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LAW JOURNAL NEWSLETTERS

The Bankruptcy Strategist®

Volume 23, Number 1A • November/December 2005

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When Is a Lease a 'True Lease'?

***The Seventh Circuit Applies Substance over Form in* United Airlines v. HSBC Bank**

By James A. Timko

Financing deals have become increasingly complicated as parties attempt to raise capital and take advantage of accounting and tax incentives. These transactions often face scrutiny when one party files for bankruptcy. During a Chapter 11 reorganization, a debtor must use all tools at its disposal to best restructure its obligations. In contrast, a creditor must work to ensure it receives the best possible return. The term "lease" is not defined in the Bankruptcy Code. Due to this lack of a clear definition, creditors and debtors will often attempt to recharacterize agreements between the parties. In this context, a secured creditor or debtor may argue that a "lease" is actually a disguised secured financing. In the converse, a party could also argue a secured financing is actually a "true lease." This is due to the Bankruptcy Code's different treatment of secured debt and leases. Depending on the factual scenario, this differing treatment could significantly change the parties' obligations.

This article reviews the Seventh Circuit Court of Appeals' recent decision in *United Airlines, Inc. v. HSBC Bank USA, N.A.*, 416 F.3d 609 (7th Cir. 2005).

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SPECIAL ISSUE
UNITED AIRLINES: TWO VIEWS

United's Long Journey into the Far Reaches of § 1110

An Annotated Recollection by Counsel

By Ronald Barliant

It looks like James Sprayregen and his team at Kirkland & Ellis have brought United Airlines to the verge of a successful exit from Chapter 11. That is all the more remarkable because a year ago, they seemed nowhere close. United was struggling with a host of problems, not the least the one that concerned me, the retention of its fleet of aircraft. The creditors who controlled those aircraft had the leverage of § 1110 of the Bankruptcy Code that allowed them to repossess the planes as if the bankruptcy did not even exist. When some of those creditors attempted to exercise the right, however, the bankruptcy court — notwithstanding § 1110 — enjoined them. And it did so on a theory that seemed to contradict the essential idea that bankruptcy is a procedure for the collective negotiation and resolution of creditors' claims: by coordinating their bargaining, United successfully argued, the aircraft creditors were guilty of an unlawful conspiracy in restraint of trade. The ensuing litigation finally established that United was wrong: There are no qualifications to § 1110's absolute protection of aircraft creditors' rights, and coordinated bargaining by creditors of a common debtor in bankruptcy is permitted under the antitrust laws. But, it took not one, but two opinions of the Seventh Circuit Court of Appeals to establish those principles.

BACKGROUND

When United Airlines filed its bankruptcy petition on Dec. 9, 2002, its fleet included about 175 airplanes financed by public investors in about 30 transactions. Their

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acquisition had been financed by the sale in public markets of certificates representing interests in trusts. The trusts lent the proceeds for the purchase of the aircraft, securing the resulting debt with liens in the aircraft and (in leveraged lease deals) the leases. Richard Hiersteiner of Palmer & Dodge LLP was lead counsel for the indenture trustees for most of those deals, and my firm became their co-counsel.

United had to negotiate the terms for retention of the aircraft it wanted to keep, but that required finding the right people with whom to negotiate. Although the trustees had some powers to act on their own, in general they required directions from a specified percentage of holders of senior certificates. But since the certificates were publicly traded, there was no easy way to identify the holders. United and the trustees had to wait for enough senior holders willing to bargain and with the votes to make decisions for each of the 30 or so public deals to identify themselves. After several weeks, requisite numbers of senior holders had found their way to James Spiotto of Chapman and Cutler LLP in Chicago. With Spiotto and a negotiating committee as their representatives, the public aircraft lenders began negotiations with United. Chapman and Cutler also became our co-counsel.

In April 2004, United and the senior holders agreed to a final deal term sheet. When the terms were presented to the court, however, the committee of unsecured creditors objected. The committee alleged that by bargaining collectively, the lenders had violated the Sherman Act. The argument began with § 1110, the provision of the Bankruptcy Code intended to protect aircraft financiers from the risks of bankruptcy. Section 1110 provides that an airline debtor has 60 days to agree to cure defaults and perform the financing agreement or lease, or get a stipulation extending that 60-day period. Otherwise, the creditor or lessor may repossess the airplanes without restraint by "any other provision of this title or any power of the court." 11 U.S.C. § 1110(a). The automatic stay no longer applied; the creditor or lessor did not even need court approval to take the aircraft. Because the lenders could repossess the airplanes at will, the committee argued, they were really negotiating for the future use of the aircraft and were therefore no different than other potential providers of aircraft to United. In fact, the committee took to calling the certificate-holders and trustees the "Aircraft Provider Group." United, so the argument went, should be entitled to a new opportunity to negotiate under competitive conditions for the equipment already in its fleet, as if the agreements under which United had obtained that equipment no longer existed. Since they were no different than sellers of new aircraft, the "aircraft providers" could not act "collusively," but had to compete with one another for United's business. The committee wanted to reward United for its defaults, something like the athlete who wants to be rewarded for a good year by tearing up his long-term contract (although United had not had a very good year). The idea seems to defeat the purpose of contracts.

The Other Side

On our side, in contrast, the lenders were not "providing" aircraft, but negotiating the resolution of existing claims. They should therefore be called the "Public Debt Group." The difference in appellations reflected the difference in the way the parties looked at the case. To the lenders and trustees, United had already enjoyed the benefit of a competitive market when it acquired the aircraft. What was at issue now was the resolution of claims arising from United's defaults under existing agreements. Yes, that resolution would include the

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The Bankruptcy Strategist®

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The Bankruptcy Strategist® (ISSN 898-8102) is published by Law Journal Newsletters, a division of ALM.

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Telephone: (800) 537-2128, ext. 9019
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Circulation e-mail: subspa@alm.com

The Bankruptcy Strategist P0000-248
Periodicals Postage Pending at Philadelphia, PA
POSTMASTER: Send address changes to:
ALM
1617 JFK Blvd., Suite 1750, Philadelphia, PA 19103
Annual Subscription: $359

Published Monthly by:
Law Journal Newsletters
1617 JFK Boulevard, Suite 1750, Philadelphia, PA 19103
www.ljnonline.com

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terms under which United could keep the airplanes, but that simply involved deciding what it would take to convince the financiers to give up their remedies, including repossession, for existing defaults. As articulated by the trustees' principal antitrust lawyer, Michael Gass of Palmer & Dodge, this was no different than any other workout of defaulted loans. It was well-settled, Mike argued, that creditors of a common debtor did not act in restraint of trade by collectively bargaining a workout with that debtor. That was exactly what the aircraft financiers, a.k.a. the "Public Debt Group," was doing.

In addition, Mike argued, even if otherwise prohibited by the antitrust laws, collective bargaining was protected in a bankruptcy case because that bargaining could have no effect — anticompetitive or otherwise — without the court's approval of the resulting agreement. That approval would break the causal connection between the bargaining and the effect, and the lenders were therefore protected by the *Noerr-Pennington* doctrine (*Noerr-Pennington* holds that if the approval of a government agency is required to put an agreement in effect, the negotiation of that agreement could not be proscribed under the antitrust laws without violating the constitutional right to petition the government).

Interestingly, United vigorously argued against the committee's position, saying, for example, "There is no colorable antitrust claim," and proclaiming the value to United of having only one negotiating partner, rather than 30. Before the court could rule on the issue, however, United withdrew from the final deal term sheet in July, 2004, because the government denied its request for assistance. The antitrust issue went into dormancy — but not for long.

The Next Offer

The lenders waited for United's next offer, but none had arrived by late Thanksgiving week. (I later learned that United was preparing an offer for delivery right after Thanksgiving, a tad too late as it turned out.) Some were becoming impatient. Until then, few airplanes had been repossessed (although, on the other side of the coin, United had returned several as it reduced its fleet size). Section 1110 is a powerful tool, but its power is limited by the market. When the market for an airplane is weak, it may make sense to leave it where it is; at least it will be maintained and insured, and under interim stipulations the trusts were collecting something for its use. But experts were saying in November 2004 that the market for used aircraft was finally improving. Moreover, neither United's long-term viability nor its emergence from Chapter 11 were foregone conclusions in late 2004. Some lenders decided to test that market rather than wait for an offer that might be inadequate or never mature into an agreement.

For whatever reasons, lenders who controlled three trusts exercised their rights to repossess 14 aircraft. At their direction, the trustees served the required notices just before Thanksgiving, demanding the return of the planes on Dec. 1. Since many people travel that time of year, it was not surprising that United filed a complaint the day after Thanksgiving seeking an injunction against the repossession of the 14 airplanes. What *was* surprising was United's principal theory. Having denounced the committee's antitrust theory in the Spring, it adopted that theory in the late Autumn. But now there was an added wrinkle: The decision to repossess the airplanes was, United alleged, an act in furtherance of the lenders' antitrust conspiracy, intended not to serve the rational economic interests of the lenders — after all, they were getting regular payments under interim stipulations that, according to United, exceeded market rates — but to coerce United to accept the "supra-market" prices demanded by the "Aircraft Provider Group" (the same people United had called the "Public Debt Group" in the Spring). United, the argument concluded, was entitled to an injunction under the Clayton Act to prevent this unlawful repossession.

Now, United was introducing another important issue. Recall that under § 1110(a), once the 60-day period (or any stipulated extension of that period) has lapsed without an election to perform the agreement (or if that election has been breached), the right to repossess the airplanes is not "limited or otherwise affected by any other provision of this title [*ie*, the Bankruptcy Code] or by any power of the court." The Clayton Act is not a provision of the Bankruptcy Code, but the issuance of an injunction under that act would, so it seemed, be an exercise of a "power of the court."

Within hours after the complaint had been filed that Friday after Thanksgiving, the bankruptcy judge heard evidence about the harm that United would suffer if it lost 14 airplanes in early December. He then granted a temporary restraining order, saying that § 1110 only proscribed his power to rely on the Bankruptcy Code, not other law, to prevent an unlawful act. A few days later, I presented a motion to dissolve the TRO, certain that he simply had not had time to fully consider § 1110. After all, his initial interpretation rendered the phrase "any power of the court" meaningless, and defeated the congressional purpose of protecting aircraft creditors in order to reduce the cost of financings. The markets did not care what law formed the basis of a restraint on the lenders' right to the collateral; they only cared that such restraint was possible. Indeed, within a week, Standard & Poor's was threatening to reduce its rating of $30 billion of aircraft financing if the TRO survived.

Without entertaining oral argument, however, the visibly angry bankruptcy judge repeated his position, this time supported by the argument that if an aircraft creditor attempted to repossess an airplane in violation of a contract with the debtor-in-possession, "certainly" the court could enjoin that breach. He stated no reason for that certainty, however, but simply assumed it, thereby begging the very question he was trying to answer: Did he have the power under

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any legal principle to enjoin a repossession protected by § 1110?

A Higher Court

By now it was clear that if we wanted a different answer to that question, we had to get to a higher court. The question was, how to get there. A district judge denied our motion to withdraw the reference, filed 12 days after the complaint, on the grounds that it was not timely because we had first asked the bankruptcy judge to dissolve his non-appealable TRO. It looked like we would have to endure a full-blown, very costly preliminary injunction trial that may well have taken months (considering the judge's very crowded calendar and the scope of the antitrust allegations) to conclude. Within days, the parties had noticed more than 30 depositions. Both sides were assembling platoons of lawyers. Fortunately, United and the committee (which had been allowed to intervene), with the help of the judge, gave us another option.

The same day he denied our motion to dissolve the TRO, the judge granted United's motion to compel the defendants' production of privileged documents. Subject to an in-camera inspection, he applied the crime-fraud exception to the attorney-client privilege, since violation of the Sherman Act is a felony. That holding, harsh though it was, presented us with an opportunity. In an attempt to create an appealable order, the trustees waived the in-camera inspection and respectfully refused to produce the documents, inviting a finding that they were in contempt of court. The judge was more than sympathetic with our goal. He recognized that he was sailing uncharted waters and welcomed the opportunity for prompt review of his preliminary conclusion that the lenders had violated the Sherman Act — the basis of his application of the crime-fraud exception. He announced that, "if this is a question of discretion that I have, I'll exercise it in favor of allowing an appeal. If it's a question of discretion in the district court, I would be very confident that the district court would similarly exercise its discretion in favor of an appeal."

He therefore found the defendants to be in contempt of court. Not surprisingly, however, the defendants did not ask to be held in criminal contempt, nor did the court impose a penalty. Because discovery could not go forward until the crime-fraud issue was resolved, he also canceled the preliminary injunction hearing and continued the TRO in effect "pending further order of Court." Ironically, it was that second order, continuing the TRO, that provided the ultimate key to appellate review.

The Next Step

We filed separate notices of appeal from the TRO and contempt order, together with alternative motions for leave to appeal. In the latter, we argued that even if the orders were interlocutory (and we knew they might be), the district court should exercise its authority under 28 U.S.C. § 158(a) to review them. After all, this case presented two novel and important questions of law that might determine the fate of the world's second largest airline and a billion dollar antitrust claim against major financial institutions. But, as the district court judge pointed out in his two opinions dismissing the appeals because the orders were not final and denying the motions, leave to appeal should only be granted in "exceptional circumstances." In his opinion, these circumstances did not qualify. Moreover, although the entire proceeding involved the issuance of an injunction against an act allegedly in violation of the antitrust laws, according to the district judge it would not "materially advance the disposition of the litigation" for him to decide whether: 1) the bankruptcy court had any power to issue an injunction; and 2) the defendants' conduct was actionable under the Sherman Act. With those puzzling opinions, notwithstanding the bankruptcy judge's confidence that a district judge would see as clearly as he the need for review, we had again been denied access to an Article III court.

Nevertheless, we felt certain that if we could convince a higher court to look at the merits, it would agree that the bankruptcy court was wrong. Our biggest hurdle was procedural, not substantive. If we took appeals, we would have to deal with the district court's holdings that the two orders were interlocutory. Although the district court has the discretion to hear appeals from interlocutory orders of bankruptcy courts, there is no corresponding power in the circuit courts absent district court certification, which we knew we would not get. (The standards for certification under 28 U.S.C. § 1292(b) are similar to the standards for leave to appeal, which the district court had denied.) And a district court's denial of a motion for leave to appeal is not itself appealable.

We therefore filed a petition for writ of mandamus in the Seventh Circuit, arguing that the bankruptcy court had abused its authority and seeking orders directing it to vacate both the TRO and contempt orders. Fortunately (as it turned out), we also argued in the alternative (albeit in a footnote) that the orders were appealable and the court could and should treat our petition as a notice of appeal.

Judge Easterbrook's Opinion

In an opinion written by Judge Easterbrook and issued on May 6, 2005 (*United Airlines v. U.S. Bank N.A.*, 406 F.2d 918 (7th Cir. 2005)), the court held that the declaration of contempt was neither appealable nor subject to mandamus review. The judge had neither imposed a penalty, nor found the trustees in criminal contempt, nor entered a preliminary injunction as a sanction. There would be no review of the contempt order. But, as the court said, "Given our view of the merits, however, the privilege dispute has no continuing significance."

The court reached the merits by exercising appellate, rather than mandamus, jurisdiction over the TRO. It was, the court held, a preliminary injunction notwithstanding its denomination, because it extended more than the 20 days permitted for

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temporary restraining orders by Rule 65(b) (applicable under Bankruptcy Rule 7065). And contrary to the district court's view that we had consented to the indefinite extension of the TRO, that extension was really the result of the bankruptcy court's grant, over objection, of the motion to compel production of documents. "The bankruptcy judge called off the hearing," Judge Easterbrook said, "and United now contends that as a result it may keep the collateral without paying the agreed price and without any review by an Article III judge. The trustees did not (and do not) consent to that state of affairs. The order thus must be treated as a preliminary injunction, open to appellate review." The court therefore accepted our footnoted invitation to treat our petition as a notice of appeal. Since the issues were purely legal, there was no need to remand to the district court; the circuit court would decide them now.

On the merits, the court saw no room for doubt about the meaning or breadth of § 1110(a)'s prohibition on the use of "any power of the court" to enjoin repossessions otherwise authorized by that section. "The final clause of § 1110(a)(1) prevents bankruptcy judges from using any source of law, including antitrust, as the basis of an injunction against repossession" United's argument to the contrary "would drain all meaning from the phrase 'any power of the court' in § 1110(a)(1), for the preceding language already blocks reliance on any other part of the Bankruptcy Code. Unless it is to be empty, the phrase 'any power of the court' must deal with sources of law outside the Bankruptcy Code." Section 1110 did not "repeal" the antitrust statutes, as United had argued, but only eliminated one remedy, without blocking any others or changing the application of substantive law. Therefore, even if there had been a basis for a Clayton Act injunction, Congress had withdrawn the bankruptcy court's power to issue it.

But there was no such basis. To the contrary, as a second ground for reversing the TRO, the court held that there was no merit to the antitrust claim. Indeed, the claim was "thin to the point of invisibility." Answering United's argument that the lenders were colluding to control the terms for future use of the aircraft, the court said, "As best we can make out, however, what United means by 'future terms and prices on which they … make aircraft available' is how much less than the contract price the lessors and lenders are willing to accept to forbear from repossessing planes now in United's hands." But, "Negotiating discounts on products already sold at competitive prices is not a form of monopolization." Rather, "Competition comes at the time loans are made; cooperation in an effort to collect as much as possible of the amounts due under competitively determined contracts is not the sort of activity with which the antitrust laws are concerned." That is why, Judge Easterbrook wrote, the Second Circuit in *Sharon Steel Corp. v. Chase Manhattan Bank, N.A.*, 691 F.2d 1039, 1052-53 (2d Cir. 1982), had said that a claim that creditors violated antitrust laws by coordinating their bargaining in bankruptcy was "bordering on the frivolous."

"Moreover," Judge Easterbrook said, agreeing with our second antitrust argument, "businesses are entitled under the *Noerr-Pennington* doctrine to act jointly when presenting requests to courts and agencies. *See Eastern Railroad Presidents Conferenc v. Noerr Motor Freight, Inc.*, 365 U.S. 127, 5 L. Ed. 2d 464, 81 S. Ct. 523 (1961); *United Mine Workers v. Pennington*, 381 U.S. 657, 14 L. Ed. 2d 626, 85 S. Ct. 1585 (1965). Collective renegotiation succeeds only if the court approves."

ALL OVER?

It was over. Except it wasn't.

On Friday, May 20, 2 weeks after the Seventh Circuit's decision, United moved to voluntarily dismiss its complaint on the ground that it was time to concentrate on negotiations and give up what now seemed an unwinable claim. The committee, however, opposed the motion and sought leave to prosecute the antitrust claim. The bankruptcy judge believed, agreeing with the committee, that the court of appeals had really only decided that the TRO was invalid under § 1110. Everything it said about the antitrust claim was unnecessary to that decision and therefore dicta. And not even very good dicta. In fact, the judge and committee thought, the court of appeals didn't understand the facts and got the law wrong. So, the antitrust claim Judge Easterbrook called "thin to the point of invisibility," was in the bankruptcy judge's view, "colorable." (Perhaps the color was ultraviolet.) The claim for damages survived and, he believed, it was such a large claim that even if it had only a very small chance of success, it had material value.

United argued that whatever small value the claim might have was outweighed by the risk that at least some lenders might decide that, rather than bargain with United on the one hand while litigating with the committee over the same aircraft financings on the other, it was better to take airplanes back and find other buyers. The threatened crisis that had brought on the litigation just before the Christmas travel season now loomed again just before Summer. The judge, however, refused to yield to United's business judgment that it should not take the risk. Nor did he seem to consider that the lenders would not be likely to pay much to settle a claim that had been debunked by one of the judiciary's leading antitrust experts. He denied United's motion to dismiss and continued the committee's motion to prosecute the claim to give United a chance to decide what to do.

Once again, we needed the intervention of a higher court. The district court had three times abdicated responsibility, and besides, it was the Seventh Circuit's opinion that was being disregarded. So after a busy weekend, on Monday, May 23, we filed in that court a "motion to enforce opinion." The next day, the court ordered a response by the committee within 24 hours. On Friday, May 27, it issued an order (409 F.3d 812) granting the relief we had requested.

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The court agreed with us that its conclusion that the antitrust claim "is legally untenable … was an alternative holding, and not dicta as the Creditors' Committee and the bankruptcy judge have characterized it." The court concluded that disagreement with that holding "does not license defiance by a litigant or an inferior court. We therefore direct the bankruptcy judge immediately to grant United's motion to dismiss the adversary proceeding."

Now it was really over. The day after Memorial Day, the bankruptcy judge dismissed the complaint filed the day after Thanksgiving and denied the committee's motion. The committee predictably filed the predictably futile appeals, motions for rehearing and petition for *certiorari*. But far more important, the May 27th order allowed bargaining to proceed in earnest. The parties had been talking, but there was never a practical alternative to collective negotiations with the 30 transactions. Now Jim Spiotto could skillfully guide the lenders through those negotiations with United free from the antitrust spectre and with a firmly established right of repossession if there was no deal. Five airplanes were repossessed, but within weeks United announced an agreement for the remaining public debt aircraft. The committee finally acquiesced and on Oct. 18, 2005, the Supreme Court denied *certiorari* on the committee's motion.

Conclusion

The Seventh Circuit settled questions that might arise in any airline case. The extraordinary protections of § 1110 are as broad and unqualified as Congress wrote them; no matter what breach of law is alleged, aircraft creditor's repossession rights protected by that section cannot be proscribed. The importance of that leverage will depend on market conditions, but a court cannot take it away. Further, bankruptcy contemplates, and antitrust law accommodates, the collective negotiation of claims. There is also no practical alternative. A debtor cannot efficiently negotiate with many individual creditors, and creditors denied the benefit of coordinated bargaining will only have that much more reason to seek to exercise non-bankruptcy remedies — which, when § 1110(a) applies, does not even require court approval. Moreover, in public debt cases, the problems of identifying the real parties in interest, overlaps among holders in various transactions (people with holdings in one United transaction were likely have positions in others), the number of public investors, and the sheer complexity of the issues, all make coordination among creditors even more necessary. As United itself recognized in the Springs of 2004 and, finally, 2005, that coordination and hard bargaining were the only route to a successful result.

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In this decision, authored by Judge Easterbrook, the court held that it must look to the substance of a transaction and beyond the label given by the parties to determine whether it is a "true lease".

United Airlines v. HSBC Bank: The Dispute

In the 1990s, United Airlines entered into several transactions to obtain money to improve or build its premises at four airports in four different states. For each airport, a public body issued bonds to take advantage of certain tax advantages and the funds from the bonds were turned over to United. United promised to retire the bonds and reimburse administrative costs. United then entered into a lease agreement with each public body giving them the right to evict if United did not pay its obligations. United's position in bankruptcy was that the "leases" were actually secured financing transactions. If successful, it would be able to continue to operate at the facilities, paying only a portion of the "rent" (the secured claim) and the remaining portion would be treated as unsecured.

The Bankruptcy Court held that the lease of the airport space in Denver was a "true lease" and the other three leases were secured financings. Consequently, to retain the facilities, United had to assume the Denver lease, resume payment of the full rent and cure any defaults. As to the other three transactions, United could reduce its payments to only the secured portion of the rent and the other portion would be treated as an unsecured prepetition claim.

On appeal, the district court held that state law determined whether the lease was a "true lease." In reviewing each transaction pursuant to the respective state law, the district court held that each transaction was a lease for the purposes of § 365. This placed the onus on United to assume the leases, pay arrearages and continue paying its obligations under the agreements. United appealed to the Seventh Circuit, which considered only the San Francisco transaction because it was the only one fully briefed.

The San Francisco Lease Transaction

United began leasing 128 acres at the San Francisco airport in 1973. The lease was set to expire in 2013. Rent under the lease was calculated based on an independent party's estimate of the property's market value. In 1997, United and a California state development authority entered into an agreement pursuant to which the authority would issue $155 million in bonds for United's benefit. The transaction involved the following critical elements:

- United subleased 20 of its 128 leased acres to the state authority. The sublease was for a total rent of $1.00 for a term of 36 years, which was tied to the debt-repayment schedule of the

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bonds as opposed to United's lease with the airport.

- The company then leased the same 20 acres back from the authority. The rent was set at the same amount as the interest on the bonds, plus an administrative fee. In 2033, 20 years after the expiration of United's original lease, a balloon payment was due from United in the amount of $155 million to retire the principal. If United prepaid its obligations, then the sublease and leaseback would be terminated.
- The leaseback also included a "hell or high water clause" where United would have to make the balloon payment even if its lease with the airport ended before 2033, the airport was destroyed by an earthquake or some other event prevented United from using the maintenance facility.
- A trust indenture provided that United's payment of the $155 million to the indenture trustee and would be distributed to the bondholders. The bonds were without recourse to the state authority.
- United also signed a guaranty to repay the bonds.

Substance over Form Determines Whether the San Francisco Lease Is a 'True Lease'

Financial vs. Economic Distress

The Seventh Circuit explained the importance of the finding that a transaction is a lease rather then a secured financing arrangement in light of the structure of the Bankruptcy Code. The court posits that many provisions of the Code, particularly those that deal with secured credit, specifically distinguish between financial and economic distress. Judge Easterbrook explained that financial distress occurs when a firm, albeit with positive cash flow, cannot make its payments as its debts become due. The debtor is financially distressed but not economically distressed and can write down its debt through the reorganization process. By comparison, a company experiencing economic distress has negative cash flow and liquidation may be its best option.

Easterbrook reasoned that the Code distinguishes financial from economic distress by creating a "new firm" on the petition date, unburdened by its prepetition debts. This new firm must cover new expenses, such as leases as the services are provided. The Code allows old debt to be adjusted to enhance a firm's cash flow to deal with financial distress.

To address the issue of whether payment under a "lease" is for old debt or for new value, Easterbrook observed that it is up to the bankruptcy court to separate old debt from current consumption components in a lease.

Legislative History

The Seventh Circuit began its analysis of the lease agreement with the legislative history of § 365. The court looked to the Senate Report, which reads in pertinent part:

"The distinction between a true lease and a financing transaction is based on the economic substance of the transaction and not for example, upon the locus of title, the form of the transaction or the fact that the transaction is denominated as a 'lease'." S. Rep. No. 989, 95th Cong., 2d Sess 64 (1978).

Judge Easterbrook relied on the Report to illustrate Congress's understanding of the economic realities of a transaction and the importance of being sensible when addressing financing transactions.

State Law Controls When Determining If a Transaction Is a Lease

In considering which economic features of a transaction should determine whether a transaction is a "true lease," the court reasoned that leases are state law instruments, and held that it must look to California law. However, if California law placed form over substance in identifying a "true lease", Easterbrook opined that state law would have to yield to the Bankruptcy Code. This is because such a law would directly conflict with the statutory structure of the Code. [This action was brought pursuant to § 365(d) of the Bankruptcy Code. When attempting to recharacterize a transaction for the purposes of assumption or rejection under § 365(a) of the Bankruptcy Code several courts have held that the relevant inquiry is whether it qualifies as a lease under state law. *See In re Dunes Hotel Associates Holding Company*, 212 B.R. 110 (Bankr. D.S.C. 1997); *In re Pittsburgh Sports Associates Holding Company*, 239 B.R. 75 (Bankr. W.D. Pa. 1999) (opinion subsequently vacated by request of parties upon settlement).]

Judge Easterbrook pointed to the mistaken approach taken by the district court and the parties in the suit. Each relied on federal court decisions to determine state law. These decisions are from forums that "are not the source of state law or even their oracles." The Seventh Circuit reviewed California statutes and state court decisions to determine its law.

The court took the position that it would not make sense to have the term "lease" mean one thing for real property and another for personal property. The Court then looked at California law regarding the determination of a lease in the personal and real property contexts in determining its analysis.

The California Uniform Commercial Code takes a functional approach to determine whether a transaction is a "true lease." It provides that whether a transaction is a lease or a security interest depends on "the facts of each case." Further, several factors in combination with an agreement where the lessee's payments to the lessor are to continue for the term of the lease even if the lease is terminated are per se secured transactions and not leases. These factors include: 1) the term of the lease is longer than the economic life of the goods; 2) the lessee is bound to become the owner of the goods or must renew the good for their entire economic life; 3) the lease may be renewed by the lessee for the entire economic life of the goods for nominal consideration; or 4) the lessee may become the owner of the goods for nominal to no consideration. Cal. Com. Code § 1201(36).

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True Lease

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The Seventh Circuit found that California courts have looked beyond the form of a real estate lease to determine whether it is a "true lease". *See Burr v. Capital Reserve Corp.,* 71 Cal.2d 983 (1969), and *Beeler v. American Trust Co.*, 24 Cal.2d 1 (1944). In *Beeler*, the California Supreme court held that a sale-lease-back of real property transaction was actually a mortgage. The rent was well below market because it was based on the repayment of secured credit and the lessee would become the owner of the property at the end of the term. In *Burr*, the California Supreme Court held that a sale-lease-back of certain equipment was a usurious loan and not a true lease. The *Burr* court held that the offering of property for security other than the equipment sold indicated that this transaction was not a true lease.

The Seventh Circuit held the San Francisco Lease was not a "true lease" under California law and emphasized the following factors:

- The "rent" was based on the amount United borrowed and not the market rate of the property.
- The full tenancy interest of the premise reverts back to United at the end of the term in 2033 for no additional charge. The court stated this is the "UCC's per se rule for determining secured credit."
- The balloon payment of $155 million is a common feature of secured credit, not of a lease.
- In a typical lease transaction, prepayment would result in the right to continue to occupy the property. In the San Francisco transaction, prepayment resulted in the termination of the sublease and lease.
- The destruction of the maintenance base did not affect the obligation to payment. The court found that this indicated the lease was based on the financial obligations owed and not the rent of the property.

The court did not close the door on all lease-financing transactions, opining it did "not doubt that many financing devices are true leases." In true lease transactions, the lessor finances the acquisition of property or equipment and then leases it. The lessee is saved from raising the funds itself and it can escape the rental obligation by surrendering the asset. Easterbrook found this situation to be quite different from the San Francisco transaction. The maintenance base was already under lease prior to the financing transaction. What actually occurred was United used its leasehold interest to acquire an extension of credit. This, in the Seventh Circuit's view, was clearly a financing transaction.

CONCLUSION

While not all circuit courts have yet ruled as to whether substance over form governs whether a financing agreement is a true lease, the consensus is that most courts will not allow the form of a transaction to yield over the substance of a transaction. Creditors entering into "lease" transactions must be aware of the risks of such a transaction. For example, a creditor entering into a "lease" of assets subject to great depreciation is not shielded from its "lease" being treated as a loan under the Bankruptcy Code. Also, investors should also be aware of possible risks when buying bonds to be paid through lease payments. For example, the bonds in the United case were without recourse to the state authority and guaranteed by United. Presumably, the bond holders would be reduced to claims against the bankruptcy estate.

Further, while the Seventh Circuit stated that it will look to state law first to determine the factors to be applied in its analysis, the Court did not determine nor did it appear to distinguish whether real property or personal property law applied. Instead, it looked to both to make its decision. This approach gives a court a wide breadth of factors to pick and choose from. This approach illustrates the Seventh Circuit's willingness to emphasize substance over from in its recharacterization analysis.

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