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VOLUME 37 • NUMBER 2 • SPRING 2019

Transitioning from LIBOR to a Replacement Rate Index: What Steps Should Lenders Take Now?

By Andrew Kalgreen

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Financing Robotics: Scoping the Opportunity

By Paul Bent, Shawn Halladay and Andrew G. Mesches

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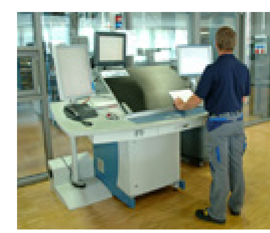
Analyzing U.S. Cannabis Laws and Their Impact on Financial Services

By Gregory D. Omer

As state cannabis laws become more commonplace, indirect connections to cannabis-related businesses are increasingly harder to avoid. Significant legal risk surrounds deposit services, loans, and commercial finance leases. Here is an overview of the complicated web of state and federal cannabis statutes, rules, and government policies.



A Valentine's Day Massacre of Liquidated Damages: *In re Republic Airways Holdings Inc.*

By Arlene N. Gelman and Edward K. Gross

A bankruptcy court ruling in New York this year could be problematic for lessors when enforcing certain typical acceleration and collection remedies against defaulting customers. Specifically, *In re Republic Airways Holdings Inc.* may impair the reliability of SLV-based liquidated damages provisions even in hell-or-high-water leases and guaranties of those obligations under unconditional and absolute guaranties. The authors will explain why they believe that the court erred, and discuss the enforcement and transactional implications to lessors.

 • ISSN 0740-008X

Transitioning from LIBOR to a Replacement Rate Index: What Steps Should Lenders Take Now?

By Andrew Kalgreen

Lenders and borrowers alike are wondering when and how they will adapt to a market in which LIBOR is no longer the preferred interest rate benchmark, a development likely to occur at year-end 2021. Clearly lenders must consider the many effects of replacing LIBOR with another floating rate index. This article discusses the steps lenders should take now, and why.

The drumbeat of articles in the financial press about the end of the London Interbank Offered Rate (or LIBOR) is rising, almost on a daily basis. LIBOR has been used for decades to price everything from home mortgages to commercial loans to derivatives. So lenders and borrowers alike are wondering when and how they will adapt to a market in which LIBOR is no longer the preferred interest rate benchmark.

Some background on LIBOR, its importance, and the reasons for its downfall will help frame the discussion of the next steps that banks, equipment finance companies, and other lenders should take to manage this transition. These next steps will include (1) inventorying the LIBOR indexed loans in a lender's portfolio, (2) analyzing existing loan documents regarding the alternatives (if any) to the LIBOR benchmark already in the contracts, (3) developing or improving the standard set of loan terms and conditions to pivot from LIBOR as an interest rate option when needed, and (4) monitoring the market's preferences for a replacement floating rate index.

WHAT IS LIBOR?

LIBOR is essentially the result of a survey of certain large global banks that are operating in London financial markets. (As used in this article, the term LIBOR will refer to U.S. dollar- denominated LIBOR. However, LIBOR is also calculated for the euro, the British pound, the Japanese yen, and the Swiss franc).

The survey is conducted each business day by the Intercontinental Exchange (ICE), a U.S. company that owns exchanges for financial and commodity markets. ICE submits the survey to 18 panel banks for the U.S. dollar LIBOR. In essence, the survey asks this question: At what rate could you borrow funds, were you to do so by asking for and then accepting interbank offers in a reasonable market size just prior to 11 a.m.?

ICE discards the highest four rates and the lowest four rates (so as to eliminate outliers that could skew the results) and averages the remaining middle 10 rates. The results of the daily LIBOR survey are reported at 11:30 a.m. London time in seven different maturities, ranging from one day to one year, and are published by Thomson Reuters.

Thus, the LIBOR benchmark is meant to reflect the cost at which large, globally active banks can borrow on an unsecured basis in wholesale markets.

WHY IS LIBOR IMPORTANT?

LIBOR is very widely used in financial markets. In March 2018, the Alternative Reference Rates Committee (ARRC) convened by the Federal Reserve Board and the Federal Reserve Bank of New York (New York Fed) stated that LIBOR underpins *$200 trillion* of derivatives, loans, and other financial products.

Many banks, leasing companies, mortgage lenders, and credit card companies set their own interest rates for extensions of credit using LIBOR. It is estimated that LIBOR is the principal reference rate for *$10 trillion* of U.S. dollar loans held by U.S. financial institutions in their portfolios.

During the 2008 financial crisis, private investigations raised the question of whether or not LIBOR had been manipulated by the panel banks or been affected by false submissions.

WHY IS LIBOR BEING ELIMINATED?

The short answer to this question is that the Financial Conduct Authority (the government agency that is responsible for regulating the financial services industry in the United Kingdom and that is specifically tasked with overseeing LIBOR) announced in July 2017 that, as of year-end 2021, it will no longer compel the panel banks to provide LIBOR quotes.

Although this announcement does not mandate the end of LIBOR, it has awakened market participants to the limitations of LIBOR — and to the need to find a replacement index. The longer answer is twofold.

First, according to the frequently asked questions published by the ARRC (www.newyorkfed.org/arrc/faq), LIBOR is increasingly based on the expert judgment of the panel banks due to the declining amount of unsecured, wholesale borrowings by banks since the 2008 financial crisis. Therefore, LIBOR is less and less a robust, transactions-based market interest rate as envisioned by international standards for benchmarks. Again, as noted in the FAQs, the scarcity of underlying transactions also makes LIBOR potentially unsustainable, as many banks have grown uncomfortable in providing submissions based on expert judgment.

Second, during the 2008 financial crisis, private investigations (such as *The Wall Street Journal*) and government investigations (including the U.S. Department of Justice and the U.K. Financial Services Authority, or FSA) raised the question of whether or not LIBOR had been manipulated by the panel banks or been affected by false submissions.

In June 2012, Barclays Bank was fined $200 million by the U.S. Commodity Futures Trading Commission, $160 million by the U.S. Department of Justice, and £59.5 million by the FSA for attempted manipulation of the LIBOR and other interbank rates. This manipulation or erroneous-submission issue arises because LIBOR is survey driven and not the result of actual financial transactions.

In light of the potential risk that LIBOR could be manipulated or subject to erroneous or even biased expert judgments, and of the real 2021 deadline set by the Financial Conduct Authority, the value of LIBOR as a sustainable predictive interest rate tool has been cast into doubt and the financial services industry is searching for its replacement.

WHAT WILL REPLACE LIBOR?

Again, we have a short answer: we don't know yet. But there is no lack of interest in developing an alternative to LIBOR and the one most actively being considered is the Secured Overnight Financing Rate (or SOFR). There are excellent sources of information about SOFR available at the websites for ARRC and for the Loan Syndications and Trading Association (LSTA).

One example is the *ARRC Consultation Regarding More Robust LIBOR Fallback Contract Language for New Originations of LIBOR Bilateral Business Loans*, issued December 7, 2018 (Bilateral Loan Consultation) (www.newyorkfed.org/medialibrary/Microsites/arrc/files/2018/ARRC-Bilateral-Business-Loans-Consultation.pdf). Much of the information presented about SOFR in the balance of this article is derived from reports and consultations published by LSTA and ARRC.

The Bilateral Loan Consultation describes SOFR as follows:

> SOFR is a broad measure of the cost of borrowing cash overnight collateralized by U.S. Treasury securities. SOFR is determined based on transaction data composed of: (i) tri-party repo, (ii) General Collateral Finance (GCF) repo, and (iii) bilateral Treasury repo transactions cleared through Fixed Income Clearing Corporation (FICC).

In recognition of the importance of LIBOR and the impact of its cessation on financial markets, the New York Fed began publishing SOFR on a daily basis in April 2018.

However, SOFR was originally developed to manage the transition from LIBOR for the derivatives market, not for term-loan products. Adapted from an LSTA consultation (www.lsta.org/uploads/DocumentModel/3523/file/libor-in-the-loan-market_042418.pdf), Table 1 compares features of LIBOR and SOFR.

Table 1. LIBOR Versus SOFR: A Comparison of Features

LIBOR	SOFR
Term structure	Overnight (for now)
Unsecured	Secured (by U.S. Treasury securities)
Reflects bank cost of funds (sort of)	Risk-free (nearly) rate
LIBOR should be a higher rate	SOFR should be a lower rate
Under $1 billion of daily trading (3-month LIBOR)	Nearly $800 billion of daily trading
Easily manipulated	Not easily manipulated

There has also been some concern that SOFR, as an overnight rate, could be fairly volatile day to day. However, as shown in the FAQs, during the September 2018 to January 2019 time frame, compounded average SOFR was far less volatile as compared to daily SOFR. Furthermore, the FAQs also reveal that from 2015 through 2018, the three-month compounded average SOFR has been less volatile than three-month LIBOR.

Despite the differences between SOFR and LIBOR, the development of SOFR and its publication are important steps in establishing an alternative reference rate, and momentum is building via ARRC and other industry sources to accept SOFR as a replacement index for LIBOR. With time, it is expected that the market will arrive at a consensus toward using an index such as SOFR as LIBOR's replacement in loan products.

Some market participants have asked why other interest rate indexes are not being studied as replacements for LIBOR. Syndicated loan facilities and large bilateral corporate loans have long been structured with multiple floating rate options, including LIBOR, the prime rate (the interest rate publicly announced from time to time by the applicable bank as its prime rate or base rate) and the federal funds rate (the rate calculated by the New York Fed based on any given day's federal funds transactions by depositary institutions).

However, these two standard contract alternatives to LIBOR are not considered suitable replacements for LIBOR. The prime rate is not transaction based (rather, it is what the applicable bank says it is), and it is a fairly static rate that does not move in concert with general market trends. The federal funds rate is based on less than $80 billion of trading, it has fewer counterparties, and it is highly reliant on government-sponsored enterprises (such as Fannie Mae, Ginnie Mae, and Freddie Mac).

WHAT ARE FALLBACK PROPOSALS?

The Bilateral Loan Consultation includes an excellent description of the philosophical foundations of the two "fallback proposals," whereby loan parties contractually agree on when and how a commercial loan will be modified to replace LIBOR. This foundation language is provided verbatim below:

> The first is an "amendment approach," which would provide a streamlined amendment mechanism for negotiating a replacement benchmark in the future and could serve as an initial step towards adopting a hardwired approach (see Appendix I). Second is a "hardwired approach," which would provide market participants with more clarity as to a how a potential replacement rate will be identified and implemented (see Appendix II).
>
> The amendment approach and the hardwired approach each have their pros and cons, and they may behave differently in different market environments. The amendment approach uses loans' flexibility to create a simpler, streamlined amendment process. It is similar to the "LIBOR replacement" language that has developed in the syndicated loan market in the past year, it maximizes flexibility and it also does not rely on a rate (term SOFR) and spread adjustment methodology that does not yet exist. However, it may simply not be feasible to use the amendment approach if thousands of loans must be amended simultaneously due to an unexpected LIBOR cessation. This could create the very real possibility of disruption in the loan market. Additionally, the amendment approach is likely to create winners and losers in different market cycles. In a borrower-friendly market, a borrower may be able to extract value from the lenders by refusing to include a compensatory spread adjustment when transitioning to SOFR. Non-consenting lenders still would be subject to the lower rate. In a lender-friendly market, lenders might block a new proposed rate, forcing the borrower to pay a higher interest rate, such as the alternate base rate for a period of time. For these reasons, working group members who are proponents of use of the amendment approach at the current time generally believe that eventually some version of a hardwired approach will be more appropriate. Market participants who choose to adopt the proposed amendment approach should therefore expect that future amendments to those provisions, if possible, may be desirable prior to any LIBOR cessation.
>
> In contrast, the hardwired approach provides clarity upfront. Lenders and borrowers know that they will receive a version of SOFR plus a Replacement Benchmark Spread upon LIBOR discontinuance. Upon a LIBOR cessation event, neither borrowers nor lenders will be able to take advantage of the then-current market environment to capture economic value. However, term SOFR and the replacement benchmark spread do not yet exist, so it may be hard to determine today what the ultimate replacement rate would look like. That said, other products may determine that this is an acceptable risk, for instance, the hardwired approach proposal is closely aligned with the ARRC's fallback proposal for floating rate notes currently under consultation.

HOW DO THE ARRC FALLBACK PROPOSALS WORK?

In appendixes I and II to the Bilateral Loan Consultation are the proposed contacts terms

> **The prime rate is not transaction based and it is a fairly static rate that does not move in concert with general market trends.**

In appendixes I and II to the Bilateral Loan Consultation are the proposed contacts terms and conditions for amending loan documents to account for the cessation of LIBOR as the primary interest rate index.

and conditions for amending loan documents to account for the cessation of LIBOR as the primary interest rate index and to select its replacement. Appendixes I and II can found at pages 17 to 27 of this website: www.newyorkfed.org/medialibrary/Microsites/arrc/files/2018/ARRC-Bilateral-Business-Loans-Consultation.pdf. Appendix I adopts the "amendment approach" and Appendix II adopts the "hardwired approach."

Both appendixes have the same four basic components:

1. Identification of the triggering events that precipitate the switch from LIBOR to a new reference rate. Examples of triggering events include LIBOR cessation (or statement of LIBOR cessation), LIBOR not being published for a period of time, or the announcement that LIBOR is no longer representative. The Bilateral Loan Consultation also considers "pre-cessation" triggers and "opt-in" triggers, whereby parties can initiate a transition to a new reference rate, even if LIBOR continues to exist and be representative.
2. Selection of a replacement reference rate. For this article, it is assumed that the new rate will be SOFR.
3. Determination of the spread over SOFR. This spread should compensate for the difference between LIBOR and SOFR.
4. Modification process. This will either be the amendment approach or the hardwired approach.

As noted above, the hardwired approach depends on future development of several innovations related to SOFR. Among these innovations are the following two concepts taken from Appendix V to the Bilateral Loan Consultation:

> "Term SOFR" means the forward-looking term SOFR rate, for a term equal to the applicable Interest Period, that is selected, endorsed or recommended as the replacement for such LIBO Rate by the Relevant Governmental Body. Term SOFR does not currently exist, but is scheduled to be implemented no later than 2021, and there is the potential that it will exist much earlier.
>
> "Compounded SOFR" means, for the applicable interest period, a compounded average of daily SOFR as published by the Federal Reserve Bank of New York or any entity that assumes responsibility for publishing such rate. Compounded SOFR may be either: (i) calculated at the start of the interest period using the historical Compounded SOFR rate for the period that ends immediately prior to that date (this payment structure is often termed "in advance" since the payment obligation is determined in advance) or (ii) calculated over the relevant interest period with a lock up period prior to the end of the interest period, in which case the rate will not be known at the start of the interest period (this structure is often termed "in arrears").

SAMPLE CONTRACT TERMS

Appendix I to the Bilateral Loan Consultation provides the contract language for the amendment approach to handle the discontinuance of LIBOR and the selection of a replacement index and spread. This appendix runs 3-1/2 pages, most of which consists of 12 new definitions. Below is just the first clause of this Appendix I, which sets the table for the loan modification:

> Notwithstanding anything to the contrary in this Agreement or any other Loan Document, at or promptly after a Benchmark Transition Determination, the Lender pursuant to clause (b) of this Section titled "Effect of Benchmark Discontinuance Event" may amend this Agreement to replace LIBOR with an alternate benchmark rate (which may include Term SOFR, to the extent publicly available quotes of Term SOFR exist at the relevant time), including any Replacement Benchmark Spread, in each case giving due consideration to [any evolving or then existing convention for similar U.S. dollar denominated credit facilities for such alternative benchmarks and adjustments or] any selection, endorsement or recommendation by the Relevant Governmental Body with respect to such facilities (any such proposed rate, together with the Replacement Benchmark Spread, a "Replacement Benchmark"). Such Replacement Benchmark shall be applied in a manner consistent with market practice or, to the extent such market practice is not administratively feasible for the Lender, in a manner as otherwise reasonably determined by the Lender; provided that in no event shall such Replacement Benchmark be less than zero for purposes of this Agreement.

Appendix II of the Bilateral Loan Consultation sets forth the contract language for the hardwired approach to deal with the discontinuance of LIBOR and to select a replacement index and spread. This appendix is almost seven pages long, the vast majority of which are 25 newly defined terms.

ARRC has published three other consultations similar to the Bilateral Loan Consultation — one for syndicated loan facilities, one for floating rate notes and one for securitized credit facilities – and each of them has appendixes with sample contract language to revise loan documents using either the amendment approach or the hardwired approach.

Lenders should begin by identifying all current credit facilities (held in portfolio or administered) that include LIBOR as a floating rate option and a maturity date after December 31, 2021.

WHAT STEPS SHOULD LENDERS TAKE NOW?

First, do not panic. Second, get busy now to position your company to manage the process of making a successful change from LIBOR-based loans to loans with a replacement floating rate index.

Lenders should begin by identifying all current credit facilities (held in portfolio or administered) that include LIBOR as a floating rate option and a maturity date after December 31, 2021. Actually, any LIBOR-based loan with a maturity date in 2021 should also be identified since it is possible that a triggering event as described above in the ARRC fallback proposals could occur before year-end 2021.

Lenders will then need to analyze whether these loans include one of the following (each an "index replacement mechanism"): (1) the bank's right to select a reasonable replacement index rate and spread (this would be similar to the ARRC's amendment approach) or (2) a specific, viable and enforceable replacement index rate plus spread (this will be similar to the ARRC's hardwired approach).

Those lenders with existing LIBOR-based loan facilities that do not include an index replacement mechanism should take advantage of any time when borrowers request renewals, extensions, modifications, waivers, or concessions for any reason. Such borrower requests will present lenders with opportunities to amend their credit documents to add an index replacement mechanism.

If no such opportunity presents itself prior to 2021, lenders on their own initiative should approach their borrowers to negotiate an index replacement mechanism for credit facilities maturing after 2021.

For all new credit facilities being negotiated now that will include a LIBOR floating rate index (especially those that will mature in 2022 or later), lenders and their legal counsel should develop standard terms and conditions for an index replacement mechanism in their loan documents, based on either the amendment approach or the hardwired approach.

If market participants accept a successor index rate to LIBOR (such as term SOFR or compound SOFR), then at some point prior to 2022, lenders that have included the amendment approach in their credit documents should consider further amending their documents to replace the LIBOR provisions with the applicable SOFR provisions.

Regardless of whether lenders adopt the amendment approach or hardwired approach in their loan documents, lenders should monitor developments related to LIBOR's cessation, the market's acceptance of SOFR as an alternative reference rate index, the New York Fed's creation and publication of term SOFR and compound SOFR, and when available, the performance characteristics of term SOFR and compound SOFR as compared to LIBOR and other floating interest rate indexes.

CONCLUSION

It is beyond the scope of this article (and the author's skill set) to consider other operational issues that lenders will need to address in connection with replacing LIBOR with another floating rate index. Just to name a few: determining how government regulators will view the impact of the transition (such as stress testing); modifying or acquiring software and adjusting internal systems to capture published data about the new index and to price loans with the new index; developing customer communications to alert them to the end of LIBOR and to the replacement index; training bankers, documentation staff, and loan administration personnel on the use of the new index; and updating billing and collection systems.

Year-end 2021 may seem like it is a long way off, but given the importance and complexity of transitioning from LIBOR, its arrival is accelerating. To paraphrase C.S. Lewis on managing change: you cannot go back and undo the demise of LIBOR, but you can start where you are today to change the ending.

Andrew J. Kalgreen

akalgree@gmail.com
andrew.kalgreen@steptoe-johnson.com

Andrew J. Kalgreen is of counsel at Steptoe & Johnson PLLC in its Columbus, Ohio, office. He concentrates his practice in the areas of commercial equipment finance and leasing, municipal lease-purchase financing, and other commercial lending and public sector financing transactions. As a former senior counsel for two national equipment finance companies, Mr. Kalgreen has extensive experience in structuring, documenting, and negotiating commercial and government financing transactions and in advising financial institutions regarding federal and state laws affecting their business operations. He earned his juris doctor from the University of Chicago Law School and his bachelor of arts in political science from Kent State University in Kent, Ohio.

Financing Robotics: Scoping the Opportunity

By Paul Bent, Shawn Halladay and Andrew G. Mesches

Will the growth of robotics increase financing volume? The jury is out, but niche players with asset management skills will likely discover opportunities. As this article points out, most risks are no different from those faced in any technology-driven asset class: managing residual risk and associated soft costs in a fluid environment.

The burgeoning growth of autonomous vehicles has captured the attention of not only the public but also the equipment leasing and finance industry. The field of robotics also is experiencing rapid growth and change. Together, these technologically accelerating industries are creating concerns about their technological and societal impact. This article, a byproduct of an Equipment Leasing & Finance Foundation study, examines the robotics industry and identifies related financing opportunities and challenges.

ROBOTICS AND AUTOMATION

Automation is the technology by which a process or procedure is performed without human assistance.[1] Robotics, on the other hand, concerns itself with devices that act on the world in which they function (devices often referred to as *robots*), which in turn exhibit characteristics of autonomy. Thus, robotics is the study and science of devices that may often be, but are not always, guided or propelled by automation.

The degree of robotic autonomy, along with a robot's ability to mimic human-like activities, may require sophisticated, multiple components such as:

- Hardware – effectors, sensors, cameras, the robot framework and CPU, enterprise network, server, and storage
- Software – command and control, network infrastructure software, and specific applications
- Services – application management, education and training, facility modification, hardware deployment and support, network consulting, management and integration, operations and technology consulting, and systems integration

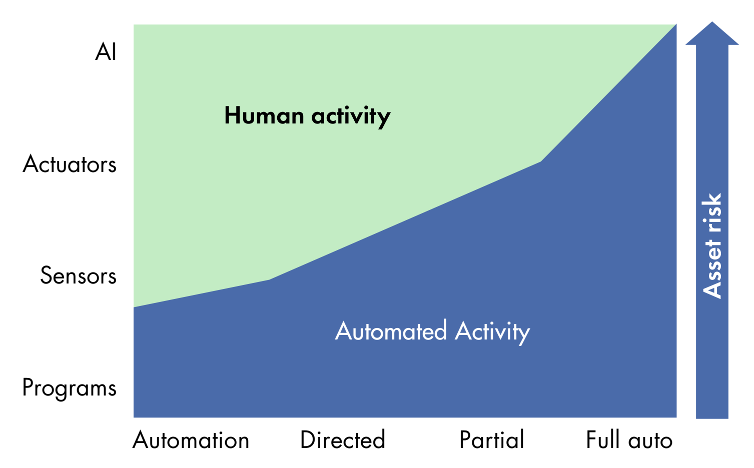
Because development of the technology behind many of these components is increasing at a rapid pace, the more sophisticated or autonomous the robot becomes, the more technology and soft costs play a role in how it functions. Consequently, although neither artificial intelligence (AI) nor complete autonomy is a required feature of robotics (think of the robotic welder), the level of robotic autonomy directly impacts how, and to what extent, these assets may be financed.

Financiers must be cognizant of these factors when choosing to pursue an equipment sector because, as illustrated in Figure 1, the closer to full autonomy a robot or robotic system becomes, the greater the asset risk undertaken by an equipment financier.

Machine learning is being incorporated into robotic activities to increase efficiency and reduce waste. Predictive analytics, or the analysis of current and historical data to predict future behavior — which has been used in truck, auto, and forklift fleet financing for some time now — is being applied in robotics to gather and track data on performance and usage. All these new, additive elements to the basic machine architecture increase the asset risk, as they require signifi-

Editor's note: This article is based on an Equipment Leasing & Finance Foundation report by The Alta Group titled Robots, Cobots, and Finance, *published in February 2019. The study is available at www.leasefoundation.org.*

Figure 1. Autonomy Curve



cant software and computing capabilities.

There also are potential safety risks as the interactions between humans and robots continue to increase. Third parties (including financing companies) increasingly risk exposure to vicarious liability, or claims in which disinterested owners/financiers are substituted for actual operators or users of robotic devices. These risks are particularly high with the rapidly growing class of robots known as *cobots*. A cobot (a portmanteau of *collaborative* and *robot*) is a robot intended to physically interact with humans in a shared workspace.

There are many questions surrounding the market potential of robotics, including the size and scope of any opportunities and their attendant risks.

Human safety always will be an issue, but new techniques are enabling safer and more enhanced physical collaboration between robots and humans in unpredictable environments, such as construction and agriculture.

Given the many disparate parts and revenue sources in a robotics application, it is not difficult to draw parallels between the more advanced robotics and managed solutions transactions (MSTs). Many MSTs, for example, depend on the Internet of Things (IoT) for data collection, robust analysis of the data, and AI to make the transaction work. The same elements are required for higher forms of autonomous robotics to function.

Market Size

There are many questions surrounding the market potential of robotics, including the size and scope of any opportunities and their attendant risks.

Current State

IDC's *Worldwide Semiannual Commercial Robotics and Drones Spending Guide* predicts that worldwide purchases of robotics and robotics-related software and services will continue to rise at a compound annual growth rate of 22.8%, reaching total spending of $230.7 billion in 2021. This IDC report includes drones (essentially flying robots, which currently account for approximately 37% of robotics spending). ABI Research predicts that the number of industrial robots sold in the United States will jump nearly 300% in less than a decade.

Currently, more than half of all robotics spending is for robotics hardware. Other categories of the robotic spend include applications management, education and training, hardware deployment, systems integration and consulting, network infrastructure, and command and control applications.

According to IDC's research, the discrete manufacturing and process manufacturing industries continue to be the largest purchasers of robotics products and services, accounting for more than half of all robotics spending throughout IDC's five-year forecast.[2] The automated production industries, such as manufacturing and wholesale, will be the second largest sector, followed by the resources industries of mining, oil and gas extraction, and agriculture.

Growth Potential

Future growth is not a given, of course, but the experts' projections of the future are positive. This is not to say that achieving that growth will be obstacle-free, as there are challenges to be overcome, such as new materials and fabrication methods, better power sources, the navigation of unmapped environments, and ethical considerations.

These challenges also can be viewed as valuable portents of the future, not just impediments to growth, as their solutions represent future, not current, technologies and capabilities. When rationalizing future opportunities in robotics, therefore, the potential that automation/autonomy can be applied to any given activity has to be assessed in terms of currently demonstrated technologies. In other words, we ask, What is the state of development and commercialization of the essential technologies required for significant future growth in any given industry or application?

Some sectors, such as farming, forestry, and construction, are less susceptible to automation because most of the environments in which their activities are performed are unpredictable. Consequently, they are not growing as rapidly as other sectors. Examples in which the factors comprising the environment keep changing include operating a construction crane or providing emergency care as a first responder.

Societal Factors
Other sectors have less potential for automation due to factors unrelated to the unpredictability of the environment. Activities in some of these industries require high levels of knowledge work or complex human interactions, such as the healthcare and education sectors.

Societal perceptions are factors that also may influence the potential growth of automation, fueled by headlines such as *Job-Stealing Robots are Steadily Taking Over America,* that referenced National Economic Research Bureau findings that, for every new industrial robot introduced into the workforce, six jobs were eliminated.[3]

Pablos Holman of Bill Gates Intellectual Ventures brings a different perspective, however:

> We're good at imagining how a robot is going to take a job and it [the job] will disappear. We're bad at imagining the new kinds of jobs we will create. Our parents could never imagine the type of job experiences we have today.[4]

Machines taking over some human activities in an occupation does not necessarily spell the end of the jobs in that line of work. On the contrary, their numbers at times increase in occupations that have been partly automated, because overall demand for their remaining activities has continued to grow.

Much of this activity does not represent job loss but, instead, a shift in the value cycle as people performing repetitive tasks are now becoming data-enabled decision-makers or are working collaboratively with cobots to improve overall efficiency, productivity, and throughput.

CHALLENGES OF FINANCING ROBOTICS

Table 1 identifies the risks in equipment finance transactions (credit, residual, legal and regulatory), along with an assessment of robotics' impact on the applicable risk in the transaction.

Credit Risk

Credit risk remains a central element in any financing transaction, and robotics is no different. The question that needs to be answered, however, is whether robotics transactions require a different, or added focus on, customer credit adjudication.

The answer is that, overall, the introduction of robotics into the credit decision does not, by itself, increase the credit risk in the transaction. This is not to say that there will not be changes in credit risk in certain areas. For example, credit risk may change if prices drop with technological advances and smaller firms are able to take advantage of newer equipment. This is the case with any technology asset, however, and is not unique to robots.

Credit issues and underwriting risks also will change if robotics is included in managed solutions. These changes are more a function of the characteristics of managed solution transactions than the robotic equipment embedded in the solution, however, and such changes are similar to those facing leasing and finance companies in other equipment sectors of the economy.

Overall, the introduction of robotics into the credit decision does not, by itself, increase the credit risk in the transaction.

Table 1. Risk Map

Risk	Impact	Comments
Credit		Potential expanded credit profile due to lower cost
Residual		
▪ Valuation		Increased risk due to technology and software
▪ Realization		Disposition expertise/effect on existing assets
Accounting		Possible friction as deals approach MST models
Income tax		Special-use equipment may be problematic
Legal		
▪ Vicarious liability		Risk from proximity to humans and property
▪ Documentation		Will follow standard industry practices
Operational		No new operational challenges introduced
Regulatory		New safety and social issues created
Funding		Will follow standard industry practices
Pricing		Will follow standard industry practices
Investment		No new issues raised

More risk   Less Risk   Least Risk

The importance placed on asset and residual value risk is dependent on at least two factors: the specific underlying assets and the ratio of assets to soft costs.

An entity financing robotics, therefore, should not need to adjust its credit policies and processes merely because it is financing robotic equipment. A relatively low impact, accordingly, has been assigned to the area of credit risk in the risk map in Table 1.

Residuals

The residual aspects of new generation equipment invariably create angst for the risk and upper-management teams, and financing robotics is no different. When it comes to setting residual values, though, is robotic equipment any different from other high-technology and software-rich equipment?

It is not likely to be, as virtually all industrial, transportation, agricultural, and medical assets – indeed, the entire Internet of Things – are incorporating increasingly high levels of automation, software (programmability), and "intelligence." The fact is that the equipment leasing and financing industry has been addressing changing technology when valuing assets almost since its inception.

The importance placed on asset and residual value risk is dependent on at least two factors: the specific underlying assets and the ratio of assets to soft costs. Key, albeit not new, considerations in residual valuation for robotics are the cutting-edge technology and high reliance on the software that is becoming commonplace in many robotic applications.

New technologies always require the continuing development of specialist knowledge to assess and realize residuals, knowledge that may initially be difficult to obtain on a timely basis. New technologies also have the potential to disrupt current used equipment markets, so residual realization on lessors' current portfolios will be affected, particularly if prices on new, more effective equipment start to drop.

Although the risks of residual valuation and realization for robotic assets remain important considerations, the development and acquisition of the underlying data upon which to base such determinations are not seen as being materially different from those for traditional equipment. Therefore, the increased risk for robotic assets has been rated as moderate relative to similar high-technology assets.

Legal

Lessors have coped with vicarious liability issues for quite some time and there is a substantial amount of case law on the subject, ranging from motor vehicles to aircraft. In fact, a federal statute[5] provides that companies that lease or rent vehicles to others may not, merely because of their ownership, be held vicariously liable when those to whom their vehicles are leased or rented behave negligently.

Although the thought of driverless over-the-road trucks running amok among the civilian population may certainly raise in some minds the unwanted specter of huge vicarious liability claims, the bottom line is that the underlying issues remain essentially the same as for other equipment.

There will no doubt be litigation in this area, and there may be a period of learning to deal with new technologies. Nevertheless, the applicable law and overall risk exposure for equipment financing companies is likely not to change significantly from the framework currently faced by financiers in this segment of the market.

Mitigating factors for vicarious liability risk might include more focus on the manufacturers for recompense, as operation of this complex equipment becomes more reliant on embedded robotic performance and controls. Lessors will need to continue to be diligent in their UCC 2-A finance lease efforts, therefore, to maintain their status as passive investors and to avoid any hint of agency between themselves and the suppliers of robotic equipment. Elements to the regulatory structure applicable to robotics, such as national standards, also may be introduced.

It can be argued that robotics, particularly autonomous classes such as vehicles, may increase the likelihood of claims against deep-pocketed lessors. Aside from the emotional component of "no one in control," though, if there are adequate regulatory safeguards in place (some of which are already beginning to take shape),[6] lessors are likely to protect themselves in the same manner as before, even with the possibility of increased claims. Consequently, the increase in vicarious liability risk has been categorized as moderate.

Regulations

There are continuing state and federal efforts to regulate the financing industry, but any regulations that arise related to financing robotics are more likely to be driven by the robotics themselves, rather than the associated financing. Since fencing off a robot to protect humans severely limits its autonomy and, hence, utility, safety will be front of mind with many regulators.

Additions to the regulatory structure might include national robotic safety and licensing standards or, perhaps, universal, no-fault insurance. At some point, these licensing restrictions may have to extend beyond operators to include repair and

Robots have been used and financed commercially for over 50 years, so the industry already is involved in financing this equipment, with the operative word being *equipment*.

maintenance providers due to the sophistication and complexity of the equipment.

Regulations intended to advance social policies also are likely, as efforts are made to protect jobs and general feelings of well-being. Many of these policies could be based on the premise behind science fiction author Isaac Asimov's Three Laws of Robotics, the first of which states that, "A robot may not injure a human being or, through inaction, allow a human being to come to harm." Any adverse change to the human condition caused by robots, therefore, may be considered antithetical to this law, however unenforceable it may be.

There is likely to be increased regulation of robotic equipment over time, and these regulations may impact the growth of robot utilization. Any impediments to equipment growth always affect financing opportunities, but for the various reasons discussed in this article, the overall increased regulatory risk of financing robotics has been deemed moderate.

CONCLUSION

Robots have been used and financed commercially for over 50 years, so the industry already is involved in financing this equipment, with the operative word being *equipment*. It must be recognized, therefore, that no matter how elaborate or complex a robot becomes, it still is a piece of equipment with many of the same risks and opportunities of other equipment classes.

The robotics industry is growing, so a portion of the growth in robotics financing will certainly come by virtue of general economic expansion. The potential for significant growth, however, will come from financing robots capable of operating in unpredictable environments.

These robots will incorporate the advanced technology, sensors, AI, data analytics, and the change in delivery and business models of what is referred to as Industry 4.0, which is an emerging industrial revolution that encompasses multiple components, including IOT, autonomous robots, the cloud and big data (see Figure 2).

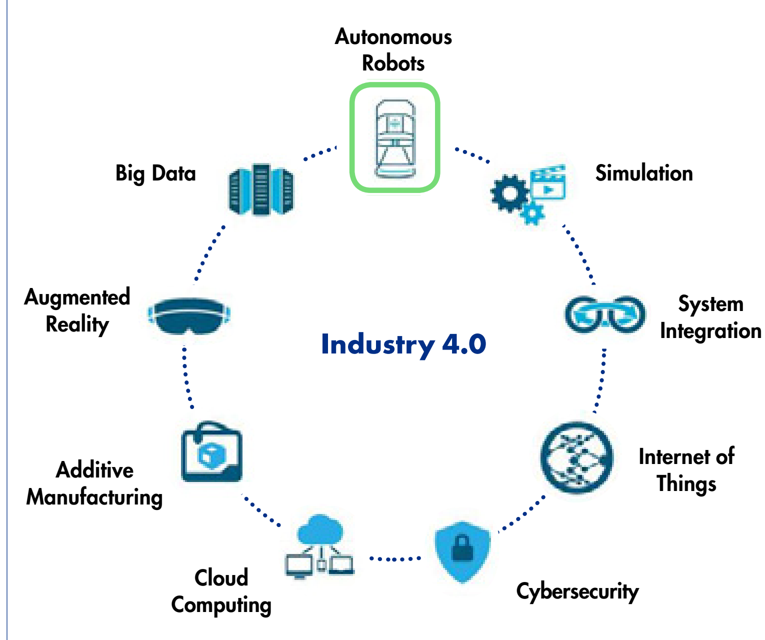
Although this article has referenced linkages between robotics and MSTs, it is important to make a clear distinction between them, as robot financings are not necessarily MSTs.[7] Even though robots can be an element of a managed solution, and although there may be convergence occurring between them, one does not create the other and vice versa: the critical aspect of MSTs is the underlying subscription pricing model, not the nature of the equipment involved. The above comment notwithstanding, increasing growth in robotic financing opportunities is probable through MSTs.

There are risks in financing robotics, just as there are risks in financing many other types of equipment. Some of these risks are inherent in the transaction, while others are created by the trends occurring within robotics and convergence with MSTs. Most risks, however, are no different from those faced in any technology-driven asset class – managing residual risk and associated soft costs in a fluid environment.

At the end of the day, the real question is whether or not robotics will increase financing volume, and if so will these gains be offset elsewhere as robots replace standard equipment operated by human workers? The jury is still out on this issue; but research indicates that, although robots may lead to changes in job demographics, increased robotics utilization will not be dilutive, as the new jobs and businesses being generated through adopting robots will generate more, rather than fewer, financing opportunities.

Robotics will create opportunities for those willing to get in front of it, and niche players with asset management skills will lead the pack in this regard. Robotics is going to be a part of the change in how business

Figure 2. Elements of Industry 4.0



is conducted in the future, as manufacturers and end-users certainly are discovering. Consequently, the equipment leasing and finance industry must embrace this trend if it is to creatively continue to meet the needs of its customers.

Endnotes

1. Groover, Mikell P. *Fundamentals of Modern Manufacturing: Materials, Processes, and Systems*, 5th ed. New York: Wiley, 2014.

2. The automotive industry accounts for a substantial portion of this volume.

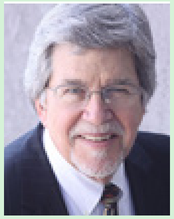
3. Glaser, April, and Molla, Rani. "The number of robots sold in the U.S. will jump nearly 300 percent in nine years," Vox, April 3, 2017 (originally on Recode.net). https://www.vox.com/2017/4/3/15123006/robots-sold-america-growth-300-percent-jobs-automation.

4. Garwood, Rita. "Innovate or Die: Lenders Must Partner with Tech Providers … or Face Disruption," *Monitor*, July/August 2018.

5. Transportation Equity Act (49 USC Sec. 30106), often referred to as the Graves Amendment.

6. As of March 2019, 29 states have enacted some form of legislation related to autonomous vehicles, according to the National Conference of State Legislatures, Autonomous Vehicles Database, March 12, 2019.

7. For further insights into this area, refer to the Foundation study *Managed Solutions: Evolutionary or Revolutionary?* available at www.leasefoundation.org.



Paul Bent

pbent@thealtagroup.com

Paul Bent is Senior Managing Director, Legal Services, The Alta Group, in Long Beach, California. He has been an active participant in the equipment leasing and financing industry since 1978 as an investment banker, corporate CEO, transaction attorney, and testifying expert witness. He leads Alta's Legal Services and Business Quality Assessment practices, which offer litigation support, expert witness, due diligence, and specialized investigative services in equipment leasing and finance. Mr. Bent's active engagements include appearing as an expert in disputes involving end-of-term equipment returns, interpretation of lease documentation, and industry standards of care and practice. His article, "Whither the Hell-or-High-Water Clause: Will This Venerable Leasing Construct Survive the Expanding Use of Managed Solutions Transactions?" appeared in the Winter 2017 journal. He has been a member of the ELFA Legal Committee and continues to serve on its Amicus, Financial Services Regulations, and Publications subcommittees. Mr. Bent received a BA cum laude in mathematics and computer science from the University of California–Los Angeles and a JD (law review) from Southwestern University School of Law, also in Los Angeles.

Shawn Halladay

shalladay@thealtagroup.com

Shawn Halladay, managing director of The Alta Group based in Salt Lake City, Utah, is an internationally recognized consultant and author in the equipment leasing and finance industry, with over 40 years of experience across all aspects of the business. He brings value to clients through his ability to effectively combine and translate the risk, finance, accounting, and tax complexities of leasing into a commercial perspective. Mr. Halladay is a member of the Financial Accounting Committee of ELFA and serves on the editorial review board of the Foundation. He holds a BS in accounting and an MBA in finance from the University of Utah, Salt Lake City.

Andrew G. Mesches

amesches@thealtagroup.com

Andrew G. Mesches, a director of The Alta Group based in Sequim, Washington, has worked in the financial services industry for four decades, including three in the highly regulated banking industry. He has extensive expertise in credit underwriting, credit policy, portfolio management, compliance, and collections, and served as the senior risk and credit officer in multiple bank leasing organizations. Mr. Mesches was a longtime member of the ELFA Credit & Collections Committee, serving as a past chair. He received a BA in economics from the State University of New York at Buffalo and also did graduate work at the State University of New York in Albany.

Analyzing U.S. Cannabis Laws and Their Impact on Financial Services

By Gregory D. Omer

As state cannabis laws become more commonplace, indirect connections to cannabis-related businesses are increasingly harder to avoid. Significant legal risk surrounds deposit services, loans, and commercial finance leases. Here is an overview of the complicated web of state and federal cannabis statutes, rules, and government policies.

"It is a riddle wrapped in a mystery inside an enigma."

When Winston Churchill spoke those words, he was not describing the status of the current U.S. cannabis laws, but he could have been.[1]

For the past decade, most state governments and the federal government have been busily adopting various types of cannabis laws, rules, and policies. However, none of these efforts have demystified the legal landscape for cannabis activity in the United States. In fact, this morass of government action has added significant confusion to that landscape, not only for companies interested in growing and selling cannabis but also for financial institutions being asked to provide financial services — such as deposit services, loans, and commercial finance leases — to state-authorized cannabis licensees and the people and companies with which they do business.

The high level of confusion and uncertainty in U.S. cannabis laws has resulted in most financial institutions being very reluctant to provide financial services to cannabis-related businesses, due to the significant legal risks involved.

This article will provide an overview of the complicated web of state and federal cannabis statutes, rules, and governmental policies as well as a basic understanding of the legal risks involved in providing financial services to cannabis businesses.

TYPES OF CANNABIS: MARIJUANA[2] VERSUS HEMP

State and federal laws, rules, and policies generally address two different types of cannabis:

- Marijuana, which has a high concentration of delta 9 tetrahydrocannabinol (THC),[3] the element that causes the feeling of being "high," and
- Hemp,[4] which has a very low concentration of THC (and, therefore, cannot be used to produce the psychoactive high feeling of marijuana) but has other uses, such as use as a material in the manufacture of rope, textiles, clothing, bioplastics, paper, building materials, and certain foods.

At one time, both marijuana and hemp were covered by one definition and equally prohibited under U.S. federal criminal law. However, these two types of cannabis are now defined and treated differently under federal and many state laws.

MARIJUANA LAW SUMMARY

The following is a summary of the current status of marijuana laws in the United States:

Federal Criminal Prohibition on Marijuana

Under federal criminal law (the Controlled Substances Act of 1970[5]), it is illegal in any state in the United States to possess or sell marijuana. This federal criminal prohibition applies regardless of whether the marijuana is for medical or recreational purposes and *supersedes all state marijuana authorization laws*.

This federal criminal prohibition is the most important aspect of the current confusion regarding the legal status of marijuana. In a nutshell, under this federal law, marijuana is illegal and criminally prohibited in

> This budget amendment has been adopted as a public law each applicable year, but it does not amend or impact the validity of the Controlled Substances Act or AML law prohibitions related to marijuana.

every state of the United States, regardless of whether the state has marijuana licensing laws and regulatory programs and regardless of whether the marijuana is for medical or recreational purposes.

Federal Criminal Prohibition on Financial Services Related to Marijuana

A related prohibition in the U.S. federal anti-money-laundering (AML) law prohibits financial institutions from knowingly processing transactions involving proceeds of any criminal activity.[6] Because the possession and sale of marijuana is criminal under federal law, any loan, deposit, commercial finance lease, or other financial service connected to marijuana activity is prohibited under this federal anti-money-laundering law.

In addition to this direct prohibition in the AML law and the direct prohibition under the Controlled Substances Act, federal law also criminalizes the less direct activity of aiding and abetting violators of these prohibitions and conspiring with others to violate the prohibitions.[7]

The Controlled Substances Act and AML law prohibitions seem very clear, but they are only the starting point for the current maze of state and federal government laws, rules, policies, and pronouncements related to the legal status of marijuana.

State Licensing Laws

As of April 1, 2019, 36 states had adopted laws authorizing either medical or recreational marijuana, or both, and the number of states with such laws continues to increase.[8] These laws include licensing requirements and other standards for growers, manufacturers, and sellers of marijuana.[9] Some of these state laws and rules also include guidance for banks and other financial institutions interested in providing financial services to licensed marijuana-related businesses.[10]

All these state laws were passed in spite of the fact that the federal criminal prohibitions described above preempt such state laws.[11] Also, when states began to issue licenses under these state laws, the federal government did not take action to stop the licensing by enforcing the Controlled Substances Act and AML federal criminal prohibitions. To the contrary, the federal government took several actions that facilitated these state marijuana licensing laws.

Federal Appropriations Law Restrictions on Enforcement

Since 2014, the United States has repeatedly adopted a federal budget amendment (known most recently as the Rohrabacher-Blumenauer Amendment), which forbids the U.S. Department of Justice from using federally appropriated funds to enforce the federal criminal law prohibitions on marijuana, with regard to violations in states that have *medical marijuana* licensing laws, if the violators are following those state laws.[12] The amendment does not address recreational marijuana issues.[13]

This budget amendment has been adopted as a public law each applicable year, but it does not amend or impact the validity of the Controlled Substances Act or AML law prohibitions related to marijuana. It simply stops the Justice Department from using federally appropriated funds to enforce those prohibitions.

Also, the Rohrabacher-Blumenauer Amendment is a periodic, temporary restriction. In other words, each time the amendment is adopted, it is only applicable to the budgeted federal funds for the specific fiscal year for which it is adopted. When a new fiscal year commences, the amendment must be readopted to have any impact on the funds to be appropriated in that year. Also, if the amendment is not adopted at any point in the future, its terms would not provide any protection for past actions.

Federal Justice Department Policy Limits on Enforcement

From 2014 to 2018, the Justice Department operated under a policy set forth in a set of publicly issued memoranda (collectively referred to as the Cole Memorandum) under which the Justice Department would not "prioritize" for prosecution violations of federal marijuana laws, if those violations occurred in states that have marijuana licensing laws and the violators were in compliance with those state laws.[14]

The Cole Memorandum had a similar impact as the Rohrabacher-Blumenauer Amendment. It did not change the federal criminal prohibitions related to marijuana, but it did indicate the Justice Department's choice not to enforce those prohibitions in scenarios involving marijuana-based businesses that are compliant with applicable state law regulating marijuana activity.

The Cole Memorandum was rescinded in January 2018 by then-Attorney General Jeff Sessions.[15] However, since that time the Justice Department, including specific U.S. attorneys in several jurisdictions, have either directly or impliedly indicated that they do not intend to target violations of federal marijuana laws if those violations occurred in states that have marijuana licensing laws and the violators are in compliance with those state laws.[16]

Treasury Department Guidelines for Financial Services

In 2014, the Financial Crimes Enforcement Network (FinCEN), a division of the U.S. Treasury Department, issued guidance (the FinCEN Guidance) regarding expectations for financial institutions (including banks and certain nonbanks) that deal with the marijuana industry, including due diligence requirements that the financial institutions should implement and specific federal AML law "suspicious activity report" (SAR) filing requirements related to marijuana-related businesses.[17] The FinCEN Guidance specifically references the Cole Memorandum, and it implied that FinCEN would not pursue action against financial institutions that follow the FinCEN Guidance.

Despite the rescission of the Cole Memorandum, the FinCEN Guidance has not yet been rescinded. Secretary of the Treasury Steve Mnuchin testified before Congress in February 2018 that the FinCEN Guidance would not be rescinded "without a replacement."[18]

Like the Rohrabacher-Blumenauer Amendment and the Cole Memorandum, the FinCEN Guidance:

- was issued despite the fact that the federal AML law prohibits financial institutions from providing financial services to marijuana-related businesses, and
- does not amend or otherwise impact the federal AML law prohibitions on processing financial transactions involving proceeds of marijuana transaction activity.

Due to risk concerns based on the federal AML law and Controlled Substances Act prohibitions, most banks are still reluctant to provide financial services to marijuana-related businesses, despite the FinCEN Guidance.

Absence of Federal Prudential Bank Regulatory Guidance

Perhaps more importantly, despite FinCEN's efforts at providing guidance for banks to conduct financial services for marijuana-related businesses, FinCEN is not the only — or most significant — federal agency that banks must answer to regarding potential violations of AML law. FinCEN is not a bank regulatory agency. In other words, although FinCEN has authority to issue guidance and make rules on AML issues and to enforce such rules, FinCEN does not charter banks nor does it conduct bank examinations. The federal agencies that charter and/or examine banks are the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), and the Board of Governors of the Federal Reserve System (the Fed), which are collectively referred to as "prudential bank regulatory agencies."

Every state and federally chartered bank is under the jurisdiction of a federal prudential bank regulatory agency, and none of these agencies has officially adopted or endorsed the FinCEN Guidance or issued any similar type of guidance for banks to follow in connection with providing financial services to marijuana-related businesses.

Aside from occasional oral anecdotal references to the FinCEN Guidance, the prudential bank regulatory agencies have not issued any clear, formal guidance on the issue of financial services for marijuana-related businesses.[19] Each agency has made statements in certain limited forums that address marijuana banking issues, and the messages have been mixed. For example:

- The Federal Reserve Bank of Kansas City, one of the 12 Federal Reserve Banks that carry out regulatory supervision and examination of banks and bank holding companies, has taken the position in court that:

  > The manufacture and distribution of marijuana remains illegal under federal law, as does facilitating such actions through the processing of financial transactions with funds derived from marijuana manufacturing and distribution.[20]

- Similarly, at a meeting of the Advisory Committee on Community Banking of the FDIC in 2016, in response to a question from a committee member about banking services for cannabis businesses, an FDIC staffer commented that "as long as there is a conflict between Federal and state law, the FDIC remains bound by Federal law."[21]
- However, at a meeting of the Mutual Savings Association Advisory Committee hosted by the OCC in 2016, a committee member posed a question to an OCC staffer about providing banking services for medical cannabis businesses. In response, the OCC staffer referenced the Cole Memorandum and FinCEN Guidance and responded that, "… it is possible to provide banking services if the right controls are in place."[22]

Aside from occasional oral anecdotal references to the FinCEN Guidance, the prudential bank regulatory agencies have not issued any clear, formal guidance on the issue of financial services for marijuana-related businesses.

Most banks remain reluctant to provide financial services to marijuana-related businesses because they have no concrete guidance for offering those services from the prudential bank regulatory agency that will be visiting them periodically to conduct examinations, including

> Today hemp can be used for a myriad of purposes, ranging from rope and textiles to building materials and composites to certain foods and health products that utilize the cannabidiol (CBD) present in hemp.

examining their compliance with AML laws, such as the AML laws that prohibit conducting financial transactions involving proceeds from marijuana activity.

Carve-out for Certain Parts of Marijuana Plant

The Controlled Substances Act prohibitions related to marijuana do not apply to certain parts of the marijuana plant, but the practical impact of the exemptions for those plant parts is limited.

The definition of *marijuana* in the Controlled Substances Act states that it applies to "all parts of the plant *Cannabis sativa L.*, whether growing or not …"[23] However, despite this language, the definition goes on to exempt certain parts of the plant, most notably, the "mature stalks" and "sterilized seed" of the plant, and certain products derived from those stalks and sterilized seeds.[24]

These definitional carve-outs do not include all parts of the plant. For example, nonsterilized seeds, leaves, and flowers of the plant are not included in the carve-outs. Therefore, the carve-outs do not permit growing any marijuana plants, because growing the plants would necessarily involve nonsterilized seeds, leaves, flowers, and so on. Instead, the carve-outs allow parties in the United States to import the carved-out parts of the plant from foreign jurisdictions, and the carved-out products derived from those parts, without violating the Controlled Substances Act.

In other words, a U.S. resident could import goods made from the carved-out parts of the marijuana plant or import marijuana plant stalks or sterilized seeds to process into the carved-out products. However, such importation and any creation of food or drug products using imported marijuana plant parts or products are subject to U.S. legal restrictions and conditions. State law could also prohibit the marijuana plant parts exempted under the Controlled Substances Act and related products.

The marijuana definitional carve-outs in the Controlled Substances Act appear to have been initially directed at hemp processing and products, many of which are commonly made from the stalk or seeds of the cannabis plant. However, more significant exemptions were added to the federal law in 2014 and 2018 to authorize domestic U.S. hemp growth under certain conditions, as explained below.

HEMP LAW SUMMARY

Hemp is a type of cannabis cultivated for centuries to make rope, using the fibers of the plant's stalk, before the advent of synthetic materials.[25] Today hemp can be used for a myriad of purposes, ranging from rope and textiles to building materials and composites to certain foods and health products that utilize the cannabidiol (CBD) present in hemp.[26]

Legal Distinction Between Hemp and Marijuana

As referenced above, hemp has a very low content of THC, the psychoactive ingredient in marijuana. Specifically, hemp is defined under current federal law as cannabis with a THC concentration of not more than 0.3% on a dry weight basis.[27] Accordingly, hemp (including the CBD in hemp) cannot produce a high feeling, like marijuana, when ingested.

Hemp and marijuana are varieties of the same plant: *Cannabis sativa L.* The two varieties are generally similar in appearance but have certain physical distinctions: hemp plants tend to be taller with a thinner leaf than marijuana plants.[28] However, for U.S. legal purposes, the only distinction between the two varieties is the 0.3% THC content standard.

2014 Farm Bill

For over 40 years, the sale and possession of hemp was prohibited under the Controlled Substances Act because the definition of marijuana under that act was written broadly, to cover all varieties of *Cannabis sativa L.*[29] As explained above, the only significant exemption directed at hemp was for certain parts of the plant and certain products derived from those parts, but these exemptions did not permit growth and cultivation of the plant in the United States.

However, the Agricultural Act of 2014 (the 2014 Farm Bill) created an exemption from the Controlled Substances Act for state-sponsored "pilot programs" for the growth and cultivation of hemp, although the exemption applies only:

- to parties duly licensed by a proper state governmental authority that has established a pilot program consistent with 2014 Farm Bill requirements, and
- if the hemp in question is being grown and cultivated for *research purposes*.[30]

Licensees under the 2014 Farm Bill remained subject to federal laws governing importation of nonsterilized hemp seeds and restricting any drug products created from hemp, such as federal Food and Drug Administration restrictions.[31]

Although the scope of the "research purposes" language

As of April 1, 2019, the USDA had neither established its own hemp licensing and regulatory program nor approved any state hemp licensing and regulatory program.

was not completely clear in the 2014 Farm Bill, several states adopted implementing rules and pilot programs for hemp growth under that law, and they amended their state-controlled substances laws, as necessary, resulting in thousands of acres of legal, state-licensed hemp production under the 2014 Farm Bill.[32]

2018 Farm Bill

In December 2018, the Agricultural Improvement Act of 2018 (the 2018 Farm Bill) implemented an exemption for hemp from the definition of marijuana under the Controlled Substances Act.[33] However, the growth, possession, and sale of hemp are still subject to restrictions under federal and state law. For example, under the 2018 Farm Bill:

- Any state can prohibit hemp activity under state law, in which case hemp will remain illegal in that state.
- Any state that does not prohibit hemp activity under state law can:
  - institute a licensing and regulatory program for hemp activities in compliance with 2018 Farm Bill standards and approved by the U.S. Department of Agriculture (USDA), in which case a licensee can engage in hemp activities pursuant to the terms of that state program, or
  - if the state does not institute its own licensing and regulatory program for hemp activities under the 2018 Farm Bill, the licensing and regulatory program established by the USDA will apply to that state, in which case a licensee under the USDA program can engage in hemp activities pursuant to the terms of that program.[34]
- Any state can limit interstate transfer of hemp through that state until the USDA federal and/or USDA-approved state licensing and regulatory programs for hemp under the 2018 Farm Bill are effective. After these licensing regimes are in place, states cannot limit interstate transfer of duly licensed hemp shipments.[35]

However, as of April 1, 2019, the USDA had neither established its own hemp licensing and regulatory program nor approved any state hemp licensing and regulatory program. Until such licensing and regulatory programs are instituted, hemp cannot be grown, possessed, or sold under the 2018 Farm Bill in any state. In the meantime, licensees under state laws implemented under the 2014 Farm Bill can continue to conduct authorized activities under those laws.

Also, although the 2018 Farm Bill does not include a restriction on the purposes of hemp (such as the "research purposes" restriction in the 2014 Farm Bill), licensees will be subject to federal and state law restrictions on food and drug products created from the hemp and other applicable restrictions, such as restrictions on importing hemp seed.

LEGAL RISKS IN PROVIDING FINANCIAL SERVICES FOR CANNABIS BUSINESSES

Due to the legal issues outlined in this article, providing financial services to cannabis-related businesses – including hemp-related businesses – involves significant risk.

Risks Regarding Financial Services for Hemp-Related Businesses

Although hemp is no longer criminally illegal under the federal Controlled Substances Act:

- possession and sale of hemp may still be criminal under state law;
- the 2018 definitional carve-out for hemp in the Controlled Substances Act is based on the 0.3% THC standard, so any hemp plants that exceed this threshold would be illegal;
- hemp is also subject to other regulations under the 2014 Farm Bill and state implementation laws, and to regulations to be developed under the 2018 Farm Bill and state implementation laws; and
- licensing to grow legally authorized hemp continues to be complicated, with:
  - no state or federal licenses yet available under the 2018 Farm Bill, and
  - 2014 Farm Bill licenses under state pilot programs being limited to growth for "research purposes."

Any financial services provider considering offering financial services to a hemp-related business should review the risks involved, including the ability of the provider to implement an appropriate AML law program and undertake the related costs. An appropriate AML law program would have to address the applicable risks, including but not limited to:

- Initial and ongoing due diligence regarding:
  - the customer's licensing status and legal authority to operate its hemp-related business, as well as its compliance with applicable state and federal hemp law, particularly including the 0.3% THC standard;
  - the customer's business plan, expected sources and uses of funds, and intended business relationships; and
  - whether the customer's business or any other commonly controlled businesses

would involve marijuana or proceeds derived from marijuana;

- Consideration of interstate commerce and transportation issues that may be implicated (in light of state-by-state licensing requirements);
- Risk of crop/product seizure and destruction, as well as risk of seizure of other assets, if hemp laws are violated (e.g., the hemp exceeds the 0.3% THC standard);
- Issues in perfecting and enforcing security interests and in taking possession of hemp as collateral due to the state and federal licensing requirements;
- Consideration of FDA oversight and restrictions that may be applicable to the customer's line of business; and
- Consideration of whether the applicable insurance is adequate to protect against risks.

Risks Regarding Financial Services for Marijuana-Related Businesses

Any financial services provider considering offering financial services to marijuana-related businesses should consult its legal counsel regarding the federal criminal prohibitions and the related direct and indirect risks and costs, including the myriad of issues that could arise in connection with providing financial services to a customer engaging in an activity that is criminally prohibited under federal law.

Financial services providers considering accepting those risks should also consult with their federal and state regulators before making the decision. Even careful execution of related risk mitigation steps will not insulate a financial services provider from the major risks involved in working with marijuana-related customers. As long as marijuana remains federally criminal, these risks will remain, also.

CONCLUSION

Based on the current state of the law, most banking organizations and many other financial services providers are reluctant to assume the risks involved with providing financial services to marijuana-related businesses. Many are similarly leery of providing services to hemp-related businesses.

Unfortunately, as state cannabis laws become more commonplace, many financial companies will find that indirect connections to cannabis-related businesses will be increasingly harder to avoid. For example, a bank in a state with medical or recreational marijuana licensing laws may have a policy not to lend to or take deposits from a state-licensed marijuana grower or dispensary company. However, that same bank may learn that many of its existing customers have relationships with marijuana licensees in which those existing customers are receiving funds from the licensees.

These existing customers may include employees of the licensees, sellers or lessors of equipment or real estate to those licensees, and miscellaneous other service providers for those licensees. Ironically, even local and state governments will likely be in receipt of funds from marijuana licensees in the form of tax and fee payments.

Accordingly, many financial services providers are already finding it hard to avoid some potential exposure to AML law issues based on the federal prohibitions on processing transactions involving funds from marijuana activity.

Obviously, federal legislation is needed to solve the current disconnect between federal prohibitions on marijuana activities and the state laws licensing those same activities. Multiple pieces of federal legislation are currently being considered to provide resolutions to the set of mysterious riddles and enigmas that comprise current U.S. cannabis law.

Accordingly, one of the biggest understatements of 2019 may be Federal Reserve Board Chairman Jerome Powell's quote about U.S. cannabis laws when he testified before Congress in February: "I think it would be great to have clarity.[36]

Endnotes

1. With this quote from a 1939 BBC broadcast, Churchill was actually referring to the potential action of the Soviet Union at the outset of World War II. See The Churchill Society, "The Russian Enigma Broadcast," available at www.churchill-society-london.org.uk/RusnEnig.html.

2. The spelling *marihuana* is used in the federal Controlled Substances Act (see 21 USC Sec. 802(16)) and certain other laws, rules, and government policies, rather than the more common *marijuana* spelling. This article uses only the more widely accepted *marijuana* spelling.

3. See, e.g., 21 USC Sec. 802(16) and 7 USC Sec. 1639o(1).

4. Ibid. The term *hemp* as used in this article refers only to "hemp" as defined in 21 USC Sec. 802(16) and 7 USC Sec. 1639o(1), which is the variety of *Cannabis sativa L.* with a THC concentration of not more than 0.3% on a dry weight basis.

5. See 21 USC Sec. 841(a) and 12 CFR Sec. 1308 *et seq*. Marijuana is classified by the U.S. Drug Enforcement Administration as a Schedule 1 controlled substance.

6. 18 USC secs. 1956 and 1957.

7. 18 USC Sec. 2(a) and 21 USC Sec. 846.

8. See the website of the Conference of State Bank Supervisors at www.csbs.org/marijuana-state-state-policy-map.

9. See, e.g., Chapter 69.50 Revised Code of Washington.

10. See, e.g., https://dfi.wa.gov/documents/banks/marijuana-faqs.pdf and https://dfi.wa.gov/banks/marijuana.

11. *Gonzales v. Raich*, 545 US 1 (2005).

12. See, e.g., Consolidated Appropriations Act, 2018, Pub. L. No. 115-141, 132 Stat. 348.

13. Ibid.

14. James M. Cole, Deputy Attorney General, U.S. Department of Justice, "Memorandum for All United States Attorneys: Guidance Regarding Marijuana Enforcement" (August 29, 2013), available at www.justice.gov/iso/opa/resources/3052013829132756857467.pdf; James M. Cole, Deputy Attorney General, U.S. Department of Justice, "Memorandum for All United States Attorneys: Guidance Regarding Marijuana Related Financial Crimes" (February 14, 2014).

15. Jefferson B. Sessions III, Attorney General, U.S. Department of Justice, "Memorandum for All United States Attorneys: Marijuana Enforcement" (January 4, 2018).

16. See, e.g., Letter from William P. Barr (current U.S. Attorney General, then nominee) to Lindsey Graham, Chairman, U.S. Senate Committee on the Judiciary, and Dianne Feinstein, Ranking Member, U.S. Senate Committee on the Judiciary (January 27, 2019); Department of Justice, U.S. Attorney's Office, Eastern District of Washington, "Federal Marijuana Enforcement Policy," news release (January 5, 2018).

17. Financial Crimes Enforcement Network Guidance, "BSA Expectations Regarding Marijuana-Related Businesses," FIN-2104-G001 (February 14, 2014).

18. Tom Angell, "Trump Treasury Secretary Wants Marijuana Money in Banks," *Forbes* (February 6, 2018).

19. See, e.g., presentations by staff members of the OCC, FDIC, and Federal Reserve Bank of Kansas City at the Missouri Bankers Association Marijuana Banking Seminar, Columbia, Missouri (March 20, 2019).

20. See Answer Brief of Appellee at 12, *The Fourth Corner Credit Union v. Federal Reserve Bank of Kansas City*, 861 F.3d 1052 (10th Cir. 2017) (No. 16-1016). This document was filed July 5, 2016.

21. Minutes from FDIC Meeting of the Advisory Committee on Community Banking (November 3, 2016).

22. Minutes from OCC Meeting of the Mutual Savings Association Advisory Committee (August 3, 2016).

23. 21 USC § 802(16).

24. Ibid.

25. "Industrial Hemp in the United States: Status and Market Potential," U.S. Department of Agriculture, Economic Research Service (January 2000).

26. Ibid.

27. See, e.g., 21 USC Sec. 802(16) and 7 USC Sec. 1639o(1).

28. Jeremy Berke, "Mitch McConnell Wants to Legalize Hemp – Here's How It's Different from Marijuana," *Business Insider* (March 27, 2018). Note that, by analogy, the differences in these two varieties of *Cannabis sativa L.* could be seen as similar to the differences in various breeds of dogs, all of which are *Canis familiaris*.

29. See "FDA Regulation of Cannabis and Cannabis-Derived Products: Questions and Answers," U.S. Food and Drug Administration, available at www.fda.gov/newsevents/publichealthfocus/ucm421168.htm#whatare.

30. Agricultural Act of 2014, P.L. 113-79, Sec. 7606; 81 Fed. Reg. 53395 (August 12, 2016).

31. Ibid.

32. See, e.g., "2018 Farm Bill Provides A Path Forward for Industrial Hemp," American Farm Bureau Federation (February 28, 2019), available at www.fb.org/market-intel/2018-farm-bill-provides-a-path-forward-for-industrial-hemp.

33. Agriculture Improvement Act of 2018, P.L. 115-334.

34. Ibid.; see also "Agriculture Improvement Act of 2018: Highlights and Implications," U.S. Department of Agriculture, Economic Research Service (February 25, 2019), and "The 2018 Farm Bill (P.L.115-334): Summary and Side-by-Side Comparison," Congressional Research Service (February 22, 2019).

35. *Big Sky Scientific LLC v. Idaho State Police*, 2019 WL 438336 (D. Idaho 2019).

36. "Federal Reserve Head Calls for Clarity on Marijuana Banking Issues," *Boston Globe* (February 26, 2019).

Gregory D. Omer
gdomer@thompsoncoburn.com

Gregory D. Omer is a partner with Thompson Coburn LLP in St. Louis, Missouri. He represents nationwide banking organizations, as well as regional and community banks, in a broad-based regulatory practice, focusing in the areas of banking, financial services, and corporate matters. His practice also involves representation of loan companies, money services businesses, and various other types of financial service providers. Mr. Omer chairs the American Bar Association State Banking Law Developments Subcommittee and has previously served as chair of both the Missouri Bankers Association Legal Advisory Board and Missouri Bank Regulatory Reform Task Force. He is also the former chief counsel of the Missouri state bank and financial services regulatory agency. He regularly speaks and writes on developing issues in banking law and has served as an expert witness and a law school lecturer on banking law topics. Mr. Omer graduated from the University of Missouri School of Journalism, Columbia, magna cum laude and from Duke University School of Law in Durham, North Carolina.

A Valentine's Day Massacre of Liquidated Damages: *In re Republic Airways Holdings Inc.*

By Arlene N. Gelman and Edward K. Gross

A bankruptcy court ruling in New York this year could be problematic for lessors when enforcing certain typical acceleration and collection remedies against defaulting customers. Specifically, *In re Republic Airways Holdings Inc.* may impair the reliability of SLV-based liquidated damages provisions even in hell-or-high-water leases and guaranties of those obligations under unconditional and absolute guaranties. The authors will explain why they believe that the court erred, and discuss the enforcement and transactional implications to lessors.

Enforceable liquidated damages remedies are among the most essential provisions in many of the lease forms used by industry participants when documenting equipment financings and refinancings. On Valentine's Day 2019, the United States Bankruptcy Court for the Southern District New York issued an opinion in which it refused to enforce both an agreement by a lessee in a hell-or-high-water lease to pay liquidated damages to the lessor, as well as a guarantor's absolute and unconditional guarantee of that obligation.[1]

It is important that equipment lessors understand the implications of this bankruptcy court holding because it is likely to be considered by other courts when deciding the enforceability of similar liquidated damages remedies or raised by lessees after default or when negotiating lease documents that include these provisions. Should other courts follow this case, it could affect the credit underwriting, pricing, asset management, documentation, and other functions associated with deal origination, as well as having legal implications to transactional, enforcement, and bankruptcy lawyers who frequently represent equipment finance providers.

The court's opinion related to a motion for summary judgment (SJM) with respect to objections by Republic Airways Holdings Inc., et al. (Republic or the debtors) to claims filed by Wells Fargo Bank Northwest, N.A., as owner trustee, and ALF VI Inc. as owner participant (Residco), in connection with Republic's Chapter 11 bankruptcy case. Residco's claims included liquidated damages and other amounts resulting from Republic's rejection of seven commercial aircraft leases.[2]

Republic's SJM raised two major issues for the court to consider:

> (i) whether the liquidated damages provisions in the leases violate Article 2A of the New York Uniform Commercial Code and are therefore unenforceable as against public policy, and (ii) if so, whether the guarantor of the obligations in the leases is nevertheless liable to pay the otherwise unenforceable liquidated damages.[3]

By its opinion, the court granted Republic's SJM, finding that the liquidated damages provisions in the rejected leases were unenforceable against both the Republic lessee and guarantor because the court believed that these provisions violated the UCC Sec. 2A-504 requirement that a liquidated damages formula must be "reasonable in light of the then-anticipated harm from default."[4]

The authors of this article believe that the court's findings were based on misinterpretations or mischaracterizations of the applicable statutory and case law, as discussed below. Although the Bankruptcy Court's opinion is nonbinding on future litigants, there are concerns that this issue will reappear in other litigation or during negotiations and undermine lessors' reliance on standard and essential enforcement remedies. Accordingly, it is important that arguments similar to those made by Republic continue to be challenged by lessor parties seeking to enforce their liquidated damages provisions.

We will discuss the *Republic* case below, explain the relevant commercial laws and why we believe that this court erred in its legal analysis, and suggest strategies that might ameliorate the implications of this case.

> The liquidated damages formula is carefully calculated, scrutinized, and ultimately agreed upon, as documented in the lease by the parties. By entering into the lease, both the lessee and the lessor are documenting their mutual agreement to be bound by and have the benefit of these terms.

CERTAINTY OF PAYMENT IS ESSENTIAL TO A LESSOR'S WILLINGNESS TO INVEST

Ask most credit officers in the equipment finance industry and they will agree that the exit strategy contemplated in any credit-approved equipment finance transaction must include a remedy entitling the lessor to demand payment by the lessee of an amount calculated so that the lessor recovers its investment plus anticipated yield in the event of a default during the lease term.

Accordingly, most lease forms include some version of a liquidated damages remedy by which the lessor may, upon a default, demand and recover from the lessee an amount that will allow the lessor to achieve the benefit of its bargain, as contemplated at lease commencement. Lessors and lessees agree to liquidated damages to avoid any uncertainty that a court might award a lessor an amount that is unexpectedly lower or higher than the parties contemplated when they entered into the lease.

As is the case with all of the other economic terms in leases entered into for the purpose of providing acquisition financing or refinancing of a lessee's capital equipment, the liquidated damages formula is carefully calculated, scrutinized, and ultimately agreed upon, as documented in the lease by the parties. By entering into the lease, both the lessee and the lessor are documenting their mutual agreement to be bound by and have the benefit of these terms.

Further, the certainty that this agreed amount will be paid, as calculated, is often supported by other provisions in the lease documents, including, among others, the lessee's promise to pay all amounts due under the lease without defense or other abatement (i.e., hell or high water), and the lessee's representation that the lease is enforceable in accordance with its terms.

With respect to lease transactions supported by a guaranty, the guarantor is required to confirm that the guarantor will unconditionally guaranty the payment of all amounts payable under the lease, irrespective of any defense or claim, including any claim that the lease documents were unenforceable.

Lessors rely on the enforceability of these promises when deciding whether they will provide financing requested by the customer. Applicable law, including the UCC, interpretive cases, and other commercial laws, recognizes that sophisticated parties to commercial transactions, especially if represented by counsel, understand the implications of their promises regarding, among other things, liquidated damages and unconditional guaranties, and further understand that the UCC should not impede their freedom to bind themselves by contract to make those promises and guaranties.

If these expectations are undermined by courts choosing to ignore applicable statutory and case law and scholarly commentary, the result could include an erosion of the available lease financing or refinancing being offered to large and small businesses.

THE LAW SUPPORTS ENFORCEMENT OF LIQUIDATED DAMAGES REMEDIES IN LEASES

UCC Sec. 2A-503 (et al.): Freedom of Contract

Prior to the adoption of UCC 2A,[5] parties to lease transactions, and courts asked to resolve disputes between such parties, relied on general contract law and lease-related cases with respect to the pertinent lease terms.[6] Article 2A was a departure from both the case law and the analogous provisions of the other UCC articles that were templates for many UCC 2A provisions.

Although UCC 2A is applicable only to transactions constituting "true" leases,[7] the drafters of UCC 2A looked to provisions of UCC 2 (sales) and UCC 9 (secured transactions) for guidance regarding what they believed to be appropriately correlative matters. Many UCC 2A provisions relating to commercial (not consumer) leases are lessor favorable,[8] particularly the statutory rights afforded a lessor under a lease constituting a UCC-2A "finance lease" pursuant to UCC Sec. 2A-103(1)(g).

The lessor-favorable provisions of UCC 2A afford lessors in true lease equipment financings and refinancings the expectation that, as to most matters occurring prior to lease expiration and return of the related equipment, lessors will recover their investments, without defense or abatement.[9]

The provisions of UCC 2A also generally permit the parties to agree to lease terms that modify, supplement, or are otherwise inconsistent with the correlative provisions of UCC 2A, subject to certain conditions.[10] The Article 2A drafters noted in the relevant official comments their intent to codify leasing parties' freedom of contract.[11] This freedom of contract allows the parties to bargain for the various rights, remedies, risks, and burdens, without concern that a court might interfere with the commercial judgment of the parties as reflected in the terms and conditions of a lease.[12]

The freedom of contract afforded to both lessors and lessees promotes lease financing of capital equipment pursuant to terms bargained for by the parties. These bargained-for terms often reflect the circumstances in which the parties find themselves, including among others, the then-market conditions, credit and asset-specific considerations, and other matters pertinent to their respective decisions to enter into the subject lease transaction.

The drafters of Article 2A clearly appreciated the role of effective default and remedy provisions in equipment lease transactions, respecting the judgment of the parties to craft provisions that aligned with the business realities of these transactions. For example, although UCC Sec. 2A-523(1) lists certain statutory events of default, UCC 2A defers to the parties to rely instead on negotiated default triggers to be included in their lease documents.[13]

By doing so, Article 2A left it to the parties to determine with appropriate specificity what events might, with or without notice or cure periods, constitute defaults and give rise to statutory or negotiated remedies. This deference by the Article 2A drafters allowed leasing parties to cover not only the typical payment or other defaults or breaches, but also defaults relating to customer-related credit or corporate matters, equipment-specific matters, or other events or circumstances contemplated in the internal credit approval underlying the lessor's willingness to enter into the transaction.

Among the most important remedies to a lessor after the occurrence of a material payment or performance default are the rights to cancel the lease,[14] recover possession of the leased equipment,[15] and demand that the lessee pay damages in an amount that will, collectively, allow the lessor to achieve the benefit of its bargain as contemplated when it entered into the lease.[16]

Although UCC 2A provides a lessor with various fact-based damages remedies that may be exercised upon a lessee's default,[17] most lease documents include damages remedies that are consistent with the economics and market practices relating to the contemplated lease transaction, and such additional or substituted remedies are also allowable under Article 2A.[18] Pursuant to UCC Sec. 2A-503(1), leasing parties may agree to include in their lease documents similar or different default remedies from those provided by statute in UCC 2A.[19]

Of course, the enforceability of negotiated, nonstatutory remedies is still subject to the prohibition in UCC Sec. 2A-108 against unconscionable terms.[20] But, as noted by White and Summers, "the drafters continued to respect leasing parties' freedom of contract by allowing courts to sever any unconscionable term (as opposed to voiding the lease or even a single lease provision in its entirety)."[21]

Similarly, UCC Sec. 2A-504(2) allows a lessor to exercise the other remedies available under UCC 2A if the liquidated damages provision does not comply with UCC 2-A-504(1), or if it is "an exclusive or limited remedy that circumstances cause to fail of its essential purpose."[22]

UCC Sec. 2A-504: Liquidated Damages

Among the provisions both relied upon by lessors for certainty of payment and supporting the parties' freedom of contract flexibility is UCC 2A-504. As was the case with Article 2 in the context of contracts for the sale of equipment, inventory, and other "goods,"[23] Article 2A drafters chose to expressly support the validity of liquidated damage remedies in leases by including UCC 2A-504(1).

This statutory recognition of liquidated damages in leases was similar to, but meaningfully different from, the correlative UCC 2 coverage of liquidated damages, and reads as follows (emphasis added):

> *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.*[24]

The differences between the drafters' approach to UCC 2 and UCC 2A liquidated damages remedies are obvious when comparing the text of UCC 2-718 and UCC 2A-504. As noted above, the drafters of UCC 2A-504 chose a more transactional approach regard-

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Of particular relevance to the *Republic* case is the recognition in the official comments that it is common leasing practice for the parties to rely on liquidated damages that include a residual value component.

ing liquidated damages than was the case with the much more restrictive statutory liquidated damages provisions of UCC 2-718,[25] including the requirements in UCC 2-718 regarding the "difficulties of proof of loss and inconvenience or nonfeasibility of otherwise obtaining an adequate remedy."[26]

As explained by the drafters, "[m]any leasing transactions are predicated on the parties' ability to agree to an appropriate amount of damages or formula for damages in the event of default or other act or omission" and UCC 2A-504(1) "has created a revised rule that allows greater flexibility with respect to leases of goods."[27] The Article 2A drafters further explained the decision to exclude the more restrictive Article 2 tests as follows: "The ability to liquidate damages is critical to modern leasing practice; given the parties' freedom to contract at common law, the policy behind retaining these two additional requirements here was thought to be outweighed."[28]

As drafted, UCC 2A-504 purposefully excludes the more restrictive tests in UCC 2-718 and in (non-UCC 2A) common law,[29] instead allowing leasing parties to use their *reasonable* commercial judgment when determining at lease commencement the damages recoverable by the lessor if the lessee fails to pay or perform as promised, or the lessor suffers the existence of some other default, under the lease.[30]

Consistent with the notion that the parties should have the freedom to bargain for a reasonable liquidated damages formula or other calculation methodology for their transaction, the provisions of UCC 2A-504 do not specify what may or may not be a valid liquidated damages formula or other calculation methodology applicable to all or any specific types of lease transactions.

However, the official comments to UCC 2A-504 do provide examples of common liquidated damages formulas, without endorsing or criticizing any of them.[31] Per Official Comment 3:

> A liquidated damages formula that is common in leasing practice provides that the sum of lease payments past due, accelerated future lease payments, and the lessor's estimated residual interest, less the net proceeds of disposition (whether by sale or re-lease) of the leased goods is the lessor's damages. Tax indemnities, costs, interest and attorney's fees are also added to determine the lessor's damages.
>
> Another common liquidated damages formula utilizes a periodic depreciation allocation as a credit to the aforesaid amount in mitigation of a lessor's damages. A third formula provides for a fixed number of periodic payments as a means of liquidating damages. Stipulated loss or stipulated damage schedules are also common.
>
> Whether these formulae are enforceable will be determined in the context of each case by applying a standard of reasonableness in light of the harm anticipated when the formula was agreed to.[32]

Of particular relevance to the *Republic* case is the recognition in the official comments that it is common leasing practice for the parties to rely on liquidated damages that include a residual value component.[33]

Stipulated Loss Value-based Liquidated Damages Provisions

As noted in the above-referenced official comments, UCC 2A-504 does not endorse a particular formulation for what might constitute a liquidated damages amount or formula that is "reasonable in light of the then anticipated harm caused by the default or other act or omission."[34]

Most leases include default-triggered damages remedies by which the lessor may demand payment from the lessee of damage amounts. These amounts often include some or all of: all accrued and unpaid rent and other amounts payable on or prior to the date of the lessor's demand, together with tax and other indemnification payments, amounts attributable to specific breaches, and enforcement-related costs. However, the component in lease damages remedies that is most often litigated relates to stipulated amounts or formulas that are intended to approximate at the point of determination the amounts the lessor expected to receive had the lease not been canceled or terminated prior to its scheduled expiration.

There are two primary types of these stipulated acceleration damages. One type would require a lessee to pay all unaccrued rent, discounted to present value by a reasonable discount rate, less (net) actual or market rent for the coterminous re-lease term, discounted by the same discount rate. The other type includes both the accelerated rent amount and a residual value component, reduced by the (net) sales proceeds or market sales value of the leased equipment.

This residual value component is often specified in the lease or in a schedule or other attachment to the lease, as a specific amount or as a percentage of the purchase price and other amounts paid or "financed" by the lessor in connection with its acquisition and leasing of the equipment. The stipulated amount or percentage will in most cases correlate to a scheduled rent payment date and decline incrementally from commencement until the scheduled expiration of the lease.

A typical specified or formula-derived amount[35] will, as of each correlative rent payment date, approximate the aggregate of the remaining periodic rent payments and anticipated residual value (each discounted to present value at an agreed discount rate), any assumed but unrealized tax benefits, and, perhaps, a prepayment or other similar consequential damages charge.

However, in a "true" lease, the last scheduled amount or percentage corresponding with the lease expiry date should approximate the meaningful (i.e., neither fully amortizing nor nominal) residual value anticipated by the parties at lease commencement.

These specified or formula-derived amounts are often referenced as *stipulated loss value or casualty value* (SLV) amounts because they are also relied upon by the parties to determine the amount to be paid by the lessee or casualty insurer in the event that an item of equipment is destroyed, damaged beyond repair, or stolen, or the item suffers some other casualty. The parties may also rely on these amounts in connection with an early termination or purchase option relating to the leased equipment.

As discussed below, the liquidated damages formula in the *Republic* leases included an SLV-based component obligating the lessee to pay, among other amounts, the difference between the residual equipment value anticipated by the parties at lease commencement (discounted to present value), less the actual equipment value at the time of the disposition.

In *Republic*, the debtors argued that this formula component was inherently unenforceable as an unreasonable allocation to Republic of market value risk. The court agreed, even though the parties mutually accepted and relied upon the related SLV calculations and independent appraiser's estimation of the actual market value with respect to each aircraft during and after the terms of their leases.[36]

Pertinent Liquidated Damages Cases

State law governs the enforceability of a liquidated damages provision in a lease, whether being considered in a bankruptcy or other federal court or in a state court.[37] In numerous cases, courts have been asked to consider, under the laws of a particular state, the enforceability of liquidated damages provisions in leases.

These cases cover a broad spectrum of transactional circumstances, including asset types, sophistication of the lessee, amounts claimed, bankruptcy or nonbankruptcy courts, and liquidated damage formula components.[38]

In *Republic*, the parties to the leases mutually agreed that New York law would govern the transactions, so the most relevant cases to be considered by the *Republic* court would be cases in which SLV-based liquidated damages provisions similar to those found in the *Republic* leases have been tested under the current New York law (i.e., UCC Sec. 2A-504).

Case Law Addressing SLV-based Liquidated Damages Claims

Numerous courts have enforced liquidated damages provisions containing a residual interest component (whether applying pre- or post-Article 2A law).[39] Indeed, at least one court noted that the enforceability of such a common SLV liquidated damages formula was evidenced by "the fact that it is just such provision contemplated by the drafters of Section 2A-504."[40]

Courts have also refused to enforce SLV liquidated damages provisions after determining that these liquidated damages provisions failed UCC Sec. 504(1)'s reasonableness test. For instance, courts have refused to enforce SLV liquidated damages provisions that either did not decline at all or failed to decline at a rate the court deemed sufficient so as to satisfy the reasonableness test in UCC Sec. 504.[41] In addition, courts have rejected liquidated damages provisions that result in a windfall or double counting for the lessor.[42]

However, there are few notable cases that have stricken SLV liquidated damages provisions, even though such provisions did not contravene Article 2A standards. These cases, which have been cited by other courts (including the court in *Republic*) as persuasive or precedential authority,[43] should be carefully scrutinized. *Interface Grp.-Nevada v. TWA (In re TWA)*[44] and In re *Montgomery Ward Holding Corp.*[45] are two such cases.

Similar to the circumstances in *Republic*, in *TWA*, the value of the leased equipment unexpectedly and significantly declined between the time of lease formation and the breach triggering the leases' liquidated damages provisions.

Similar to the circumstances in *Republic*, in *TWA*, the value of the leased equipment unexpectedly and significantly declined between the time of lease formation and the breach triggering the leases' liquidated damages provisions.[46] Unlike *Republic*, the facts of *TWA* (all of which occurred prior to 1994[47]) required the application of pre-Article 2A standards, including standards that the Article 2A drafters purposefully rejected.

The history of the related transactions was long and complicated by the time that the debtors filed Chapter 11 in 2016.

For example, Article 2A rejected the uncertainty and proportionality tests that clearly guided the *TWA* court's holding. Indeed, the *TWA* court's discussion of market risk shift is sandwiched between the Third Circuit complaining that the lessor (a) "never explained to this court, and certainly not to the satisfaction of the bankruptcy court, why actual damages could not be ascertained upon breach" and (b) "would have [the Court] disregard the requirement of proportionality because *TWA* expressly agreed to the formula as valid and enforceable." In that regard, the *TWA* decision has been statutorily overruled by Article 2A.

In addition, there are several reasons why *Montgomery Ward* also fails to support striking properly drafted SLV-based liquidated damages provisions. First, it appears that the "casualty value" component in the liquidated damages provision in that case declined yearly.[48] A reasonable estimate of the anticipated residual value for various types of equipment would take into account that the value of such equipment changes at a faster rate than on a yearly basis.

Second, and more importantly, the Third Circuit agreed that anticipated residual value of leased equipment is a measure of damages properly recoverable by a lessor and ultimately determined that the amount the lessor in *Montgomery Ward*

> was entitled to receive [was] the sum of (1) the amount of any unpaid rent, (2) the present value at the time of breach of the monthly rentals for the then-remaining 10 months of the leases, and (3) the then-present value of what would have been, when the lease terms began, the anticipated aggregate residual value of the leased equipment at the scheduled termination of the leases.[49]

As such, and despite contrary opinion commentary, the *Montgomery Ward* decision actually *supports* enforcing liquidated damages provisions including the above three components, as was the case with the *Republic* leases.

With all the above statutory and case law background in mind, we now turn to the specific facts and holding of the *Republic* case.

THE REPUBLIC CASE

The Pertinent Facts[50]

The history of the related transactions was long and complicated by the time that the debtors filed Chapter 11 in 2016. Some pertinent details regarding the transaction history are summarized below.

The Original Leases

The original leases related to sale-leaseback transactions entered into between June 2001 through November 2003, pursuant to which Wells Fargo Bank Northwest, N.A., as the owner trustee, and Mitsui & Co. (U.S.A.), Inc. (Mitsui), as original owner participant, purchased from Embraer-Empresa Brasileira de Aeronautica S.A. (Embraer) seven Embraer ERJ 145 aircraft and concurrently leased these aircraft to the Republic lessee (the Lessee) pursuant to seven lease transactions.

In sum, these were sale-leaseback transactions in which the Lessor funded the full purchase price for the aircraft and agreed to lease the aircraft back to the Lessee.

Base Pricing Model

The Lessee was a sophisticated party and represented by counsel experienced in aircraft transactions and sophisticated financial advisors. These financial advisors for the Lessee developed and negotiated the pertinent financial terms and provisions including the base pricing model (BPM) used to calculate the scheduled periodic rent (the basic rent) and the scheduled stipulated loss value amounts used for all seven original leases.

Based on the base pricing model, the calculation of the basic rent and stipulated loss value took into account the following:

(a) the amount to be financed by the Lessor,[51] including the sum of (i) the purchase price for each aircraft and (ii) the fees for the Lessee's financial advisor (the financed amount);

(b) the basic rent amounts will, if timely paid, cause the financed amount to amortize down to an agreed residual amount supported by an independent appraisal of the forward-looking estimated value of the aircraft at the end of the lease term; and

(c) interest accruing on the outstanding amount of the financing amount at the rate of 4% (on an after-tax basis).

At any point in time (e.g., on the date of a casualty or an event of default), the stipulated loss value specified in each of the original leases represented the related financed amount as amortizing down to the residual amount, together with an amount to compensate the Lessor for any failure to achieve its anticipated income tax benefits as a result of an early termination of that original lease. (Such amount is termed the *unpaid lease financing amount,* or ULFA.)

By agreement among all the parties, the base pricing model set forth a zero-sum equation in which the unpaid lease financing amount would be repaid to the Lessor in all circumstances upon a default by the Lessee. Accordingly, if the lease was terminated or canceled prior to the expiration of the lease term, the Lessor would be repaid the unpaid lease financing amount during the term from a combination of the basic rent payment prior to the early termination or cancellation date and the SLV calculated as of such early termination or cancellation date.

Also, if the lease was not earlier canceled or terminated, the Lessor expected to receive full repayment of the financed amount from a combination of the basic rent payment through the expiration of the lease term, and the net sales proceeds of the aircraft, which the parties all assumed would be no less than the residual amount.

The Residual Value

The residual value assumption by the parties was based on the expected future values published by AVITAS. When calculating the base pricing model for use in the determining the basic rent and SLV in each of the original leases, the parties relied upon the expected values for ERJ 145 aircraft for 20 years estimated by AVITAS in its bluebooks for aircraft market value, published at about the same time as the commencement of the leases.

The Lessor retained AVITAS to prepare a report that summarized the future-looking valuations determined by AVITAS at the start of the original leases for the expected values of the aircraft at the expiration of the leases. The parties took a conservative approach when determining the residual amount value for each of the aircraft, setting it at an amount that was expected to be materially less than the future-looking value expected to exist at the end of term for each of the leases based on the AVITAS valuations.

Assumed Recovery of the ULFA

The agreement among the parties that the economic terms of the original leases and other related transaction documents would allow the Lessor to recover the unpaid lease financing amount was consistently reflected in the pertinent provisions of these documents.

For example, the SLV of the aircraft at any given time prior to the expiration of the lease term was equal to the ULFA determined as of the applicable date. (That is, the original financed amount, less a credit for the basic rent payments made on or prior to that date, increased by a 4% after tax interest accrual on the unpaid balance, as adjusted by tax attributes.)

The SLV was used to determine the amount payable to the Lessor upon the occurrence of a casualty to the aircraft, the required casualty insurance coverage amount, the early purchase and termination options, and in the liquidated damages remedy. In the context of the liquidated damages remedy, not only was the SLV component calculated to achieve that purpose but so was the pre-lease expiry allocation of risk to the Lessee regarding a market value diminution of the aircraft, as later discussed.

Manufacturer Support

Embraer originally provided two forms of support to Mitsui as the original owner participant, including the deficiency agreements and the residual value guarantees. The deficiency agreements provided a limited protection for damages arising from events of default during the term of the associated lease, and the residual value guarantees provided a limited protection for damages arising due to a loss in value of the aircraft, assuming the associated lease was not canceled or terminated prior to its scheduled expiration date.

The 2012 Amendments

In connection with a restructuring of the original leases, the parties entered into various related agreements in 2012, including amendments to the original leases (the 2012 Amendments), a financial support agreement, a guarantee, and a reimbursement agreement. The 2012 Amendments amended certain provisions of the original leases, including adjustments to the scheduled periodic rent payments (the basic rent) and the return conditions, but no changes were made to the SLV tables or the liquidated damage amounts.

The restructuring included not only the 2012 Amendments but also:

(a) Mitsui agreed to rent concessions,

(b) Embraer agreed, pursuant to the reimbursement agreement, to pay certain amounts to Mitsui with respect to each aircraft, and

(c) the Lessee's parent corporation (Republic Airways Holdings Inc. or RAH) entered into a guarantee of the original leases as amended by the 2012 Amendments.

> **The 2012 Amendments amended certain provisions of the original leases, but no changes were made to the SLV tables or the liquidated damage amounts.**

The 2013 Amendments and Restatement

The parties further amended the original leases (including the 2012 Amendments) by entering into amended and restated leases for each aircraft in 2013. Very few of the original lease terms were revised. Although the leases both eliminated the reimbursement structure implemented in connection with the 2012 Amendments and preserved the adjustments to the basic rent, the SLV, the

The Leases were "true" leases under UCC Sec. 1-203 and constituted "finance" leases within the meaning of Article 2A.

liquidated damages remedies, and the other economic terms of the original leases remained unchanged.

The 2014 Assignment to Residco

In 2014 Mitsui assigned its owner participant interest in the aircraft and the leases to Residco, which became the owner participant. In connection with the assignment, RAH issued the same form of guarantees to Residco and the owner trustee as were provided in 2012 for the benefit of Mitsui and the owner trustee, and the Lessee executed lessee consent letters (one for each aircraft) for the benefit of the lessor parties.

Under the Lessee consents, the lessee specifically confirmed to the lessor parties that, among other things, each of the leases "shall continue in full force and effect as the legal, valid and binding obligations of the … Lessee enforceable in accordance with its terms."

The *Republic* Leases as Amended (the Leases)

The Leases were "true" leases under UCC Sec. 1-203 and constituted "finance" leases within the meaning of Article 2A. Among other pertinent terms, the Leases included:

(a) hell-or-high-water promises by the Lessee to pay any amount of "rent" (which includes both basic rent and SLV) when due and without defense or offset,

(b) Lessee representations and warranties that the original leases and other operative documents were "enforceable in accordance with their respective terms" such that the remedies would be adequate for the "substantial realization of the benefits" provided under such operative documents, and

(c) stipulations that the Leases were to be governed by New York law.

Each of the Leases included identical liquidated damages remedies by which the Lessor could demand that the Lessee pay, in addition to any unpaid basic rent for the aircraft, liquidated damages "for loss of bargain and not as a penalty (in lieu of basic rent payable for the period commencing after the date specified for payment in such notice)."

The liquidated damage formulas in the Leases included damages remedies entitling the Lessor to demand: (A) the sum of (1) unpaid basic rent due prior to the exercise of remedies, plus (2) the stipulated loss value (calculated as of such date), minus (3) the then "fair market sales value" (as defined in the leases), together with (B) all out-of-pocket enforcement costs and costs associated with exercising control over and disposing the aircraft.

The SLVs for each aircraft, correlating to each month of the Lease term, were set out in schedules to each of the Leases. The scheduled SLV amount for the first month is equal to the purchase price plus related transaction expenses for each aircraft.

As noted by the court, over the term of each Lease, "the SLVs adjust on a month-to-month basis such that, after accounting for monthly payments of basic rent and tax benefits, they are always equal to the amount that provides the lessor with a four percent return on the Aircraft purchase."[52] Upon expiration of the term, "the SLV equals the residual value that Lessor needs to realize from the Aircraft for its four percent return."[53]

The Guaranties

As previously noted, RAH entered into the guarantees in favor of the Lessor, pursuant to which RAH unconditionally and absolutely guaranteed the Lessee's obligations under each of the Leases. Each of the guarantees included all of the usual waivers of defenses, acknowledgments, and other provisions supporting the unassailable nature of RAH's guarantees of payment and performance under all circumstances. Among RAH's waivers and acknowledgments provided in each guaranty was the following:

> Guarantor understands and agrees that its obligations hereunder shall be continuing, absolute and unconditional without regard to, and Guarantor hereby waives any defense to, or right to seek a discharge of, its obligations hereunder with respect to the validity, legality, regularity or enforceability of any Operative Agreement, any of the Obligations or any collateral security therefor or guarantee with respect thereto at any time or from time to time held by any Guaranteed Party or any other circumstances whatsoever (with or without notice to or knowledge of [Lessee] or Guarantor) that constitutes, or might be construed to constitute, an equitable or legal discharge of [Lessee] or the Obligations or of Guarantor under this Guarantee (other than payment and performance of the Obligations in full).[54]

The Bankruptcy, Claims, and Objections

The debtors filed Chapter 11 petitions in the U.S. Bankruptcy Court for the Southern District of New York in February 2016. Soon after that, the debtors and Residco entered into a Section 1110 Stipulation, pursuant to which the debtors returned the aircraft and rejected the Leases between April 2016 and October 2016. Given the then-market conditions associated with ERJ 145 aircraft, including the saturation of the market caused by Republic having rejected a significant number of its leases of such aircraft, the aircraft's actual value at the time of the debtors' lease rejection was significantly less than the parties anticipated at lease formation.

Residco filed proofs of claim aggregating over $55 million relating to the Leases and guarantees for alleged damages arising from Republic having rejected the Leases, a large part of which consisted of the anticipated residual value as reflected in the Leases' SLV liquidated damages formula.[55]

The debtors filed objections to Residco's claims, arguing that the actual lease-rejection losses were "readily calculable" and aggregated only $5.7 million.[56] The debtors ultimately filed their SJM, which was countered by Residco's opposition.

Republic's SJM
In their SJM, Republic asked the court to grant it a summary judgment denying Residco's liquidated damages claims, based on Republic's argument that (a) the Leases' liquidated damages provisions were unenforceable as against public policy because they violate Article 2A, and (b) because the liquidated damages remedies under the Leases were unenforceable, Residco's claims for such damages against the guarantor were also unenforceable.[57]

Residco's Opposition
In its objection to Republic's SJM, Residco countered Republic's assertions by arguing that the liquidated damages claims should be enforced because, among other things, voiding the liquidated damages provisions would violate the parties' freedom to contract, especially given the parties' sophistication and the complex nature of the underlying Article 2A "finance" leases.[58]

Further, with respect to the guarantees, Residco argued that under New York state law, the guarantees were "irrevocable" and "ironclad," and therefore RAH waived its right to any defense, including any defenses based on public policy.

The Court's Holding
After considering the arguments by both parties, the court granted Republic's SJM, finding that "the liquidated damages provisions in these leases are unenforceable because they violate Article 2A's requirement that they be reasonable in light of the then-anticipated harm from default."[59] The primary focus of Republic's argument and the court's holding was the SLV component of the liquidated damages formula. Essentially, Republic argued, and the court agreed, that the SLV-based liquidated damages formula inequitably allocated to the Lessee the risk that the market value of the leased aircraft might significantly decline during the terms of the Leases.

The court found that this allocation was against public policy and may not be enforced against the Lessee, despite its contractual promise to pay the negotiated damages amount, or against RAH (as guarantor), despite its contractual promise to unconditionally guaranty the Lessee's payment of all amounts payable under the Leases, irrespective of any such defense.

HOLDING REGARDING LEASE CLAIMS (AND WHY IT WAS FLAWED)

The court's refusal to enforce the SLV-based liquidated damages provisions in the Leases was based on its interpretation and application of UCC 2A-504. In reaching that decision, the court concluded that the SLV amounts included in the liquidated damages remedies were calculated to protect Residco's investment "regardless of where default may have left the parties,"[60] and that uncorrelated market factors were not linked to the default (i.e., the rejection of the leases).[61]

According to the court, the large disparity between the remaining rent amount and the corresponding SLV amount in the Leases' liquidated damages formulas evidenced that such formulas failed to satisfy the "reasonableness" requirement of UCC 2A-504.[62]

The court also concluded that although acceleration formulas may be enforceable for insurance purposes and as value protection under an early termination or other similar option,[63] SLV-based liquidated damages formulas are not necessarily enforceable because of the statutory reasonableness requirement.

The court begins its analysis by looking to Article 2A and the standards for liquidated damages before and after Article 2A's enactment. Although the court recognized that Article 2A significantly departed from pre-Article 2A tests that had included uncertainty and proportionality requirements, the court focused on 2A-504's retention of the reasonableness requirement as a justification for relying on pre-Article 2A case law.

With respect to the guarantees, Residco argued that under New York state law, the guarantees were "irrevocable" and "ironclad," and therefore RAH waived its right to any defense, including any defenses based on public policy.

Specifically, the court stated:

> In sum, the reasonableness requirement was part of the common law test predating Article 2A and remains part of the test today. Accordingly, the Court sees no reason why it would not consider prior case law on the reasonableness of liquidated damages, including the *TWA* decision, to be relevant and useful precedent.[64]

The court correctly notes that static or insufficiently declining liquidated damage clauses are inherently unreasonable. The liquidated damages at issue in the *Republic* case, however, declined monthly and could never fit into such an inherently unreasonable category.

As explained above, however, the problem with the court's reliance on *TWA* is that the Third Circuit in that case was clearly viewing the liquidated damages clause at issue through a pre-Article 2A lens.[65] As such, the Third Circuit made clear that it was not viewing the "reasonableness" of the liquidated damages in isolation from the prior (but now no longer used) uncertainty and proportionality requirements. Contrary to the court's determination, *TWA* is not relevant to post-Article 2A cases because it never considered Article 2A's significant departure from pre-Article 2A common law.

Moreover, the court gives short shrift to the reasons why Article 2A purposefully departed from Article 2 and prior common law tests for liquidated damages, failing even to mention the significant commentary on the purpose behind Article 2A-504's simplified liquidated damages test.

As also set forth above, and ignored by the court, Sec. 2A-504's official comments expressly state that this section's departure from prior, more stringent tests was compelled by, and critical to, modern leasing practice and to allow greater flexibility for leasing parties to liquidate damages (with the understanding that many leases are predicated on the parties' ability to liquidate damages).[66]

Moreover, while the court thereafter correctly recites current Article 2A standards, its recitation only underscores the problems with the court's conclusions. For example, the court recognizes that "reasonableness must be judged at the time of contract formation"[67] but supports its holding by referring to actual damages at the time of the breach,[68] which runs afoul of both the proper time to test the liquidated damages clause and reinserts into the analysis the discarded proportionality test.

The court also correctly notes that "sophistication of the parties may shed light as to what harms were actually anticipated when the deal was struck,"[69] but then fails to actually consider the fact that at the time of contract formation Republic was not only represented by counsel and financial advisors that created the base pricing model behind the SLV formula but also the fact that Republic itself was a seasoned industry participant that was well aware of aircraft values and, in fact, had originally purchased the aircraft that was later sold to the Lessor and leased back to Republic.[70]

In addition, the court correctly notes that static or insufficiently declining liquidated damage clauses are inherently unreasonable.[71] The liquidated damages at issue in the *Republic* case, however, declined monthly and could never fit into such an inherently unreasonable category.[72]

The court continues its one-sided analysis in its discussion of market risk allocation and determination that the parties cannot allocate risk without violating Article 2A-504's reasonableness requirement.[73] As an initial matter, the court misdescribes the liquidated damages as "transferring" the residual value risk upon default.[74] The Leases never *transferred* the risk of market decline; instead, the market risk allocation was both a material part of the parties' contract and a term the parties were free to (and did) negotiate. Ignoring such a negotiated material contract term also ignores a fundamental contract tenet: that contracting parties are entitled to the benefit of their bargain.[75]

Similarly, the court ignores the import of the parties' negotiated agreement when it rules that there is no causal link between anticipated harm and the debtor's default. Putting aside the fact that causation and intent are generally fact issues that should have precluded summary judgment, *any* default prior to the end of the Lease terms caused harm to Residco because Residco bargained for all the benefits associated with Republic's full payment and performance for the full term of each Lease.

Stated another way, Residco (and its predecessor-in-interest) agreed to invest in this transaction only because the Lessee agreed to satisfy *all* its lease obligations for the full term of the Leases. The nature of a default agreed by leasing parties as entitling a lessor to cancel or terminate a lease, or causing the same by operation of law (i.e., the rejection of a lease in a Chapter 11 case), is irrelevant in that the result remains the same — that is, the nonbreaching party is entitled to enforce its contractual damage remedy that included an anticipated residual value component (and the risk that the actual value of the leased property might decline below the parties' anticipated residual value).[76]

Under the court's analysis, if a lessee fails to insure leased aircraft (which is indisputably a material breach) but the aircraft suffers no damage, the lessor would be entitled to no damages at all, because failing to insure the aircraft would not cause a loss of rent or any other monetary harm, unless there were an accident or incident that occurred and the lessor is unable to recover from either the insurer or the lessee.

However, such an absurd result would render such leasing parties' agreement a nullity in a situation, even though no lessee could legitimately claim that the lessor acted unreasonably in deciding to enforce its rights to agreed damages as a result of the lessee's default (such as in the above example regarding failing to insure the leased aircraft).

Likewise, in *Republic*, Residco was harmed by the early termination of the Leases, resulting in Residco's failure to realize its entire bargain. That bargain included full and timely payment and performance by Republic of all its obligations for the entire scheduled term of each of the leases as well as return of the aircraft in the required condition after the Leases' terms expired.

Accordingly, Residco was entitled to enforce the liquidated damages formula in the Leases, which was intended to compensate Residco for damages the parties mutually recognized at lease commencement as approximating the damages Residco would suffer if the Leases were canceled or terminated prior to expiration.

The court's continued analysis further highlights its errors. For example, the court's lengthy comparison of remaining rent at the time of default to the liquidated damages amount[77] wrongly invokes the Article 2A-rejected proportionality test.

If the drafters believed that only rent (or even rent plus actual costs and damages from harm to the leased goods) were the sole recoverable amount for breach, the drafters could have easily expressly stated this — or not included a liquidated damages provision at all in Article 2A. In such a case, lease damages would simply equal rent, costs, and return of the goods (or if the goods could not be returned or were damaged, an additional amount to cover the goods' value at the time of the breach).[78]

Indeed, arguably the entire reason for having a liquidated damages clause is that contracting parties recognize some identifiable risk and wish to contractually allocate who bears such risk.

In addition, the official comments specifically provide an example of a common liquidated damages formula that includes "the lessor's estimated residual interest."[79] If the inclusion of such a common term was *per se* unreasonable, there is no point in citing this example without a statement that such component is not available under Article 2A.[80]

Further, in response to any doubt over Article 2A's drafters' statement that whether liquidated damages formulas such as the examples provided in the official comments are "enforceable will be determined in the context of each case by applying a standard of reasonableness in light of the harm anticipated when the formula was agreed to,"[81] the most sensible way to interpret such a comment is that a formula where the residual interest component has no basis in fact (where, for example, the residual value is in excess of expert estimates) would be a situation where "the lessor's estimated residual interest" is not "reasonable in light of the anticipated harm."

The court's flawed analysis is also evident from the court's inability to find case support for its conclusion and its citation to inapposite cases or cases that support the validity of Residco's liquidated damages provisions. For example, the court cited *Northwest Airlines*[82] as an example of a case with purportedly similar liquidated damages as the leases.[83]

Northwest Airlines, however, relied on Minnesota common law that included the uncertainty test rejected by Article 2A[84] and addressed a *non*-declining SLV liquidated damages formula.[85] Because the liquidated damage formula in the Republic Leases declined monthly, there was no reason to cite *Northwest Airlines* or for the court's additional reference to the *TWA* decision (which, for the reasons stated above, has no relevance after the enactment of Article 2A) in support of rejecting "static margins or profit factors above and beyond compensation for loss."[86]

Nor was there a reason for the court to refer to cases where invalidated liquidated damages contained no provision to credit the leased equipment's value or disposal proceeds[87] or where the damages included *both* future rent and the stipulated loss value of the equipment.[88]

Notably, the court admits "that no court has *per se* rejected inclusion of residual interest liability in a liquidated damages provision"[89] but then nonsensically relies on a case that supports the SLV liquidated damages at issue in *Republic*.[90]

The court's lengthy comparison of remaining rent at the time of default to the liquidated damages amount wrongly invokes the Article 2A-rejected proportionality test.

Finally, the court unpersuasively determines that Article 2A-407's hell-or-high-water protections for finance lessors do not change the result because 2A-407 does not trump 2A-504's reasonableness requirement, and "such a reading would appear to violate the rules of statutory construction to read provisions in a harmonious manner."[91]

However, the obvious way to read these two statutory provisions in harmony is to give them both their intended meaning.

The two sections in fact complement each other in that 2A-504 allows lease contracting parties the freedom to allocate market value risk, and 2A-407 prevents lessees from escaping their contractual obligations once they accept the leased goods.

> This holding is confounding because none of the cases cited by the court support its conclusion: there are no fraud, illegality, or limitations issues alleged by Republic in its motion for summary judgment.

Failing to read these two provisions in a truly harmonious manner simply encourages lessees to breach their lease whenever the leased equipment no longer fits their needs, or becomes obsolete, or when the assigned warranty protections prove ineffective. Such a reading is clearly untenable given the statute and the drafters' official commentary as detailed above.

As other courts, commentators, the Article 2A drafters, and Article 2A itself make clear, there is nothing penal about leasing parties making an informed business decision to allocate market value risk.[92] Quite to the contrary, Article 2A, in line with modern finance leasing practice, encourages such allocation. The court's unsupported conclusion finds a penalty where none exists.

HOLDING REGARDING GUARANTY CLAIMS (AND WHY IT WAS FLAWED)

The court's results-driven analysis is equally apparent in the portion of the opinion addressing RAH's unconditional guarantees. Put simply, the court's refusal to enforce the guarantees was contrary to applicable law.

After rejecting the debtors' argument that the court use its equitable powers under Bankruptcy Code Sec. 105 and acknowledging that "New York law provides for stringent enforcement of unconditional guarantees,"[93] the court then contravenes clearly applicable law and determines that the guarantees violate public policy.[94]

Indeed, after string-citing a number of cases where New York courts and courts applying New York law unequivocally hold that unconditional guarantees foreclose affirmative defenses and counterclaims, *including* claims of fraudulent inducement into signing the guaranty itself,[95] the court then string-cites a number of cases that have nothing to do with the guarantees at issue in this case.

Just as the court repeatedly cited to static or other clearly distinguishable damage formulas in its liquidated damages analysis, the court cites to similarly inapposite cases in this section, such as:

(a) a case in which "a creditor's wrongful post-execution conduct triggered the event that accelerates or causes the guarantor's liability,"[96]

(b) cases discussing fraud,[97]

(c) cases where the court refused to enforce illegal contracts,[98] and

(d) a case barred by New York's statute of limitations applicable to guarantees.[99]

The court then holds that "[g]iven the weight of authority, this Court concludes that the Guarantees here are not enforceable for the same reason as the underlying obligations: the liquidated damages clauses in the Leases violate public policy."[100]

This holding is confounding because none of the cases cited by the court support its conclusion: there are no fraud, illegality, or limitations issues alleged by Republic in its motion for summary judgment.

Moreover, in 2016, the Second Circuit issued an opinion directly on point, *136 Field Point Circle Holding Company LLC v. Invar Int'l Holding Inc.*, 644 Fed. Appx. 10 (2d Cir. 2016), which supports the exact opposite conclusion reached by the court in *Republic*. In *136 Field Point*, the Second Circuit held that New York law barred an unconditional guarantor from raising the defense that the liquidated damages clause in the underlying guaranteed contract was an unenforceable penalty.[101]

The court's refusal to follow *136 Field Point Circle Holding Company LLC v. Invar Int'l Holding Inc.*, 644 Fed. Appx. 10 (2d Cir. 2016), underscores the court's disregard for any authority that supported enforcing the valid and enforceable guarantees.

As an initial matter, the court's dismissal of this admittedly on point case from the Second Circuit because the case is unpublished rings particularly hollow when the court had no issue with citing to and relying upon a transcript from the *Tidewater* bankruptcy case.[102]

In addition, the court's attempts to distinguish this on point case again underscore the unsupportable nature of the court's rulings. For example, the fact that the Second Circuit did not address any public policy argument is of no consequence because the Second Circuit's ruling inherently found that public policy was not contravened by enforcing the guaranty waivers under New York law.

Moreover, while it is self-evident that public policy is not contravened if New York law *repeatedly* enforces unconditional guarantees and will not even allow a fraudulent inducement claim to undermine such unconditional obligations, the court itself recognized this fact when it quoted the following from *VNB New York Corp. v. M. Lichtenstein LLC*, 2011 WL 4024664, at *9 (Sup. Ct. Kings Cty. Sept. 8, 2011): "It is not against public policy to enforce a waiver of the right to interpose counterclaims ... [and s]uch a waiver constitutes an insurmountable obstacle to defendants' attempt to assert these defenses and counterclaims."[103]

To make matters worse, the court then attempts to distinguish the cases cited by the Second Circuit in *136 Field Point,* which *enforced* unconditional guarantees, notwithstanding allegations and behavior in those cases far more concerning the facts in the *Republic* case (i.e., a liquidated damages clause entered into by sophisticated parties and sanctioned under applicable statutory law). Specifically, the court found that cases rejecting arguments that collusion and fraudulent inducement claims could invalidate an unconditional guaranty[104] did not support enforcing the guarantees, because these cases failed to invalidate guarantees "on grounds of public policy,"[105] which is a circular way of simply refusing to acknowledge that the New York law does not believe that unconditional guarantees violate public policy.

The court then continues its circular reasoning and to ignore the obvious conclusion that public policy is not violated by unconditional guaranties of obligations of this type when it states that post-*136 Field Point* cases are also distinguishable for the same reason — that is, because these subsequent cases uphold the guarantees, as opposed to invalidating them on public policy grounds.[106]

Arguably, the court's guaranty ruling is even less defensible than its liquidated damages ruling, where at least some support (no matter how outdated or misconstrued) existed. Here, however, there is no support whatsoever for the court's refusal to enforce the guarantees.

PRACTICAL IMPLICATIONS AND SUGGESTIONS

It is extremely likely that debtors in bankruptcy and defaulting lessees outside of bankruptcy will continue to challenge SLV liquidated damages provisions where there is a large disparity between the anticipated residual value at lease formation and actual sale or rental proceeds obtained after leased equipment is sold or re-let after a lessee's default.

Although the authors disagree with the *Republic* case's holding, we do note that the *Republic* case — and cases cited by the *Republic* court in support of its holding — represent a risk to equipment lessors because these cases undermine the reliability of SLV-based liquidated damages clauses.

However, although these cases may be unsettling, we are not suggesting that lessors strike these provisions from the lease forms because, as noted above, we believe that they are consistent with UCC 2A-504.

Instead, and so long as lessors understand that courts may continue to invalidate these liquidated damages provisions (particularly when the value of leased goods substantially drops after lease inception), lessors should focus on those aspects of any liquidated damages formula that are likely to be scrutinized if challenged in an enforcement or bankruptcy case.

The formula should be calculated based on economics that have been mutually agreed upon by the parties. Fundamentally, the damages amount should be consistent with the lessor's achieving the benefit of its negotiated bargain as determined from time to time during the lease term to no lesser extent than would have been the case if the lease was not earlier canceled.

If an SLV-based formula is included, the SLV amount should take into account the lessor's economic expectations, which expectations are likely to include the lessor recovering the purchase price it advanced, its anticipated yield on that investment, any loss of assumed tax benefits, and some prepayment charge.

If the formula includes the accelerated remaining rent, it should be discounted to present value as of the date of determination using a reasonable discount rate. If the formula also includes the anticipated residual value of the aircraft at lease expiration, it should also be discounted at a reasonable discount date.[107] The formula should not be constructed in a manner such that, at lease commencement, the lessor would likely receive an amount that would constitute a windfall because of either an unreasonable anticipated residual value or double counting.

> If an SLV-based formula is included, the SLV amount should take into account the lessor's economic expectations, ... the lessor recovering the purchase price it advanced, its anticipated yield on that investment, any loss of assumed tax benefits, and some prepayment charge.

By way of example, an SLV-based component should not include an amount intended to cover lost tax benefits if the other formula components also included an income tax indemnification amount. Similarly, the formula should not include the disposition costs if that amount is also netted out of the mitigation credit.

Lessors should consider including in their lease forms acknowledgments or other assurances by their lessees supporting the enforceability of the liquidated damages formula. It might also be useful for lease forms to include an acknowledgment by a lessee that the lessor may avail itself of alternative acceleration remedies.

Most importantly, the lessor should not be entitled both to demand the formula amount and also to recover possession of the aircraft without a mitigation credit to be applied against the lessee's damages obligation. It would be advisable if the calculation of the mitigation amount is aligned with the calculation of the damages amount.

Accordingly, if the formula includes the present value of the accelerated remaining rent, the mitigation amount should also be comprised of the present value of the remaining rent under an actual or prospective re-lease of the equipment having similar terms to the canceled lease during a coterminous period.[108]

If the formula includes the anticipated lease expiry residual value, the mitigation amount should include the sales proceeds or a market sales value of the aircraft. If actually sold, the sales proceeds applied should be net of the disposition costs, sales, and other related reductions from the amounts received by the lessor in connection with the sale. If the equipment is not actually sold, the market value should take into account the actual condition of the aircraft; the likely disposition costs, taxes, and other charges; and the date on which the equipment might be available for a sale.

Lessors should consider including in their lease forms acknowledgments or other assurances by their lessees supporting the enforceability of the liquidated damages formula. It might also be useful for lease forms to include an acknowledgment by a lessee that the lessor may avail itself of alternative acceleration remedies, either detailed in the lease or otherwise available to the lessor under UCC 2A in the event that a court is unwilling to enforce the liquidated damages formula agreed to by the parties and set forth in the lease. By way of example, consider the following[109]:

> In furtherance of the foregoing, and as an inducement to Lessor to purchase and lease the Equipment to Lessee pursuant to this Lease, Lessee hereby acknowledges and agrees that:
>
> (i) the liquidated damages payable pursuant to this Section [__], (A) are to be paid in lieu of future Basic Rent, (B) are (as of both the date hereof, and the Acceptance Date) reasonable in light of the anticipated harm arising by reason of an Event of Default,[110] and (C) are not a penalty;
>
> (ii) Lessee's obligation to pay, and Lessor's right to receive, such liquidated damages in accordance with this Lease shall be absolute, irrevocable, independent, and unconditional and shall not be subject to (and Lessee hereby waives and agrees not to assert) any existing or future defenses or other Abatements[111] for any reason or under any circumstance whatsoever and is otherwise protected by the provisions of Section [__][112] hereof; and Lessee's agreement to pay such liquidated damages in accordance with the terms of this Section [__] was bargained for, understood and accepted by Lessee for all purposes, and shall be enforced in accordance with such terms by any court asked to consider the same;
>
> (iii) the occurrence of any one or more of the Events of Default shall be deemed, for all purposes, to substantially impair the value to Lessor of the transactions contemplated under the Lease Documents;[113]
>
> (iv) in the event that, notwithstanding the intent and express agreement of the parties, either the liquidated damages provision in this Section [__] is deemed noncompliant with applicable law, or circumstances cause it to fail of its essential purpose,[114] Lessor may exercise any of the other remedies provided herein, or available under UCC 2A or other applicable law (including the right to demand and be paid any or all of (A) all then accrued and unpaid Rent,[115] (B) the present value of all then unaccrued Basic Rent for the remaining Term, discounted at the Discount Rate, with an appropriate credit consistent with whether and how Lessor disposes of the Equipment, and (C) any incidental or consequential damages, less expenses saved by Lessor, if any, as a direct consequence of its cancellation of this Lease in connection with such Event of Default),[116] and
>
> (v) Lessor shall have no obligation to make any of the remittances to or apply any credits in favor of Lessee that are contemplated in this Section [__] if Lessor has paid such amounts to any other Person that has demanded and is entitled to the payment of such amount.

Finally, an approach discussed, but not necessarily endorsed, among the authors and other attorneys in the equipment financing industry is to include an acknowledgment in the lease by the leasing parties of the compensatory aspects of damage remedies, including any risk allocations. Any such acknowledgment would allow a court to understand the legitimate business purposes of the parties when they entered into the lease and agreed to those remedies, when asked to determine if the damages formula or amount was "reasonable" for the purposes of UCC Sec. 2A-504. Often in lease disputes, enforcement proceedings may take place decades after the effective date of such transactions.

Of course, any description of the risk and damage allocations should be drafted in a manner so as to avoid undercutting the true-lease nature of the lease transactions.

Perhaps memorializing this mutual business understanding with a sufficiently detailed acknowledgment might be more persuasive than hoping that a court would reach the desired conclusion by analyzing the calculations behind the SLV amounts listed on a lease schedule.

Such an acknowledgment might lessen or eliminate the need to prove the legitimate purposes of such damages and risk allocations, which may be very difficult (if not impossible) decades after the lease was documented. Of course, any description of the risk and damage allocations should be drafted in a manner so as to avoid undercutting the true-lease nature of the lease transactions.

Also, it is unclear from the *Republic* opinion whether that court would have come to any different conclusion if the risk were expressly acknowledged in the Leases, or if it would have considered any such acknowledgment of risk-allocation to be an admission that the basis for the liquidated damages was an inherent and intentional violation of public policy.

In sum, lessors should be mindful that the *Republic* case provided no reliable road map to avoid unfortunate decisions of this type in the future.

CONCLUSION

The authors of this article believe that the *Republic* opinion reflects the result desired by the court and not the applicable law. It is our hope that most other courts, if asked to consider these same issues, whether under New York law or under the UCC and other commercial laws of other states, will reach conclusions consistent with the UCC 2A provisions and case law enforcing liquidated damages provisions with a residual value component.[117]

We also hope that the *Republic* court's refusal to enforce an unconditional and absolute guaranty governed by New York law remains an anomaly.

However, the *Republic* opinion represents a risk to equipment lessors until more reasonable decisions become available. Until such time, the *Republic* court's holding (as well as the *Tidewater and Montgomery Ward* decisions) may impair the extent to which lessors may rely on UCC 2A when drafting, negotiating, and agreeing upon the essential provisions of their leases and guaranties.

Lessors may consider various protective measures when compiling the transactional materials to keep in their files supporting the enforceability of its lease and guaranty documents. They may also consider addressing some of the matters raised by the court in its *Republic* holding by providing related acknowledgments, alternative remedies, and waivers, as referenced above.

Endnotes

1. *In re Republic Airways Holdings Inc.*, 598 B.R. 118 (Bankr. S.D.N.Y. Feb. 14, 2019). Please note that one of the authors of (Arlene Gelman) and one of the contributors (Michael Edelman) to this article represented the lessor parties in this case, and that the parties settled their disputes shortly after the lessor parties filed a notice of appeal.

2. The Republic leases and the related transactions are described in the discussion of the pertinent facts later in this article.

3. *Republic*, 598 B.R. at 121. The court also considered what it referred to as a "secondary issue," whether the lessor had a valid administrative priority claim for post-petition rent relating to certain of the leased aircraft. Ibid. This article focuses only on the "primary" issues referenced above.

4. UCC § 2A-504(1); all references to "UCC" or "Article" refer to the Uniform Commercial Code, as adopted in the State of New York.

5. Article 2A became effective in New York on June 30, 1995 (1994 N.Y. Laws 114).

6. Unfortunately, as discussed below, the *Republic* court also relied upon cases interpreting and applying the pre-UCC 2A common law standards regarding the enforceability of liquidated damages remedies when holding that the liquidated damages formulas in the leases were invalid. Those pre-UCC 2A cases are referenced below as context for how and why the holdings of those cases should not have been viewed as persuasive authority with respect to the leases, all of which were entered into after UCC 2A was adopted in New York (the governing law state stipulated by the parties in the leases).

7. This characterization is determined for commercial law and bankruptcy purposes by the "bright line" and other tests and considerations in UCC 1-203 and related case law. Specifically, UCC § 1-203(b) provides that a security interest, and therefore not a true lease, is created if the lessee is obligated to pay rent for the lease term, if the lease is not subject to termination by the lessee and if: (1) the original term of the lease is equal to or greater than the remaining economic life of the goods; (2) the lessee is bound to renew the lease for the remaining economic life of the goods or is bound to become the owner of the goods; (3) the lessee has an option to renew the lease for the remaining economic life of the goods for no additional consideration or for nominal additional consideration; or (4) the lessee has an option to become the owner of the goods for no additional consideration or for nominal additional consideration. If the tests set forth in UCC § 1-203(b) are not dispositive as to the true-lease characterization, courts may consider (pursuant to UCC § 1-203(a)) pertinent case law, including cases examining the "economic realities" and other similar-purposed examinations of purported lease transactions. See *Ford Motor Credit Co., LLC v. Lasting Impressions Landscape Contractors, Inc. (In re Lasting Impressions Landscape Contractors Inc.)*, 579 B.R. 43 (Bankr. D. Md. 2017); and *In re QDS Components Inc.*, 292 B.R. 313 (Bankr. S.D. Ohio 2002).

8. See, e.g., UCC § 2A-407 (commonly referred to as hell-or-high-water protections that make a lessee's contractual obligations irrevocable upon the lessee's acceptance of leased goods) and § 2A-523(f) (lessor's cumulative and expansive default remedies).

9. UCC § 2A-407.

10. See, e.g., UCC § 2A-301 (lease contract enforceable according to its terms); § 2A-501 (defaults may be determined by lease contract); § 2A-503 (parties may modify, substitute and add default rights and remedies in lease contract); and § 2A-523(f) (the lessor can pursue remedies in lease contract).

11. UCC Official Commentary to § 2A-101, § 2A-301 & § 2A-504.

12. See James J. White & Robert S. Summers, *Uniform Commercial Code* § 16:11 (6th ed., 2010) ("White and Summers"), citing to Official Comment 1 to UCC § 2A-503 ("Comment 1 to section 2A-503 explicitly embraces the broad view of freedom of the parties to agree on their remedies and, not too subtly, instructs the courts not to meddle with those restrictions. … Section 2A-503 authorizes many terms; it tells the courts that the drafters believe the world would be a better place if the courts did not intervene to remake the deal on the occasion of a dispute between the parties even long after the deal was made.").

13. UCC § 2A-501(1) ("Whether the lessor or the lessee is in default under a lease contract is determined by the lease agreement and this Article."). See also UCC § 2A-523. Referenced events of default in § 2A-523(1) include lessee's wrongful rejection or revocation of acceptance, failure to make a payment when due or repudiation, either with respect to the affected equipment or with respect to all of the equipment if the value of the whole lease is "substantially impaired."

14. UCC § 2A-505(1).

15. UCC § 2A-525(2) and (3).

16. UCC §§ 2A-503, 504, 527, 528 or 529 (as applicable).

17. UCC § 2A-528 (lessor damages include accrued and unpaid rent as of the date of default, the present value remaining, and any incidental damages allowed under § 2A-530 less expenses saved in connection with the default).

18. UCC § 2A-504, § 2A-103(4), and § 1-102(3).

19. UCC § 2A-503(1) provides that "[e]xcept as otherwise provided in this Article, the lease agreement may include rights and remedies for default in addition to or in substitution for those provided in this Article and may limit or alter the measure of damages recoverable under this Article." See also UCC § 2A-528 (sanctioning additional, different remedies and damages by qualifying that remedies set forth thereunder govern default "[e]xcept as otherwise provided with respect to damages liquidated in the lease agreement (§ 2A-504) or otherwise determined pursuant to agreement of the parties (§§ 1-102(3) and 2A-503)").

20. UCC § 2A-108.

21. See White and Summers, citing to UCC § 2A-108 ("If the court as a matter of law finds a lease contract or any clause of a lease contract to have been unconscionable at the time it was made the court may refuse to enforce the lease contract, or it may enforce the remainder of the lease contract without the unconscionable clause, or it may so limit the application of any unconscionable clause as to avoid any unconscionable result."). Also, assuming the liquidated damages remedy is exclusive, UCC § 2A-503(2) permits a party to pursue other UCC § 2A remedies if an exclusive remedy in a lease "fails for its essential purposes or provision for it is unconscionable."

22. UCC § 2A-504(2) (permitting the lessor to rely on the other statutory remedies (e.g., the acceleration remedies in UCC 2A-527, 528 and 529, as and to the extent applicable).

23. UCC § 2-718.

24. UCC § 2A-504(1) (emphasis added).

25. See UCC § 2A-504 Official Comments ("Subsection (1) is a significantly modified version of the provisions of Section 2-718(1)").

26. Ibid. See also Lawrence's Anderson on the Uniform Commercial Code § 2A-504:10 (3d ed., 2010).

27. UCC § 2A-504 Official Comments.

28. Ibid. Notably, UCC § 2A-504 also does not include UCC § 2-718's pronouncement that "[a] term fixing unreasonably large liquidated damages is void as a penalty."

29. See, e.g., *In re Dow Corning Corp.*, 419 F.3d 543, 549-50 (6th Cir. 2005) (addressing liquidated damages under common law test requiring satisfaction of the following conditions: "First, [(1)] the anticipated damages for a breach must be difficult or impossible to estimate. Also, [(2)] the amount of liquidated damages must be a reasonable forecast of the amount necessary to render just compensation. In addition, [(3)] 'liquidated damages must not be disproportionate to actual damages,' as measured at the time of the breach. Thus, if the liquidated damages are disproportionate to the actual damages, the clause will not be enforced and recovery will be limited to the actual damages proven.").

30. UCC § 2A-504(1).

31. UCC § 2A-504 Official Comments.

32. bid.

33. Ibid.

34. UCC § 2A-504(1). Notably, however, if the drafters believed any component of their listed examples was prohibited (e.g., anticipated residual interest), the drafters could have easily so stated.

35. A specified percentage to be multiplied against the lessor's acquisition cost and other capitalized amounts.

36. *Republic,* 598 B.R. at 133-34.

37. "Whether a contract clause which nominally prescribes liquidated damages is in fact an unenforceable penalty provision is a question of state law." *United Merchants & Manufacturers Inc. v. Equitable Life Assurance Society of the United States,* 674 F.2d 134, 141 (2d Cir. 1982).

38. See, e.g., *Wells Fargo Bank NW, N.A. v. U.S. Airways Inc.*, 2011 N.Y. Slip op. 52188, 2011 WL 6141034, at *4-5 (N.Y. Co. Supreme Ct. Dec. 1, 2011) (holding that holdover rent for aircraft calculated at twice the lease's regular monthly rental amount was a reasonable liquidated damages clause (not an unenforceable penalty) and noting that the leases "were negotiated by sophisticated persons in the airline industry with experienced counsel"); *In re Snelson,* 305 B.R. 255, 264-65 (Bankr. N.D. Tex. 2003) (upholding liquidated damages provision in lease for printing press and noting that liquidated damages provisions in a commercial contract negotiated by sophisticated parties are presumptively reasonable); *Atel Fin. Corp. v. Quaker Coal Co.,* 132 F. Supp. 2d 1233, 1241 (N.D. Cal. 2001) (rejecting liquidated damages claim in an enforcement case that had a number of particularly distinguishable facts, relying on cases and a California statute that related predominantly to loans, real estate leases and other transactions, and ignoring UCC-2A); and *Pacificorp Capital Inc. v. Tano Inc.*, 877 F. Supp. 180 (S.D.N.Y. 1995) (enforcing under pre-Article 2A law SLV liquidated damages provision in lease for computer equipment).

39. See, e.g., *In re Baez v. Banc One Leasing Corp.*, 348 F.3d 972 (11th Cir. 2003) aff'g, 226 F. Supp. 2d 1345 (N.D. Ga. 2002) (approving liquidated damages provision that protected the lessor for, among other things, residual value market risk); *PNC Equipment Finance, LLC v. MDM Golf, LLC,* 2016 WL 3453657 (S.D. Ohio June 20, 2016) (enforcing SLV liquidated damages provision); *VFS Leasing Co. v. S.T.I. Inc.*, 2013 WL 1352032 (N.D. Ala. Mar. 29, 2013) (enforcing SLV liquidated damages formula as reasonable under 2A-504); *Gen. Elec. Capital Corp., LLC v. G. Howard Assocs.*, 2010 WL 2346296, at *4-5 (E.D.N.Y. May 14, 2010) (enforcing SLV liquidated damages provision where lessee bears market value risk even though court applied more stringent and outdated common law requirements); *Red Line Air Inc. v. G. Howard Assocs. Inc.*, 2010 WL 2346299, at *3-4 (E.D.N.Y. May 11, 2010) (same); *In re Snelson,* 305 B.R. 255, 264-65 (Bankr. N.D. Tex. 2003) (enforcing liquidated damages provision that included anticipated value of equipment at end of lease term); *In re D & S Electrical/Mechanical Co. Inc.*, 297 B.R. 805 (N.D. Ala. 2003) (enforcing SLV liquidated damages provision after requiring that future rents be reduced to present value); *Sun v. Mercedes Benz Credit Corp.*, 254 Ga. App. 463 (2002) (enforcing liquidated damages formula with anticipated residual interest component after severing the one portion of the formula (extra monthly lease payment even though all past due and future lease payments were already included in the formula); *Winthrop Resources Corp. v. Eaton Hydraulics Inc.*, 2002 WL 3543165, at *8 (D. Minn. Apr. 23, 2002) (although the court used liquidated damages standards under pre-Article 2A standards with Article 2A-rejected tests, court still enforced SLV liquidated damages clause); *Case Credit Corp. v. Baldwin Rental Centers Inc. (In re Baldwin Rental Ctrs. Inc.),* 228 B.R. 504 (S.D. Ga. 1998) (enforcing liquidated damages formula including anticipated residual value component); *Coastal Leasing Corp. v. T-Bars Corp.*, 123 N.C.

App. 379 (1998) (enforcing liquidated damages provision that included residual interest (along with requirement to credit net sale or rental proceeds to amounts due) and noting 2A-504's expressed intent to promote leasing parties' freedom of contract); and *Wilmington Trust Co. v. Aerovias de Mexico, S.A. de C.V.*, 893 F. Supp. 215, 218-20 (S.D.N.Y. 1995) (enforcing SLV liquidated damages provision under stricter pre-Article 2A test).

40. *Case Credit Corp. v. Baldwin Rental Ctrs. Inc. (In re Baldwin Rental Centers Inc.)*, 228 B.R. 504, 509 (S.D. Ga. 1998). The *Baldwin* court further noted that the official comments' example liquidated damages provision "is identical to the provisions in the assumed leases with the only difference being that none of the figures in the comments are reduced to present value." Ibid., at 510.

41. See, e.g., *Wilmington Trust Co. v. Global Areo Logistics Inc.*, 2011 WL 11075177, at *3 (2011) (addressing static SLV formula that could never reduce below $34 million); and *In re Northwest Airlines Corp.*, 393 B.R. 352, 355 (Bankr. S.D.N.Y. 2008) (addressing a nondeclining SLV liquidated damages formula and utilizing Minnesota common law that included the uncertainty test rejected by Article 2A).

42. See, e.g., *Carter v. Tokai Fin. Servs.*, 231 Ga. App. 755 (1998) (liquidated damages formula provided that the lessor receive the present value for the equipment's anticipated residual value, but the lessor was not required to apply any net sales proceeds from the equipment's sale to amounts owed); see also *ePlus Group Inc. v. Panoramic Communications LLC*, 2003 WL 1572000 (S.D.N.Y. Mar. 27, 2003) (refusing to grant summary judgment for the lessor because question of fact existed regarding casualty value that included purported lost profits for quickly depreciating computer equipment).

43. See *Republic*, 598 B.R. at 131; *In re Tidewater Inc.*, No. 17-11132 (Bankr. D. Del. Aug. 30, 2017). Aug. 30, 2017 Hr'g Tr. at 76:7-12.

44. 145 F.3d 124 (3d Cir. 1998).

45. 326 F.3d 383 (3d Cir. 2003).

46. See *TWA*, 145 F.3d at 130 (noting the "precipitous downturn in the airline industry") and 135 (applicable lease "termination value" for aircraft equaled $13.5 million and estimated resale value for aircraft at time of return equaled $7 million).

47. *TWA*, 145 F.3d at 136 n.1.

48. *Montgomery Ward*, 326 F.3d at 386 & 391.

49. Ibid., at 391.

50. The summaries of the pertinent facts included in this article are based on details regarding the same in the *Republic* opinion and related pleadings. We have not included citations to any of the same.

51. Although the lessor parties to the Republic leases consisted of the owner trustee and the owner participant, this section of the article refers to "the Lessor" or "Residco" as the counterparty to the *Republic* leases for ease of reference.

52. *Republic*, 598 B.R. at 125.

53. Ibid. The court found it significant that "the liquidated damages clauses and the Schedule SLVs in the [Leases] are identical to those in the Original Leases — notwithstanding the previous rent payments made and the reduction in the residual value of the Aircraft between the Original Leases and the [Leases]."

54. Ibid., at 126.

55. Residco also filed an administrative expense claim seeking post-petition rent for certain of the aircraft (the "administrative expense claim").

56. Ibid., at 127. The debtors also argued that the administrative expense claim should be disallowed pursuant to the terms of the Section 1110 Stipulation.

57. The court also considered what it referred to as a "secondary issue," whether the lessor had a valid administrative priority claim for post-petition rent relating to certain of the leased aircraft. This article focuses only on the "primary" issues referenced above.

58. UCC § 2A-103(1)(g).

59. Ibid., at 121.

60. *Republic*, 598 B.R. at 134.

61. Ibid., at 135-38.

62. Ibid.

63. Ibid., at 138.

64. Ibid., at 131. To further support reliance on the *TWA* case, court cites to the transcript of an oral ruling of the Bankruptcy Court for the District of Delaware where that court determined that *TWA* was still good law notwithstanding Article 2A's enactment. *In re Tidewater Inc., et al.*, No. 17-11132 (Bankr. D. Del. Aug. 31, 2017), Aug. 30, 2017 Hr'g Tr. [ECF No. 497]. In addition to being wrong for the reasons set forth earlier in this article, the bankruptcy court in *Tidewater* stated its decision in a cursory ruling after oral arguments without providing a detailed written analysis. Ibid., at 76:7-16. Further, the *Tidewater* court ruled that the Third Circuit's *Montgomery Ward* decision controlled damages in that case, and as also explained earlier herein, the actual damages provided in the *Montgomery Ward* decision included "the then-present value of what would have been, when the lease terms began, the anticipated aggregate residual value of the leased equipment at the scheduled termination of the leases." *Montgomery Ward,* 326 F.3d at 391.

65. See, supra.

66. UCC § 2A-504 Official Comments.

67. *Republic,* 598 B.R. at 131.

68. Ibid., at 138 ("For these reasons, Residco is wrong in claiming that 'the Debtors' reliance upon the allegedly disproportionate actual damages has no bearing upon the enforceability of the Liquidated Damages Provisions under the Leases.'") (citing Residco's opposition brief).

69. Ibid., at 132.

70. See, supra.

71. *Republic,* 598 B.R. at 133.

72. See, supra, p. 9.

73. *Republic,* 598 B.R. at 133.

74. bid. ("At the center of the parties' dispute is the fact that the liquidated damages provisions here allow for the unconditional transfer of residual value risk, or market risk, only upon default, without a cognizable connection to any anticipated harm caused by the default itself."); ibid., at 134 ("In other words, in the event of a default, this remedy formulation effected a transfer of all market risk, or residual value, including any risk of idiosyncratic depreciation or damage to a particular Aircraft.").

75. Restatement (Second) of Contracts (1981) §§ 344 cmt A. ("Ordinarily, when a court concludes that there has been a breach of contract, it enforces the broken promise by protecting the expectation that the injured party had when he made the contract. It does this by attempting to put him in as good a position as he would have been in had the contract been performed, that is, had there been no breach. The interest protected in this way is called the "expectation interest." It is sometimes said to give the injured party the "benefit of the bargain.") and 347 cmt. A. ("Contract damages are ordinarily based on the injured party's expectation interest and are intended to give him the benefit of his bargain by awarding him a sum of money that will, to the extent possible, put him in as good a position as he would have been in had the contract been performed.").

76. Stated another way, the equities associated with the allocation of value risk inherent in this SLV-based liquidated damages remedy do not turn on the nature of the breach. "The residual value guaranty represents part of the central economic bargain the lessee makes with the lessor in such leases: [I]f the lease goes to term, the lessor bears the risk of the property being worth less than it originally expected at the end of the term, but if the lease terminates early, this risk is borne by the lessee." Ian Shrank & Samuel Yim, Liquidated Damages in Commercial Leases of Personalty — The Proper Analysis, 64 Bus. Law. 757, 764 (May 2009). See also White & Summers § 16:13 ("Some believe that a liquidated damage clause allowing the lessor to recover the difference between the expected residual value and the actual residual value at the end of the lease might be unreasonable and so void. The suggestion is that a lessee should not be liable for high depreciation that arises out of market forces rather than out of unusual wear and tear. Those who advocate this position argue that these damages are not "reasonable in light of the … anticipated harm …" at the time the lease contract is entered into, as required by section 2A-504(l), because by their nature, they are unanticipated. *We disagree.*") (emphasis added).

77. *Republic,* 598 B.R. at 136-38. In addition, to the extent that the court was bothered by the inclusion of a 4% return in the SLV formula, the court could have easily severed this term and upheld the balance of the liquidated damages under UCC 2A-108.

78. See 2A-528.

79. UCC § 2A-504 Official Comments. Given the drafters' detailed comments to this section, it is reasonable to assume that the absence of such statement indicates that the drafters believed such remedy was available.

80. Given the drafters' detailed comments to this section, it is reasonable to assume that the absence of such statement indicates that the drafters believed such remedy was available.

81. Ibid.

82. 393 B.R. 352 (Bankr. S.D.N.Y. 2008).

83. *Republic,* 598 B.R. at 137.

84. In *Northwest,* the court ignored Article 2A's rejection of prior common law tests and, instead, believed that the proper standard was "that a liquidated damages clause is enforceable when (a) the amount so fixed is a reasonable forecast of just compensation for the harm that is caused by the breach, and (b) the harm that is caused by the breach is one that is incapable or very difficult of accurate estimation." 393 B.R. at 356 (internal quotation marks omitted).

85. Ibid., at 357 ("Here, however, damages never declined at all.").

86. 598 B.R. at 137.

87. Ibid., citing *Wells Fargo Equipment Finance Inc. v. The Woods at Newtown LLC,* 2011 WL 4433108, at *1 (S.D.N.Y. Sept. 23, 2011) (detailing liquidated damages formula that provided for no credit for equipment). The *Wells Fargo* court also invalidated the liquidated damages provision because actual damages were "readily ascertainable," ibid., at *5, and, thus, relied upon the uncertainty test that was purposefully omitted from 2A-504.

88. Ibid., citing *CIT Group/Equipment Finance Inc. v. Shapiro,* 2013 WL 1285269, at *7 (S.D.N.Y. Mar. 29, 2013) ("Damages comprising an independent sum for capital depreciation and future rent payments would impermissibly 'double-dip.'") (emphasis in the original).

89. 598 B.R. at 139.

90. bid., at 140, citing *Gen. Elec. Capital Corp. v, G. Howard Assoc. Inc.,* 2010 WL 2346296, at **4, 8 & n.9 (E.D.N.Y. May 18, 2010) (awarding liquidated damages under a stipulated loss value "formula that takes into account plaintiff's anticipated return of the aircraft initially financed at $3.1 million, the anticipated depreciation or residual value of the aircraft" and "defendants' previously paid rental payments" and explaining that the "stipulated loss value of the aircraft is the percentage of the capitalized lessor's costs of the aircraft determined by the applicable rent payment").

91. Ibid., at 142.

92. For any commentators that believe market risk allocation is impermissible because a lessor must bear risk in order for the contract to qualify as a true lease, this case provides a perfect example of how a lessor bears such risk under a true lease. Had the Lessee completed all its lease payments through the terms of the Leases and returned the aircraft at lease end, Residco would have been left with aircraft that all parties believed would be much higher valued when the Lessor agreed to purchase the aircraft at the Lessee's behest.

93. Ibid., at 145.

94. Ibid., at 147.

95. Ibid. at 145-46. The following is the court's own recitation of current New York law applicable to unconditional guaranties:

> [B]road, sweeping and unequivocal language in an absolute and unconditional guaranty generally forecloses any challenge to the enforceability and validity of the documents which establish defendant's liability for payments arising under the [underlying] agreement, as well as to any other possible defense to his liability for the obligations." *In re Nissan Litig.,* 2018 WL 2113228, at *5 (S.D.N.Y. May 8, 2018) (internal quotations omitted); see also *GSO Re Onshore LLC v. Sapir,* 29 Misc.3d 1234(A), 2010 WL 5071785, at *5 (Sup. Ct. N.Y. Cty. Nov. 24, 2010) (A "waiver-of-defenses provision … in a guaranty is valid and enforceable, and bars, as a matter of law, any defenses a guarantor might otherwise assert in an action to recover under its guaranty.") (citing *Citibank, N.A. v. Plapinger,* 66 N.Y.2d 90, 495 N.Y.S.2d 309, 485 N.E.2d 974 (1985); *Red Tulip LLC v. Neiva,* 44 A.D.3d 204, 842 N.Y.S.2d 1, 5-6 (1st Dep't 2007)). "It is not against public policy to enforce a waiver of the right to interpose counterclaims … [and s]uch a waiver constitutes an insurmountable obstacle to defendants' attempt to assert these defenses and counterclaims." *VNB New York Corp. v. M. Lichtenstein LLC,* 32 Misc.3d 1240(A), 2011 WL 4024664, at *9 (Sup. Ct. Kings Cty. Sept. 8, 2011) (citations omitted). This is even the case for claims of fraudulent inducement of the guarantee itself. See *Plapinger,* 66 N.Y.2d at 95, 495 N.Y.S.2d 309, 485 N.E.2d 974 ("[T]he substance of defendants' guarantee forecloses their reliance on the claim that they were fraudulently induced to sign the guarantee. …"); *VNB New York Corp.,* 32 Misc.3d 1240(A), 2011 WL 4024664, at *10-11; *Cooperatieve Centrale Raiffeisen-Boerenleenbank, B.A. v. Navarro,* 25 N.Y.3d 485, 493, 15 N.Y.S.3d 277, 36 N.E.3d 80 (2015). "To permit that [defense] would in effect condone defendants' own fraud in deliberately misrepresenting their true intention when putting their signatures to their absolute and unconditional guarantee." *Plapinger,* 66 N.Y.2d at 95, 495 N.Y.S.2d 309, 485 N.E.2d 974 (quotations omitted).

In addition to the court's cited cases, numerous other cases applying New York law uphold unconditional guaranties. See, e.g., 136 *Field Point Circle Holding Company LLC v. Invar Int'l Holding Inc.,* 644 Fed. Appx. 10 (2d Cir. 2016) (unconditional guaranty barred defense that liquidated damages in underlying obligation was an unenforceable penalty); *Duval v. Albano,* 2017 WL 3053157, at *13 (S.D.N.Y. July 18, 2017) ("Indeed, '[u]nder New York law, the only affirmative defenses that are not waived by an absolute and unconditional Guaranty are payment and lack of consideration for the Guaranty.'") (quoting *Overseas Private Inv. Corp. v. Moyer,* 2016 WL 3945694, at *4 (S.D.N.Y. July 19, 2016)); *Torin Assocs. v. Perez,* 2016 WL 6662271 at *4-6 (S.D.N.Y. Nov. 10, 2016) ("where a guaranty provides that it is 'absolute and unconditional irrespective of … any lack of validity or enforceability of the agreement'", such language "forecloses affirmative defenses and counterclaims," "which is why these provisions are colloquially called ironclad"); *County of Greene v. Chalifoux,* 127 A.D.3d 1316, 1317-18, 6 N.Y.S.3d 763, 764-65 (N.Y. App. Div. 3d Dep't 2015) (even if the principal could assert defenses based on public policy considerations, "a guarantor can be liable, despite the principal's escape from liability, if the guarantee contains language through which the guarantor expressly waives a right or defense"; thus, '"[t]he liability of the guarantor may be broader than and exceed the scope of that of the principal where the guarantee, which is a separate undertaking, clearly states that it is enforceable against the guarantor despite circumstances where liability would not attach to the principal'") (citations omitted); *Bank of Am., N.A. v Lightstone Holdings LLC,* 32 Misc. 3d 1244(A), 938 N.Y.S.2d 225, 2011 N.Y. Misc. LEXIS 4412, *13 (N.Y. Sup. Ct. July 14, 2011) (by executing unconditional guaranties, guarantors "waived their right to assert a public policy defense"); and *King v. Wells Fargo Business Credit Inc.,* 48 A.D.3d 643, 643, 852 N.Y.S.2d 349, 350 (N.Y. App. Div. 2nd Dep't 2008) (holding that an unconditional guaranty waived the defense that an early termination fee was an unenforceable penalty).

96. Ibid., at 146, citing *Cooperatieve Centrale Raiffeisen-Boerenleenbank, B.A. v. Navarro,* 25 N.Y.3d 485 (2015) (affirming lower court's determination that allegations of collusion cannot overcome an absolute and unconditional guaranty and reiterating that fraudulent inducement is also no defense to guaranty liability).

97. Ibid., citing *Navarro,* 25 N.Y.3d 485 (2015) and *MCC Funding LLC v. Diamond Point Enters. LLC,* 2012 WL 2537893, at *5 (Sup. Ct. Kings Cty. June 25, 2012).

98. Ibid.

99. Ibid., at 147, citing *In re Dreier LLP,* 421 B.R. 60 (Bankr. S.D.N.Y. 2009). The *Republic* court cites to an additional

anomalous case, *Becker v. Rosenberg,* 711 F. Supp. 173, 174 (S.D.N.Y. 1989), where the Southern District of New York states without any citation to authority that if an underlying agreement cannot be enforced neither can a guaranty of such agreement and then goes on to enforce the guaranty in that case.

100. Ibid.

101. Ibid., at *12.

102. 598 B.R. at 131.

103. Ibid., at 145.

104. Ibid., at 147-48, citing Cooperatieve *Centrale Raiffeisen-Boerenleenbank; B.A. v. Navarro,* 25 N.Y.3d 485, 493, 15 N.Y.S.3d 277, 36 N.E.3d 80 (2015); and *Citibank, N.A. v. Plapinger,* 66 N.Y.2d 90, 495 N.Y.S.2d 309, 485 N.E.2d 974 (1985).

105. Ibid., at 148.

106. bid.

107. UCC § 2A-103(1)(u).

108. By "coterminous," we mean a term commencing on the date the equipment was released or available for release under a prospective re-lease, and expiring on the scheduled expiration date of the canceled lease.

109. The authors note that the sample text provided above is intended solely as an example of text that may be used to address certain of the issues raised in the *Republic* case, and is not intended to be exhaustive as to all of the related issues or as a recommendation as to how these issues should be addressed in any particular lease documents.

110. See the discussion above regarding UCC 2A-504's reasonableness test.

111. The term "abatements" when used in an equipment lease is often defined to include any abatement, reduction, setoff, defense, counterclaim, or recoupment with respect to any periodic rent or other payments due under the lease.

112. The hell-or-high-water section of the lease.

113. Consider the pertinent default trigger coverage in UCC 2A-523.

114. See, for example, UCC §§ 2A-523, 2A-525, and 2A-526, permitting a lessor to rely on the other statutory acceleration remedies in UCC §§ 2A-527, 2A-528 and 2A-529, as and to the extent applicable.

115. The term "Rent" as used in the above sample text is intended to include both scheduled, periodic rent as well as any and all other payments required under the lease (e.g., indemnifications, reimbursements, casualty payments, and enforcement or transactional costs.

116. Consider how this aligns with the above-referenced statutory acceleration remedies.

117. Again, so long the liquidated damages do not result in a windfall as a result of, for example, allowing for the double counting of damages or using a residual value that is in excess of a value justified by appraisals and/or market conditions at lease inception.

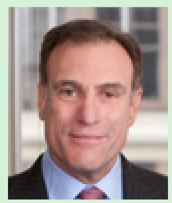
Acknowledgments

The authors gratefully acknowledge the contributions to this article by Deborah Abram, Michael Edelman, and Jonathan Rauch, also of Vedder Price.

Arlene N. Gelman

agelman@vedderprice.com

Arlene N. Gelman is a shareholder in the Chicago office of Vedder Price P.C., in the firm's commercial litigation and corporate reorganization, bankruptcy and insolvency groups. She serves as co-chair of Vedder Price's creditors' rights and collections groups. She concentrates her practice in the representation of lenders, large equipment lessors, and other creditors in U.S. state, federal district, appellate and bankruptcy courts. She prosecutes breach-of-contract and replevin actions and represents the interests of secured and unsecured creditors in various state courts and in bankruptcy matters. A frequent speaker at ELFA conferences, Ms. Gelman was selected by her peers from 2013 to 2019 as a "leading lawyer" in Bankruptcy & Workout: Commercial and Creditor's Rights/Commercial Collections. In addition, she received an "AV Preeminent" peer rating in Martindale-Hubbell. She is a member not only of ELFA but also the Illinois State Bar Association and the International Women's Insolvency & Restructuring Confederation. Ms. Gelman is a graduate of the University of Illinois (BA with distinction, 1989) and Boston University School of Law (JD, 1994).



Edward K. Gross

egross@vedderprice.com

Edward K. Gross is a shareholder in and founded the Washington, DC, office of Vedder Price P.C. He has more than 35 years' experience representing bank-affiliated and other large, independent, and captive financing providers in documenting, structuring, and negotiating equipment and tech solutions finance transactions.These transactions include construction and acquisition financings and monetizing existing assets of all types, including telecommunications, high-tech, agricultural, energy, and logistics equipment, as well as MES and bundled transactions. He has earned an international reputation, representing market-leading aircraft and helicopter financing providers, investors, and operating lessors, as well as large publicly or privately held businesses, government entities, and high-net-worth individual users of these assets. His asset-based capital markets practice includes securitizations, structured financings, portfolio purchases, back-leveraging, and discounting, participation, and other syndication transactions. Mr. Gross previously served on the board of trustees of the Equipment Leasing and Finance Foundation, and the ELFA Board of Directors and Legal Committee. He now chairs ELFA's Air, Rail and Marine Subcommittee. In addition to recognition by numerous national and international legal organizations, he received ELFA's Distinguished Service Award in 2008 and the Legal Committee's Edward A. Groobert Excellence in Leasing Award in 2011. He is also the immediate past chair of the UCC Leasing Subcommittee of the ABA Business Law Section as well as co-author of the leases article in the annual UCC Survey edition of the ABA *Business Lawyer.* Mr. Gross was awarded a BA from the University of Maryland in 1978 and a JD from the University of Baltimore School of Law in 1981.