INTERNATIONAL LAW OFFICE

Aviation - USA

Clarification of Bankruptcy Code Gives Aviation Financiers Wings

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August 31 2005

In today's turbulent airline industry few things are certain; however, secured lenders can take heart based on the Seventh Circuit's May 2005 decision in *United Airlines Inc v US Bank*.(1) The central issue in *United* was whether the airline's indenture trustees could repossess their collateral - 14 aircraft - upon United's default under the relevant financings pursuant to Section 1110 of the Bankruptcy Code.(2) Although United alleged antitrust violations due to coordinated efforts of various indenture trustees, the court found all laws were dutifully followed and that the trustees were entitled to repossess the aircraft at issue if United failed to cure all defaults and pay the full rentals then due. The decision is a victory for lenders, which gain a degree of financial stability through the assurance that the courts will protect their investments.

History of Section 1110

Section 1110 of the Bankruptcy Code was enacted to "protect the financiers of extremely expensive, highly maintenance-intensive, mobile equipment".(3) The volatile nature of the airline industry necessitates the provision. Without a guarantee of protection for their investments, lenders would be unwilling to finance multimillion-dollar fleets of aircraft for an industry uniquely susceptible to bankruptcy. The assurance offered by Section 1110 is the suspension of the automatic stay, thereby allowing financers access to repossess their collateral if the debtor cannot perform its obligations within 60 days of the bankruptcy filing. The finance party may elect to allow the debtor to continue using the equipment, but this is an exception left to the discretion of the finance party. As the court in *United* recognizes, Section 1110 treats "aircraft different from other assets" and "it is exactly this prospect that makes credit available on better terms when air carriers shop for financing in the first place".(4)

Such special legislative protection for lenders can be traced to the 19th century railroad industry, where expensive equipment was frequently financed and bankruptcy was an all too common occurrence.(5) Congress enacted Section 77(j) of the Bankruptcy Act 1898 as a way of allowing financiers to "take possession of the collateral despite the commencement of a reorganization".(6) Such protections were first enacted for the airline industry in 1957, followed by protections for certain water vessels in 1968.(7)

The birth of contemporary lender protection for the airline industry took place in 1978 when Congress adopted a new federal Bankruptcy Code. Section 1110 preserved the rights of aircraft financiers to repossess their collateral should the debtor airline default. Over the course of the following 22 years, Section 1110 was twice amended by Congress in an effort to clarify ambiguities brought to light through bankruptcy court litigation. The 1994 amendments expanded the definition of covered carriers, clarified whether leases and security interests in equipment were subject to Section 1110, and defined the relationship between Sections 1110 and 1129 of the Bankruptcy Code.(8) The *Western Pacific Airlines Case* spurred on the 2000 amendments, which clarified that lessors have "an unqualified, immediate and complete right to retake possession and control" of their collateral if the debtor fails to remedy their obligations within 60 days.(9) The most recent reinforcement of these special lender rights comes in the Seventh Circuit's *United Airlines v US Bank* opinion.

United Airlines v US Bank

One of the main interpretative challenges presented by Section 1110 has been how to reconcile its special provisions with general bankruptcy principles and other applicable law. That dilemma was certainly one of the key debates in *Western Pacific*. In the case the district court reversed the bankruptcy court's decision and concerned itself with the internal conflicts in the Bankruptcy Code between Sections 1110, 362, 363 and 1129. The district court also expressed interest in upholding principles of equity, fearing the repossession of the aircraft by trustees would threaten the airline's new creditors.(10) This kind of conflict of laws proved particularly thorny in the interpretation and application of Section 1110 until the clarification offered by the Seventh Circuit in *United.*

The circumstances of *United* are by no means unique. In 2002 United Airlines entered bankruptcy with approximately 175 of its aircraft subject to finance leases. Under the Bankruptcy Code, Section 1110 is the controlling law on the rights of the debtor airline and its lenders to possess the aircraft. Following the statute's guidelines for the consensual workout exception,(11) United's lessors "initially agreed to accept less than the contractual payments".(12) Two and a half years later, in November 2004, the patience of United's financiers had run dry and United had not yet offered a plan of reorganization. At that time, the indenture trustees demanded repossession of 14 aircraft unless United could cure all its defaults and resume the full rental payments promised in the original contract. The departure from the norm took place when, instead of adopting one of the courses of action offered by the trustees and contemplated by Section 1110, United filed an adversary action accusing its lenders of violating Section 1 of the Sherman Act (15 United States Code).

The antitrust arguments made by United did not persuade the court, which held that: "Negotiations on reductions to be taken in bankruptcy, when the buyer cannot pay all of its debts, are common and lawful, under the Noerr-Pennington doctrine if nothing else."(13) However, the court went on to clarify this matter even further, so that there is no doubt as to the special nature of Section 1110:

> *"The final clause of Section 1110(a)(1) prevents bankruptcy judges from using any source of law, including antitrust, as the basis of an injunction against repossession... Courts cannot prevent aircraft lessors or secured lenders from repossessing their collateral."(14)*

The court's strong position on the applicability of Section 1110 reaffirms Congress' 2000 amendments and confirms the idea that the special protection facilitates "access to financing for airlines, increased development of the industry, and consequently enhanced convenience and safety for the travelling public".(15)

Application of Section 1110

Adopting the guidelines provided in *United* and the 2000 amendments, a debtor airline has 60 days to cure any outstanding defaults before the filing of a petition. Defaults that occur between the filing of the petition and the end of the 60-day period must be cured by the end of 30 days from the date of default or the expiration of the 60-day grace period. After the expiration of the 60-day period, defaults must be remedied in accordance with the pre-petition terms if the agreement allows for a cure.(16) If the debtor airline is unable to satisfy its obligations, the financier has the lawful right to take possession of its collateral.
There are two exceptions to the procedure outlined in Section 1110: (i) the financier may agree to allow the debtor airline to continue using the aircraft; and (ii) the debtor can pay the full amount required by the original contract.(17) In the event that the repossession is illegal, *United* unambiguously states that: "Section 1110(a)(1) does not bar a damages action for wrongful possession."(18) Through its comprehensive interpretation of the statute, the Seventh Circuit reinforces the idea that the purpose of Section 1110 is to assure lenders "a self-help remedy", thereby making "aircraft credit available on better terms".

Comment

The court in *United* provided a clear and convincing interpretation of Section 1110, recognizing that adhering to the letter of the law and making practical business decisions can occur hand in hand. *United* is a sound precedent that will benefit the entire airline industry. As Judge Easterbrook recognized:

> *"The competitive solution is for both sides to have access to markets - and that outcome is achieved by allowing repossession. The lessors will get the current market price for airframes of the type and age involved. United, too, will enjoy a competitive price: it can buy or rent equivalent planes on going terms."(19)*

This perspective safeguards both sides of the bargain and empowers financiers to lend with confidence that its investments will be protected by Section 1110 of the Bankruptcy Code.

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Endnotes

(1) *United Airlines v US Bank*, 406 F3d 918 (Seventh Circuit 2005).

(2) 11 USC Section 1110.

(3) In *Re Western Pacific Airlines Inc*, 219 BR 298, 301 (Bankr D Colo 1998).

(4) *United*, 406 F3d at 924.

(5) Gregory P Ripple, *Special Protection in the Air(line Industry)*: The *Historical Development of Section 1110 of the Bankruptcy Code*, 78 Notre Dame L Rev 281, 286 (2002).

(6) *Id* at 288.

(7) *Id*.

(8) *Id* at 291.

(9) In *Re Western Pacific Airlines Inc*, 219 BR at 300.

(10) Jason J Kilborn, *Thou Canst Not Fly High With Borrowed Wings*: *Airline Finance and Bankruptcy Code Section 1110*, 8 Geo Mason L Rev 41, 47 to 49 (1999).

(11) 11 USC Section 1110(b).

(12) *United*, 406 F3d at 921.

(13) *Id* at 925. See *Eastern Railroad Presidents Conference v Noerr Motor Freight Inc*, 365 US 127 (1961); *United Mine Workers v Pennington*, 381 US 657 (1965) (holding that businesses are entitled to act jointly when presenting requests to courts or agencies).
(14) *Id* at 924.

(15) Kilborn, *Thou Canst Not Fly High With Borrowed Wings*, 8 Geo Mason L Rev at 66 (1999).

(16) Ripple, *Special Protection in the Air(line Industry)*, 78 Notre Dame L Rev at 297 to 298 (2002).

(17) *United*, 406 F3d at 922.

(18) *Id*.

(19) *Id* at 925.

"This article first appeared in the International Law Office Aviation Newsletter at www.internationallawoffice.com."

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