we are covering it in this 2017 Survey because it remains relevant and was not covered in our 2016 Survey.

126. *Id.* at 391.

appropriate measure of damages was the cost of remediating the breached obligations, or the diminution in value attributable to the breaches; and (2) whether the plaintiff proved its damages with “sufficient certainty.”<sup>127</sup> In this case, the lessor purchased and dry-leased an aircraft (Aircraft 1) to the lessee pursuant to a lease (the “Lease”) and also entered into a management-services agreement (the “MSA”) with the lessee so that it could charter another of the lessor’s aircraft (Aircraft 2).<sup>128</sup> Both the Lease and the MSA contained provisions requiring that the lessee maintain and, as needed, repair the pertinent aircraft and ensure that all such maintenance and repair work was “performed in accordance with the standards set by the Federal Aviation Regulations” and to “maintain log books and records” in accordance with the Federal Aviation Regulations.<sup>129</sup> When both aircraft were returned by the lessee to the lessor, the lessee had breached both the Lease and MSA by failing to keep proper records and part tags as required under the applicable Federal Aviation Regulations (“FARs”) for maintenance performed on each of Aircraft 1 and Aircraft 2.<sup>130</sup>

The lessor claimed that the correct measure of damages was the “cost of repair” and presented evidence supporting the amount of repair costs it was demanding.<sup>131</sup> The court noted that “[i]f a defect in the performance of a contract can be remedied, the ordinary measure of damages is the cost of repair.”<sup>132</sup> In this case, the breach could be remedied by re-doing all of the maintenance work on each aircraft and recording the maintenance and part tags appropriately.<sup>133</sup> However, the lessee contended that this would constitute “economic waste” (i.e., a windfall to the lessor) and that the more appropriate measure of damages recoverable by the lessor would be the diminution in value of the respective aircraft.<sup>134</sup> The court analyzed whether the “cost of repair would be grossly out of proportion to the value which the correction would add to the property involved”<sup>135</sup> and balked at the “notion of replacing undisputedly good parts with new parts for the sake of obtaining complete maintenance records.”<sup>136</sup> Additionally, the lessor had already sold Aircraft 1, and the lessee contended that awarding damages to the lessor based on the cost-of-repair would result in a windfall to the lessor, as there was no practical likelihood that the lessor would actually re-do the maintenance work.<sup>137</sup> The court agreed and held

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127. *Id.* at 392.

128. *Id.* at 391.

129. *Id.*

130. *Id.* at 391–92.

131. *Id.* at 392.

132. *Id.* at 393 (citing *Fink v. Denbeck*, 293 N.W.2d 398, 402 (Neb. 1980)).

133. *Id.* at 392–93.

134. *Id.* at 393.

135. *Id.* (citing *A-1 Track & Tennis Inc. v. Asphalt Maint., Inc.*, No. A-99-433, 2000 Neb. App. LEXIS 187, at \*5 (Ct. App. June 20, 2000)).

136. *Id.* The lessee’s position was bolstered by the testimony of both its own expert and the lessor’s expert, each of whom testified that there were alternative methods of compliance with the pertinent FARs without having to replace the new parts or re-perform the maintenance work. *Id.* at 393–94.

137. *Id.* at 394 (noting that the *Restatement* “explicitly links windfall with economic waste”); see RESTATEMENT (SECOND) OF CONTRACTS § 348 cmt. c (AM. LAW INST. 1981).

that the appropriate measure of damages to compensate the lessor should have been an amount representing the diminution in value suffered by each aircraft as a result of the lessee's non-compliance with the aircraft return conditions.<sup>138</sup> Unfortunately for the lessor, it had not presented sufficient evidence of any diminution in value damages.<sup>139</sup> As a result, the court found that the lessor failed to prove its damages with "sufficient certainty" and awarded the lessor nothing for the lessee's breaches.<sup>140</sup>

Lessors should write the return provisions in their aircraft lease forms to avoid any "economic waste" defenses and to provide for damages formulas that compensate the lessor without affording it a windfall.

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138. *BLB Aviation*, 808 F.3d at 394.

139. *Id.* at 394–95.

140. *Id.* at 395. In Nebraska, it is a question of law as to whether "the evidence of damages is 'reasonably certain.'" *Id.* The only evidence presented by the lessee to the court that might have been pertinent to a diminished value claim was that the lessor had sold Aircraft 1 for \$425,000. *Id.* However, no pre-buy inspection was performed, and the lessor failed to provide any evidence as to how much the aircraft would have been worth had the lessee not breached its obligations and proper records and tags were available. *Id.* The lessor also failed to present any evidence that the value of Aircraft 2 was diminished by the lessee's failure to obtain and maintain proper maintenance and repair records and tags for Aircraft 2. *Id.*

