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United Airlines Recharacterization ‘Victory’ Revisited

In a recent opinion written by Judge Frank H. Easterbrook, the U.S. Court of Appeals for the Seventh Circuit reversed a decision by the U.S. Bankruptcy Court for the Northern District of Illinois ruling on the valuation of an airport terminal that served as collateral for certain United Airlines bonds.¹ The Seventh Circuit held that the bankruptcy court’s valuation was clearly erroneous, and determined that the bondholder appellants rather than being materially undersecured were fully secured. Additionally, the Seventh Circuit criticized the bankruptcy court’s determination of a discount rate as an improper average of the rates proffered by the parties.

Background

In order to fund improvements of its facilities at the Los Angeles International Airport (LAX), United entered into a transaction with Regional Airports Improvement Corporation (RAIC), a public entity created for the purpose of issuing bonds to raise capital for airport improvements. Under the transaction, RAIC sold bonds to investors and in return, United assigned its rights and interests in terminal leases to the improvement corporation, which then “subleased” the same interests back to United. The payments that United made to RAIC under this lease were the sole source of payment for the bonds.

During its chapter 11 case, United challenged the true nature of this transaction, claiming the transaction should be recharacterized as a loan rather than a lease. RAIC, the City of Los Angeles and the indenture trustee for the RAIC bonds argued that the transaction was a true lease. When a transaction is characterized as a lease, §365 of the Bankruptcy Code provides that the debtor must either assume the lease and fully perform all of its obligations, or if it chooses to reject, surrender the property.²

Alternatively, if the transaction were treated as a loan, United could retain the property by providing for payment of the value of the collateral without necessarily paying the full

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amount under the bonds. United would only owe the bondholders the economic value of their collateral. Since United could not abandon its operations at LAX, the only way it could avoid paying the full amount of the bonds was to argue that the transaction really was not a lease, but a secured loan.

United prevailed on its challenge, recharacterizing the terminal lease as a loan.³ In a prior appeal before Judges William J. Bauer, Easterbrook and Daniel A. Manion, the Seventh Circuit upheld the bankruptcy court decision holding that (1) the genuine nature of the transaction indicated that it was a secured loan despite the titles and terms used, and (2) California law, which controlled which economic features should shape the lease-versus-loan inquiry, favored that outcome as well.⁴

The circuit panel then remanded the case for valuation of the terminal collateral. Pursuant to United’s confirmed plan, the appellants would receive cash to the extent of their secured position.

Valuation Analysis

Following the recharacterization decision, the bankruptcy court identified the collateral as if the initial transaction were a secured financing rather than a lease, determining that the 345,167 square feet of terminal space that United assigned to RAIC in the bond arrangement (RAIC facilities) was the appropriate collateral for the bond claims.⁵ Turning to valuation, there was agreement that the appropriate standard,

given United’s continuing use of the terminal, was its replacement value, meaning “the price a willing buyer in the debtor’s trade, business, or situation would pay to obtain like property from a willing seller.”⁶ Although comparable transactions analysis is a preferred methodology, it was not useful here because improved air terminal leaseholds at LAX are rarely sold. Hence, the bankruptcy court agreed with both parties’ experts that the value of the leasehold was the discounted stream of rental payments that the RAIC facilities could receive in the market during the term of the lease. United relied upon actual airport leasing transactions. The appellants challenged the relevance of airport activity in leasing unimproved space, and instead pointed to a transaction involving improved terminal space.

United relied upon the rate it currently paid for the terminal space under long-term leases with the City of Los Angeles. At the time of United’s chapter 11 plan confirmation, this rent was \$17 per square foot per year. United argued that such rate was the market rate because it was what a willing seller (the airport) charges to willing buyers (the airline). The bondholders’ expert asserted that the terminal could generate a rent of \$63 per square foot per year, based on a model which extrapolated a square foot rent equivalent from the arrangements with a consortium of airlines for improved space in Terminal 2 (LAX2). These arrangements took into account the usage, landing, and other sharing fees paid at LAX2, including assumptions regarding the level of air traffic. The bankruptcy court found that the bondholders’ expert analysis was too speculative and not applicable to United’s terminal space which involved a single airline, and instead ruled that the \$17 per square foot was an accurate market rate.

The bankruptcy court next had to determine the appropriate discount rate to apply to expected future payments. United offered a discount rate based on the industry-wide cost of capital, reflecting the credit risk of the obligor, the airline, while the bondholders offered a discount rate

based primarily on the taxable equivalent of the current yield to maturity of General Obligation Airport Revenue Bonds (GARBs), reflecting the market rate for airport obligations.

The court held that neither party's discount rate adequately measured the risks inherent in the relevant stream of income. The court decided that the appropriate discount rate lay somewhere in between the two rates suggested by the parties and chose the midpoint of the two rates as the best conclusion possible from the evidence presented.

Applying this market and discount rate to the usable space of the RAIC facilities, the court valued the collateral at approximately \$33 million, meaning that the remaining \$27 million of the bond claims were unsecured. Judge Harry Leinenweber of the District Court for the Northern District of Illinois affirmed the decision and the bondholders appealed to the Seventh Circuit.⁷

Circuit Reverses

On appeal to the same panel that had previously recharacterized the transaction as a secured loan, Judge Easterbrook, writing for the panel, found the lower courts' analyses regarding both the appropriate annual rental rate and discount rate to be clearly erroneous. On appeal, the bondholders argued that the bankruptcy court's finding was incorrect because (1) it reflected a discount that the airport extended to airlines in the early 1980s to persuade air carriers to make investments, and (2) it reflected the rate for unimproved terminal space even though the bond proceeds were used to improve the space that served as collateral, making it more valuable improved space.

The Seventh Circuit did not find the first argument persuasive in terms of establishing clear error. The bondholders argued that the airport could charge significantly more than \$17 per square foot because demand for air travel had gone up since the discounted rental rate was offered to United, and the airport had been unable to expand. The Seventh Circuit held that the bankruptcy court did not commit clear error in preferring evidence of actual transaction prices over an argument based on belief about what prices could have been.

The circuit found the appellants' second argument far more persuasive. It held that a price for unimproved space does not measure the value of the collateral and that any valuation method that treats improvements as worthless cannot be appropriate. Though the Seventh Circuit did not accept the bondholders' \$63 per square foot rental assessment as completely accurate, it recognized that it was the only estimate in the record of an improved space's going rate and therefore should not have been disregarded by the lower courts.

Interestingly, rather than remand for further hearing, Judge Easterbrook volunteered a totally different analysis which was far more objective-oriented. He observed that any potential rental price higher than \$30 would yield a valuation that makes the bonds fully secured even at the discount rate chosen by the lower courts. Reasoning that the data the bondholders presented regarding LAX2 showed that United's space could be leased to other airline carriers for at least \$30, Judge Easterbrook concluded that the bondholders were, therefore, entitled to full payment.

The Seventh Circuit also found that the lower courts' analysis in selecting a discount rate was flawed. A judge should choose the right discount rate rather than splitting the difference between the rates offered by the parties. Again, rather than remand for further hearing, the panel held that the discount rate could not exceed 8 percent, the rate of return on the unsecured GARBs issued by the airport, as an unassailable conclusion.

The court reasoned that being the proprietor of terminal space at LAX is not particularly risky due to the high demand for gates, and therefore, secured debt investors in United's space would not demand more than 8 percent, the rate of return offered on the unsecured GARBs.

Although valuations are theoretical, the appellants' burden of establishing that a trial court's valuation is clearly erroneous should be substantial, especially in light of the further admonition regarding witness credibility in Bankruptcy Rule 8013.

With an 8 percent discount rate, a rental rate of approximately \$23 per square foot was enough to make the bonds fully secured. The circuit held that, because the improved space in LAX2 fetches almost three times this amount, the lenders were entitled to full recovery.

Conclusion

The *United Air Lines* decision confirms that theoretical valuations in the context of a chapter 11 plan, if exposed to appeal, may be vulnerable. The facts of *United Air Lines*, which by the terms of United's confirmed chapter 11 plan permitted post-confirmation valuations, provided a rare opportunity for an appellate court to review a contested valuation.

In most cases a confirmed plan and its valuation findings are fairly insulated from appeal by the doctrine of equitable mootness. Yet, this case demonstrates that the courts of appeal may have a significant role in determining theoretical valuations that impact recoveries

under a plan of reorganization.

Valuations such as those in *United Air Lines* are inherently difficult and subjective where there is no liquid market for the asset and no comparables available. These very attributes of the valuation are what make the Seventh Circuit's decision surprising. Although valuations are theoretical, the appellants' burden of establishing that a trial court's valuation is clearly erroneous should be substantial, especially in light of the further admonition regarding witness credibility in Bankruptcy Rule 8013.

Yet, the *United Air Lines* opinion indicates that the courts of appeal, or at least the Seventh Circuit, will determine whether there was clear error and also make the actual determination that a creditor is fully secured. Basing its opinion on the same evidence available to the lower courts, the Seventh Circuit completely rejected the rental rate valuation accepted by the bankruptcy court and in doing so increased the value of the collateral by more than 100percent.

The circuit did not purport to know the correct rental rate, it simply rejected the lower courts' valuation theory and replaced it with its own. The panel also held that the appellants had not only established that the discount rate finding was clearly erroneous as an improper middle of the road approach, but also had proffered the clearly correct discount rate.

Perhaps, the prior history with this matter propelled the Seventh Circuit to answer the core question of what recovery the bondholders should receive. One can only assume that Judge Easterbrook was fully aware that his answer entirely undermined the apparent victory that United enjoyed in the recharacterization appeal.

1. *United Air Lines Inc. v. Regional Airports Improvement Corp.*, 564 F.3d 873 (7th Cir. 2009).

2. 11 U.S.C. §365.

3. *United Air Lines Inc. v. HSC Bank USA*, (In re UAL Corp.), 307 B.R. 618 (Bankr. N.D. Ill. 2004).

4. *United Air Lines Inc. v. U.S. Bank Nat'l Ass'n*, 447 F.3d 504 (7th Cir. 2006).

5. *United Air Lines Inc. v. UMB Bank, N.A.* (In re UAL Corp.), 374 B.R. 625 (Bankr. N.D. Ill. 2007).

6. *Assocs. Commercial Corp. v. Rash*, 520 U.S. 953, 960 (1997).

7. *UMB Bank, N.A. v. United Air Lines Inc.*, 2008 WL 4866188 (N.D. Ill. June 13, 2008).