

## Return Conditions in Commercial Aircraft Leases: Determining “Value and Utility”

In *U.S. Bank National Association v. Southwest Airlines Co.*,<sup>1</sup> the U.S. District Court for the Southern District of New York resolved a return condition dispute arising under the provisions of a lease that permitted the lessee to substitute engines and parts with engines and parts of “equivalent value and utility.” The lease at issue was fairly typical of leases drafted in the ’80s and ’90s that focused more on financial terms and less on the technical terms involved in the return of aircraft. Although more recent leases place a greater emphasis on technical terms and return conditions, including efforts to define what constitutes equivalent value and utility, the *Southwest* case is nevertheless relevant in analyzing the rights of the lessor and lessee regarding the relationship between engine and parts replacements and return conditions.

In June 1987, U.S. Bank National Association (as successor owner trustee) (“Plaintiff”) leased three Boeing 737-3H4 Aircraft to Southwest Airlines, Inc. (“Southwest”) for a twenty-year term. At lease end in 2007, Southwest returned the aircraft, but Plaintiff claimed that Southwest failed to satisfy certain requirements of the lease in respect to such return. In particular, Plaintiff claimed that Southwest removed the engines, certain other components and other parts and replaced them with engines and certain parts worth millions less. In anticipation of return, Southwest advised Plaintiff that it planned to return replacement engines rather than the leased engines. Four of the six leased engines

had undergone heavy maintenance and had their life-limited parts (LLPs) replaced.<sup>2</sup> Five of the six leased engines had received a 3D Aero modification.<sup>3</sup> The landing gear and auxiliary power units were replaced with parts having less life remaining to overhaul or replacement. The parties agreed that as a result of the substitution of the replacement engines and parts, the Aircraft were worth millions of dollars less. Plaintiff argued the reduction in value was approximately \$20.5 million, and Southwest asserted it was approximately \$5.9 million.

Plaintiff claimed that Southwest’s replacements breached the requirements contained in Sections 5(a) and 8 of the lease that the replacement engines and parts be of at least equal “value and utility” to those replaced. Southwest argued that although the lease is ambiguous, the only requirement it needed to meet in respect to the replacement engines was to comply with the minimum requirement that the replacement engines have at least 1,750 cycles remaining before next overhaul.

Section 5(a) of the lease, relating to the return of the Engines, provided in substance that Southwest had the right to replace Engines so long as at return the replacement engines were “of the same or another manufacturer, of equivalent utility and value, and suitable for installation and use on the Airframe without impairing the value or utility of the Aircraft.”<sup>4</sup> In addition, Section 5(a) of the lease provided that

“each such [E]ngine . . . will have at least 1,750 cycles remaining before the next scheduled engine removal.”<sup>5</sup>

Section 8 of the lease, which addressed Southwest’s replacement of “Parts,” provided as follows:

Lessee may . . . remove in the ordinary course of maintenance, service, repair, overhaul or testing, any Parts . . . provided that Lessee, except as otherwise provided in [Section 8(c)] will, at its own cost and expense, replace such Parts as promptly as practicable. All replacement Parts . . . shall be in as good operating condition as, and shall have a value and utility at least equal to, the Parts replaced.<sup>6</sup>

Pursuant to Section 8(c) of the lease, Southwest was allowed to make “alterations and modifications” to the Aircraft provided that:

[n]o such alteration, modification or addition shall materially diminish the value or utility of such Airframe or such Engine, or materially impair the condition or impair the airworthiness thereof below the value, utility, condition or airworthiness immediately prior to such alteration, modification or addition assuming such Airframe or such Engine was then of the value and utility and in the condition and airworthiness required to be maintained by the terms of this Lease Agreement.<sup>7</sup>

Much of the lawsuit focused on the meaning of the phrase “value and utility “ as used in Sections 5 and 8 of the lease. Plaintiff argued that “value and utility” unambiguously required Southwest to return engines with a “monetary worth and usefulness”<sup>8</sup> at least equivalent to that of the leased engines. Southwest argued that it only had to meet the return condition requirements relating to the Engines, which it did because the Engines had at least 1,750 cycles remaining at

return, and that the words “value and utility” imposed no additional duty on Southwest. Experts on both sides testified as to the various possible meanings of the words “value and utility.” Nevertheless, the court found as a matter of law that the lease was not ambiguous and that the language of Section 5 of the lease required that the replacement engines have both a “value” and “utility” equal to the leased engines and at least 1,750 cycles remaining, and that Southwest’s interpretation that the terms “value and utility” imposed no additional requirements on Southwest would render the “value and utility” clause in Section 5(a) of the lease meaningless.<sup>9</sup> With respect to the parts, the court found Southwest’s “systematic effort to outfit the Aircraft with inferior parts” breached the “value and utility” requirement of Section 8.<sup>10</sup>

Plaintiff also argued that Southwest had discriminated against the leased aircraft in violation of Section 7(a) of the lease. Section 7(a) required Southwest to “maintain, service, repair and overhaul . . . the Aircraft . . . so as to keep the Aircraft maintained in the same manner and with the same care as used by lessee with similar Aircraft owned by lessee.”<sup>11</sup> The court found that it was undisputed that prior to the return of the Aircraft, Southwest “stripped the Aircraft of their valuable Engines and Parts, and replaced them with comparatively inferior Engines and Parts thereby constructing three substantially degraded airplanes.”<sup>12</sup> The court found that Southwest failed to offer any evidence that it maintained any other similar aircraft, or that it generally treated all its aircraft, in this manner.<sup>13</sup>

Although the court found pursuant to Section 5(a) of the lease that Southwest had to meet both the “value and utility” requirement as well as the 1,750-cycles-remaining requirement, the court never actually defined the meaning of “value and utility.” Based on the facts of the *Southwest* case on cross-motions for summary judgment, the court did not have to do so as both Plaintiff and

Southwest agreed that as a result of the substitution of engines and parts, the Aircraft were worth millions of dollars less (although they disagreed on how much less).<sup>14</sup> In this regard the case is not particularly instructive on the meaning of the words “value and utility.” Nevertheless, the decision does caution that at least in a lease with similar language, some concept of “value and utility” in addition to meeting return conditions is relevant in an engine and parts substitution. In a case in which it is not clear that the substitution resulted in a decrease in value or utility, a court would likely need testimony on whether such a decrease occurred, and such testimony could relate to the meaning of “value and utility.”

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<sup>1</sup> 2009 WL 2163594 (S.D.N.Y. July 20, 2009).

<sup>2</sup> The cost of a new set of LLPs is approximately \$1.75 million for a CFM 56-3B-1 engine. *Id.* at 4.

<sup>3</sup> The list price of a 3D Aero modification is approximately \$1.4 million per engine. The 3D Aero modification is designed to improve fuel efficiency and an engine’s durability on wing. 410 out of 430 of Southwest’s engines were outfitted with the 3D Aero modification. *Id.*

<sup>4</sup> *Id.* at 2. Emphasis supplied.

<sup>5</sup> *Id.* at 2. Emphasis supplied.

<sup>6</sup> *Id.* Emphasis supplied.

<sup>7</sup> *Id.*

<sup>8</sup> *Id.* at 8.

<sup>9</sup> *Id.* at 8.

<sup>10</sup> *Id.* at 10.

<sup>11</sup> *Id.*

<sup>12</sup> *Id.*

<sup>13</sup> *Id.*

<sup>14</sup> *Id.* at 5.

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