Leverage leasing was popular for aircraft leasing due to the tax benefits. Timothy Lynes, partner, and Robyn Mandel, associate, Katten Muchin Rosenman, write about the pitfalls which have appeared in tax indemnity agreements.

KEY PROVISIONS IN TAX INDEMNITY AGREEMENTS

Timothy Lynes (above) and Robyn Mandel (below)

Historically, a large portion of aircraft leasing for new equipment was accomplished through leveraged lease transactions, which benefited lessee airlines by providing cheaper lease rents and equity owners by providing certain tax incentives.

In these structures, generally, the owner trust (OT) is the legal owner and lessor of an aircraft; the OT leases the aircraft to the lessee airline (lessee); and the equity owner or owner participant (OP) owns the beneficial interest in the aircraft.

The OP borrows funds to purchase the aircraft from third-party lenders (lenders) and pledges certain of its interests in the aircraft to an indenture trustee (security trustee), who holds the mortgage of the aircraft for the benefit of the lenders. The OP can typically take advantage of accelerated depreciation deductions that an airline would otherwise be unable to exploit, and is therefore willing to advance about 20% of the purchase price of an aircraft.

There are a few main agreements that typically govern the leveraged lease. First, the OT acting on behalf of the OP enters into a lease of the aircraft to lessee (the lease). The OT and the lenders enter into an agreement under which the lenders loan funds to the OT on a non-recourse basis (the indenture). Further, the OT assigns to the security trustee, as security, the OT's (i) ownership interest in the aircraft and (ii) rights under and interest in the lease.

Lastly, and the subject of this article, is the tax indemnity agreement (TIA) between only the OP and lessee.

The TIA is vital to the structure of leveraged lease transactions because it protects the OP's tax benefits in the transaction. If the OP loses its right to exploit its tax incentives under the leveraged lease, then the OP does not receive a substantial amount of its anticipated benefits in the transaction, and the lessee, after having reaped the benefit of reduced rent throughout the term of the lease, leaves the OP with no recovery. The TIA is entered into to close this gap. Specifically, under the TIA, the lessee agrees to compensate the OP in the event it is forced to recapture tax deductions it has taken in connection with a foreclosure.

Second Circuit awards victory to owner participants by holding that only payment of SLV in whole precludes recovery under the TIA

In each recent airline bankruptcy the airline debtor challenged the OP's claims under the TIAs. Some of the challenges have been litigated through the US Court of Appeals for the Second Circuit. In an overwhelming victory for OPs on June 22 2010, the Second Circuit allowed the claims of certain OPs in the Delta Air Lines (Delta) bankruptcy case, which had arisen under TIAs, reversing the rejection of such claims by the bankruptcy court, as affirmed initially on appeal to the district court.[1]

The TIA claims of the OPs in the case had been rejected by the bankruptcy and district courts because of certain exclusions to recovery set forth in the TIA. The court reviewed three different TIAs, each with variations of an exclusion that the OP was not entitled to collect under the TIA in the event that Delta paid SLV (stipulated loss value). The lease provides that on a default by the lessee, the lessor (or the security trustee, as assignee) can demand that lessee pay SLV. SLV is fixed at the time of execution of the lease and is intended to cover payment of the remaining debt with interest and an amount to cover tax losses.

Under the indenture, any proceeds of SLV paid by lessee would first be applied to pay the lenders for their expenses and any outstanding balance on the loan. Remaining funds under the waterfall, if any, would be payable to the OP. In the event of full payment of SLV by lessee, presumably, the security trustee would receive sufficient funds to pay off the loan and the balance of the proceeds would allow the OP to be compensated for its tax losses. In such case payment by the lessee to the OP under the TIA would result in double recovery by the OP.

In stark contrast to the earlier decisions by the

bankruptcy and district courts, the Second Circuit held with respect to each of the variations of the exclusion that it reviewed, that only payment by the lessee of the whole amount of SLV, which results in recovery by the OP through the waterfall, should trigger the exclusion. Therefore, since Delta paid the security trustee as lease rejection damages approved by the bankruptcy court, an amount significantly less than SLV, and the OP did not recover any proceeds from the waterfall, Delta was still liable to the OP under the TIA.

The court recognized that the TIA was designed to remedy the tax loss that an OP suffers when a lessee defaults, and that the exclusion served only to prevent the OP from double recovery. In the bankruptcy context, however, there is no double recovery by the OP, since the amount of the lease rejection damages was less than SLV and none of those proceeds were distributed to the OP. Despite ruling in favour of the OPs, the court noted its holding would not result practically in full recovery by the OP, but it would give the OP a claim in the bankruptcy case against the debtor airline.

Specifically, the three variations of the exclusions considered by the Second Circuit were as follows: (i) "any event whereby a party... is required to pay" SLV, (ii) "any event whereby the lessee pays an amount equal to [SLV]", and (iii) "any event whereby the lessee pays [SLV] or an amount determined by reference [to SLV]".

In the first instance, the court determined that it was not the intention of the parties to preclude recovery whenever a demand for SLV was made, whether or not such demand is met. In the second instance, the court found that the holding of the underlying courts, in which they deemed SLV paid when such obligation was discharged in bankruptcy, was "nonsensical and self-defeating" because the most likely occasion to result in a demand by the OP under the TIA would be after Delta became insolvent.

Similarly, in the third instance (although the court noted this presented a closer question, but only slightly), the court found the exclusion to be an ambiguous contract term; however, the "parties could not have intended that payment of any percentage of SLV would discharge Delta's obligations under the TIAs". Such ruling would effectively nullify the TIAs by stripping the OP of the protection provided by the TIA.

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Furthermore, the court acknowledged that the lessee had entered into the TIA, a separate agreement with the OP giving the OP a right to direct recovery from the lessee. The court held that when Delta agreed to pay the security trustee lease rejection damages in a certain amount, Delta should have considered its obligations to the OP as well, and if its payment to the security trustee (when added to amounts it was obligated to pay the OP) resulted in overpayment by Delta, it was Delta's own fault, because of the separate contractual agreements running to the security trustee and the OP.

To the extent that Delta was being required to pay duplicative amounts, the court held that "the proper remedy was disallowance of the claims of the [security trustee] to the extent [such amounts] were predicated on the owner participant's TIA entitlements".[2]

Second Circuit leaves open the issue of whether voluntary transfer by OP is attributable to the exercise of remedies and precludes OP recovery under the TIA claims

In a different case arising out of the Delta bankruptcy that was appealed to the Second Circuit, In re: Delta Air Lines, Inc, the court examined another exclusion to recovery under the TIA involving whether a sale or disposition of the aircraft by the OP was "attributable to the exercise of a remedy available to the [OP]".[3] In that case, as part of Delta's reorganization, Delta worked with the security trustee to restructure a lease. In connection with such restructuring, the security trustee notified the OP that it intended to foreclose on the OP's interest.

In anticipation of the auction, the OP identified a potential purchaser of its interest but was unable to consummate the sale before security trustee auctioned the aircraft. After the auction, but before completion of any sale of the aircraft arising from the auction, the OP sold its interest to a third party. Therefore, to make a claim under the TIA, the OP had to show that the sale was attributable to the exercise of its remedies. The district court reversed the bankruptcy court's denial of the OP's TIA claim on that basis.[4]

Upon an occurrence of a default by Delta, the lease provisions allowed the OT (and the security trustee as assignee) to "exercise any... right or remedy [that] may be available under applicable law", including the sale of the aircraft. The OP in this case argued that the actions taken by the security trustee to send a "notice to [OT] of foreclosure, including publishing notice, registering bidders and conducting an auction", each constituted the exercise of remedies.[5]

The district court reasoned that the security trustee's agreement to restructure the leases was an exercise of a remedy under the terms of the lease, because it was a "step... authorized by law and taken by [OP] (and by extension, the [security trustee]) to remedy a default". In accepting this conclusion, the district court dismissed the bankruptcy court's

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conclusion that the renegotiation of the leases was "the future exercise of a remedy" and thus did not qualify as an actual exercise of a remedy.

Moreover, the district court found that the security trustee's actions of giving notice and holding an auction constituted an exercise of a remedy under the pertinent contractual language. Specifically, the lease provided that as a remedy for breach, the lessor could elect "with or without taking possession thereof, [to] sell or otherwise dispose of the [a]ircraft... at public or private sale". The court reasoned that giving "notice and holding an auction are part of the activity of selling the [a]ircraft" and thus would be an exercise of a remedy regardless of the fact that a sale was never consummated. A contrary conclusion, the court expounded, "would impose an unduly formalistic approach that is not supported by the plain language of" the contract.

Once the district court found that there was an exercise of a remedy, it was necessary to determine whether the sale of the OP's interest was "attributable to" an exercise of a remedy because its actions were clearly in response to the security trustee's proposed sale of the aircraft.

The court reasoned: "Once the [security trustee] exercised a remedy under the leases, it was evident that [the OP's] beneficial interest in the trusts would be extinguished, either through its consent to the restructuring or, absent consent, by foreclosure."

When this became apparent, the OP's sale of its interests was the "natural product" of the circumstances and "the option that best preserved the value of its assets". It was therefore "attributable to" an exercise of a remedy. [6]

However, the Second Circuit vacated the district court's decision and remanded the case to the district court with instructions to return the case to bankruptcy court to gather further evidence about the meaning of the phrase "attributable to the exercise of remedies".

The court noted that "while the bankruptcy court and the district court found that the contract language at issue was not ambiguous, the two courts disagreed as to what the language meant" and both courts articulated reasonable bases for their decisions. Therefore, the Second Circuit held that the terms "attributable to" and "the exercise of a remedy" are ambiguous, and such questions need to be determined by the fact finder. Since the bankruptcy court did not conduct an evidentiary hearing, there was not enough evidence on the record for the court to resolve the issue so the case was remanded.[7]

After the Second Circuit's remand, a rehearing was not held by the bankruptcy court because, on January 13 2010, the parties reached a settlement.[8] Therefore, this issue has not been resolved by the courts.

Conclusion

The Second Circuit's ruling that only payment of SLV in whole precludes an OP from recovery under the TIA is important to the debate between OPs and lessee-airlines because the court took a big picture view of the leveraged lease structure, and recognized the importance of recovery by the OP under TIAs as a basic part of that structure.

It may be indicative of how the Second Circuit might ultimately come out on the issue of whether an OP's voluntary transfer before the conclusion of a foreclosure is attributable to the exercise of remedies, and precludes recovery by the OP under the TIA.

When an OP transfers its interest in an aircraft after a bankruptcy is declared by the lessee, should the OP lose its right to recovery under the TIA because it attempts to mitigate its damages? The district court in that case dismissed the bankruptcy court's formalistic approach, instead espousing a more practical approach. Both of these cases are favourable for OPs and will likely give OPs greater leverage in settling TIA claims with lessee-airlines.

Furthermore, while this may be of assistance to OPs, it may have a dampening effect on the amount for which a security trustee can settle lease-rejection claims. Nonetheless, these outcomes help to preserve the legal viability of the leveraged lease structure going forward by keeping the incentive for OPs to participate. ■

Footnotes

1 In re: Delta Air Lines, Inc, 608 F.3d 139 (2d Cir June 22 2010).
2 Id.
3 313 Fed Appx 430, 2009 WL 577588 (2d Cir March 5 2009).
4 Lone Star Air Partners, Inc v Delta Air Lines, Inc, 387 BR 426 (SDNY 2008), rev'g In re Delta Air Lines, Inc, 05-17923, 2007 WL 2932774 (Bankr. SDNY October 5 2007).
5 Id.
6 Id.
7 313 Fed Appx 430, 2009 WL 577588 (2d Cir March 5 2009).
8 Order in In Re Delta Air Lines, Inc, 07 Civ 11143 (SAS) (SDNY January 13 2010), ECF No 16.