Pay Up or Surrender: The Seventh Circuit Puts Teeth Back into Section 1110

July/August 2005

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The bankruptcy laws of the United States have long provided special benefits to those who lease, finance or conditionally sell transportation equipment such as airplanes, trains and related parts to companies that later file for bankruptcy protection. This special interest legislation reflects lawmakers' intent to offer enhanced protection and encouragement to transportation financiers based upon the perception that the uninterrupted availability of low-cost financing in the industry and the ability of financiers to gain immediate access to their collateral notwithstanding a bankruptcy filing are vital to the continued functioning of the national economy. In the case of the aviation industry, section 1110 of the Bankruptcy Code describes the circumstances under which a chapter 11 debtor-in-possession ("DIP") or bankruptcy trustee can continue to use qualifying aircraft, vessels and related equipment. A pair of rulings recently handed down by the Seventh Circuit Court of Appeals in *United Airlines, Inc. v. U.S. Bank N.A.* indicate that the requirements of section 1110 are strictly applied, and that a debtor-air carrier fails to adhere to the clear dictates of section 1110 at its own peril.

The Bankruptcy Code's Special Treatment of Leased and Financed Aircraft and Parts

If a company that leases or has financed the acquisition of most kinds of personal property, such as equipment, files for chapter 11 protection, the DIP or any trustee appointed in the case to administer the debtor's assets generally has the right to continue using the assets in question under the circumstances specified in sections 363 and 365 of the Bankruptcy Code.

For financed property, section 363 provides that the DIP or trustee may continue to use property that serves as collateral (other than cash) so long as the secured creditor's interest in the asset is adequately protected from diminution in value. By providing adequate protection, the DIP has the right to continue using the property during its bankruptcy case until it determines either to sell (or under certain circumstances, abandon) the asset, or to include it as part of a reorganization strategy involving confirmation of a chapter 11 plan and the continuation of its business afterward.

Different rules apply to most leased personal property. Section 365 provides that the DIP may either assume (reaffirm) or reject (breach) any unexpired lease of personal property. The decision to assume or reject can be deferred until confirmation of a plan of reorganization, unless the lessor prevails upon the bankruptcy court to direct the DIP to make the decision at some earlier time in the chapter 11 case. Pending its decision to assume or reject, a DIP must perform in a timely manner all of the obligations under the lease arising on or after 60 days following the bankruptcy petition date.

Section 1110 creates special rules designed to give both lessors and financiers of aircraft equipment readier access to qualifying equipment if a debtor air carrier is unable to comply with its obligations under whatever agreement governs the transaction in question. In contrast to section 363 and 365, section 1110 provides in substance that financiers and lessors of aircraft and related equipment may not be prevented from taking possession of the assets in question in accordance with the terms of whatever agreement governs their relationship with the debtor

unless the DIP or trustee timely agrees to perform the debtor's obligations and also timely cures certain defaults. These rights are expressly conferred upon financiers and lessors notwithstanding any injunctive power of the court, or the general applicability of the automatic stay, rules governing a DIP's use or lease of property or provisions permitting the modification of secured debts under a chapter 11 plan.

The deadline established in section 1110 is generally 60 days after the bankruptcy filing. This means that the automatic stay will prevent the repossession of qualifying aircraft and parts only if the DIP agrees, with court approval, to perform all its contractual obligations, and cures any pre-existing defaults under the contract within 60 days of filing for bankruptcy. The 60-day period may be extended only if the lessor or financier agrees to an extension and the bankruptcy court approves the agreement. Upon expiration of the 60-day period (or any extension thereof) and the DIP's receipt of a written demand for surrender of the covered aircraft and related equipment, it must "immediately surrender and return" the assets to the lessor or financier.

Section 1110 does not apply to all leased or financed aircraft and related parts. The statute provides that the aircraft must be either an "aircraft, aircraft engine, propeller, appliance or spare part" as defined in title 49 of the United States Code, which broadly defines "aircraft" as "any contrivance invented, used, or designed to navigate, or fly in, the air." However, the purchaser or lessee of the aircraft must hold an air carrier operating certificate issued under title 49 of the United States Code "for aircraft capable of carrying 10 or more individuals or 6,000 pounds or more of cargo." Thus, section 1110 excludes most privately owned aircraft.

Section 1110's reach may be further limited if the aircraft or parts in question were first placed into service before 1994. Prior to that time, the statute applied only to lease, conditional sale or financing transactions that involved "purchase-money equipment security interests." As such, the lease or security interest involved had to relate to the debtor's original acquisition of the aircraft or parts in question for the lessor or vendor to be entitled to the protections of section 1110. Congress amended the statute in 1994 to eliminate this requirement, but the pre-1994 law still applies to equipment first placed into service before the amendments were enacted on October 22, 1994. Because many aircraft and related parts still fall into this designation, the exception for pre-1994 equipment may be significant. If, for example, a lease involving pre-1994 equipment is later determined to be a disguised financing transaction, but not purchase-money financing, the vendor may not be protected under section 1110.

As amended, section 1110 applies to all kinds of qualifying aircraft leases and financing transactions. It creates a powerful package of benefits for aircraft lessors and financiers. The extent of those benefits and the inability of the courts to interfere with them were recently addressed by the Seventh Circuit in *United Airlines*.

United Airlines

At the time that United Airlines, Inc. filed for chapter 11 protection in 2002, approximately 175 of the 460 planes that it operated had been acquired by means of financings or leases that were covered by section 1110. Initially, many of the aircraft lessors agreed to permit United to continue using the leased aircraft under certain specified conditions and to accept rent at a reduced rate from that specified in their lease agreements. However, as the reorganization dragged on for more than two and one-half years, some of the aircraft lessors concluded that

United could not successfully reorganize. They accordingly demanded that United immediately return their planes unless it cured all defaults and resumed paying the full rent due under their rental agreements.

United did neither. Instead, it sued the indenture trustees representing the lessors, contending that they violated antitrust laws by coordinating their efforts to preserve the aircraft collateral and to negotiate regarding lease terms with United. United also sought an injunction preventing the trustees from repossessing the leased aircraft and parts.

The bankruptcy court issued a temporary restraining order granting United's requested relief pending a hearing on the motion for a preliminary injunction. United then sought discovery of all communications among the trustees, searching for evidence to support its illegal collaboration theory. The trustees refused on the basis of privilege, provoking the bankruptcy court to find them to be in contempt, although it never imposed any sanctions. The court simply adjourned the hearing on United's motion for injunctive relief until such time that the trustees complied with the discovery request.

The trustees appealed the temporary restraining order and the declaration of contempt to the district court, which dismissed both appeals based upon its determination that neither order was "final," and therefore subject to review by an appellate court. Thus, United was permitted to continue using the leased aircraft without either paying the full rent or returning the planes to the lessors. Moreover, it could continue to do so indefinitely because the bankruptcy court refused

to convene a hearing on United's motion for injunctive relief until the trustees complied with United's discovery requests.

The lessors petitioned the Seventh Circuit, seeking a writ directing the district court to dissolve the temporary restraining order or at least to decide the discovery dispute. Concluding that it had appellate jurisdiction because the temporary restraining order became subject to review as an injunction after it remained in effect for more than 20 days, the Court of Appeals reversed the determinations below. It remanded the case with instructions to vacate the preliminary injunction and permit the trustees to take possession of the leased aircraft unless United immediately cured its defaults and paid the full rent due under the lease agreements.

Emphasizing that "[t]he 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," the Seventh Circuit flatly rejected United's claims that section 1110 nullifies only powers conferred on a bankruptcy court under the Bankruptcy Code, and that holding otherwise would repeal the antitrust laws. "Unless it is to be empty," the Court of Appeals observed, "the phrase 'any power of the court' must deal with sources outside of the Bankruptcy Code." The Seventh Circuit went on to explain that, instead of repealing the antitrust laws, section 1110 merely curtails a particular remedy without affecting any substantive rule by providing that courts cannot prevent aircraft lessors or secured lenders from repossessing their collateral in accordance with the terms of their agreements. According to the Court, where violations of the antitrust laws have actually occurred, section 1110 does not preclude actions for damages, actions by the Federal Trade Commission or criminal prosecution.

The Seventh Circuit characterized United's antitrust claim as "thin to the point of invisibility." Creditors in a bankruptcy case, the Court explained, are clearly entitled to negotiate jointly in an effort to maximize the recovery on their claims. Moreover, the Seventh Circuit emphasized, United's contention that the lessors "colluded with one another with respect to the *future* terms and prices on which they would make aircraft available to United" was not actionable under antitrust law because the allegation referred to planes that had already been leased to United, rather than new aircraft. Observing that "[n]egotiating discounts on products already sold at competitive prices is not a form of monopolization," the Court held that negotiating reductions to be taken in a bankruptcy case, when the buyer is unable to pay all of its debts, is "common and lawful." To hold otherwise, the Seventh Circuit emphasized, would mean that a prepackaged bankruptcy, in which all creditors negotiate to reach unanimous agreement before presenting a plan to the court for confirmation, "would be nothing but a colossal cartel, unlawful *per se*."

The Seventh Circuit concluded with the following remarks directed toward the economic policy considerations underpinning section 1110:

> 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. If, as United and the Committee of Unsecured Creditors contend, the spot-market price is below not only the original rental terms but also the modified terms set when United filed for bankruptcy in 2002, then United will be better off as a result. Its problem arises if, as the lessors are betting, the price of used airplanes is higher than what United is now paying for these 14 aircraft. But if, as United contends, the highest and best use of these planes is with United, and the current competitive price is less than what United is paying in bankruptcy, then the threat to repossess is not credible, and United will keep the planes without judicial intervention (though tough bargaining may lie ahead to set the extent of the haircut from the old rental price). Only if potential sellers and lenders conspire to

> set the price at which United can acquire replacement aircraft would there be a genuine antitrust problem, and United does not contend that such a cartel is in prospect.

Subsequent Events

Notwithstanding the Seventh Circuit's ruling concerning the lessors' rights under section 1110, the lower courts did nothing to implement its directives other than to schedule a status conference on the issue. The trustees accordingly returned to the Court of Appeals, which issued yet another decision on the subject barely three weeks after its initial ruling. Observing that "[d]isagreement with [a decision's] substance may furnish a basis for a petition for rehearing (or certiorari); it does not license defiance by a litigant or an inferior court," the Seventh Circuit strongly rebuked the courts below for failing immediately to implement the relief mandated in its previous ruling. It once again directed the lower courts to dissolve the injunction and held that "[a]s of this instant, the lessors are at liberty to exercise their statutory and contractual entitlements."

Outlook

United Airlines has been perceived widely as a victory for aircraft financiers and lessors. Section 1110 is designed to ensure that airline industry financiers are assured ready access to their collateral if an airline lessee or purchaser files for bankruptcy, unless the airline is able to live up to the terms of its agreement within 60 days of filing (or within any negotiated extension). While less than ideal from an air carrier's perspective, this short time frame is intended to make it more likely that financing will be readily accessible on reasonable terms in the marketplace.

United's efforts to transform the issue from an aircraft lessor's exercise of its express statutory rights and remedies into an antitrust dispute was regarded as nothing less than an all-out assault on section 1110, and the Seventh Circuit appropriately gave short shrift to United's "legally untenable" antitrust arguments. Moreover, the Court appropriately refocused the dispute where it belongs. Section 1110 is designed to ensure that the market determines where aircraft resources are deployed, so that a bankruptcy filing disrupts the free functioning of that market as little as possible.

Given the almost wholesale mothballing of commercial jetliners and the financial woes plaguing U.S. airlines in recent years, it remains to be seen whether repossession of leased or financed aircraft will be a desirable remedy in every case. Still, the Seventh Circuit's decisions drive home the point that Congress enacted section 1110 so that aircraft financiers and lessors, unlike many other creditors, have ready access to their aircraft if a chapter 11 debtor is unwilling or unable to comply with the terms of a loan or lease agreement.

United Airlines, Inc. v. U.S. Bank N.A., 406 F.3d 918 (7th Cir. 2005).

United Airlines, Inc. v. U.S. Bank N.A., 2005 WL 1265851 (7th Cir. May 27, 2005).