

Second Circuit Holds That Equity Owners In Leveraged Lease Agreements Are Entitled To Assert Bankruptcy Claims For Tax Losses

On June 22, 2010, the United States Court of Appeals for the Second Circuit, on an appeal from the Delta Air Lines chapter 11 proceedings,¹ held that equity owners under pre-petition leveraged aircraft leases were entitled to assert claims against Delta for their tax losses stemming from Delta's insolvency and the resulting foreclosures on the aircraft.

This is the first Court of Appeals decision on the construction of key provisions of Tax Indemnity Agreements ("TIAs") common in leveraged leases, which have been the source of significant disputes over billions in potential claims in airline bankruptcies. These contractual provisions have been the subject of conflicting interpretations in the bankruptcy and district courts that specifically address concerns raised by debtors concerning potential "double recoveries" under complex corporate financings.

I. Background

Leveraged leases are financing structures commonly employed by airlines to fund the acquisition of aircraft. Under these arrangements, the purchase price is funded in part by an equity owner or "Owner Participant" (which typically pays about 20% of the cost), and the remainder is funded by debt (approximately 80%). The aircraft is then leased to the airline, which makes lease payments, which are calculated to service the related debt and provide a limited cash return to the Owner Participant. The primary benefit for the Owner Participant is not the cash return, but rather the ability to take accelerated depreciation deductions under the Internal Revenue Code, which are available to offset general taxable revenue. To protect this tax benefit, the Owner Participant enters into a TIA with the airline, pursuant to which the airline agrees to compensate the Owner Participant in the event that the Owner Participant is required to "recapture" tax deductions it had taken, for instance after a default in rent payments and subsequent foreclosure on the aircraft by the Indenture Trustee for the lenders (where the Indenture Trustee is assigned all remedies under the lease). However, another provision in the lease requires the airline to pay the "stipulated loss value" ("SLV") to the Indenture Trustee as rejection damages in the event of default,

¹ In re: Delta Air Lines, Inc., No. 08-5002-bk *et al.*, --- F.3d ----, 2010 WL 2490021 (2nd Cir. June 22, 2010).

which is calculated as of the default date to both pay the remaining debt to the lenders and – once the lenders are paid in full – compensate the Owner Participant for its losses and expected economic return. Because a portion of SLV takes into account the Owner Participant’s tax losses, there is an exclusionary provision in the TIAs providing (in various ways as discussed below) that in the event the airline pays SLV, the Owner Participant is barred from collecting under the TIA. The issue arising in the Delta litigation was the proper interpretation of this exclusionary provision in the insolvency context, when Delta “paid SLV” to the lenders but only in “bankruptcy dollars” (i.e., where the claims recovered less than 100 cents on the dollar) and the SLV paid to Indenture Trustees was insufficient to pay off the underlying debt, thus providing zero compensation to the Owner Participants.

II. The Litigation And The Second Circuit’s Opinion

Delta’s 2005 bankruptcy filing was an event of default under its aircraft leases, entitling the Indenture Trustees to foreclosure upon the aircraft. Subsequently, the aircraft were foreclosed upon and either re-leased to Delta or sold, and the Indenture Trustees filed claims for rejection damages calculated by reference to SLV. (Many of the aircraft were disposed of, and the amounts of the Indenture Trustees’ claims were fixed, pursuant to a term sheet negotiated between Delta and the lenders.) The Owner Participants separately filed claims under the TIAs based upon the recapture of their depreciation deductions based on the assumption, which turned out to be correct, that the SLV payments would return nothing to the Owner Participants. Delta objected or threatened to object to most of the Owner Participant claims (and specifically identified several claims to serve as “test cases” to govern the disposition of similar claims) on the ground, *inter alia*, that its payments of SLV to the Indenture Trustees triggered the exclusionary provisions in the TIAs and barred the Owner Participants’ claims. The United States Bankruptcy Court for the Southern District of New York (Hardin, J.) agreed with Delta and disallowed the Owner Participants’ claims, and the United States District Court for the Southern District of New York (Berman, J.), adopting the reasoning of the bankruptcy court, affirmed.

In an opinion by Judge Leval, the Second Circuit panel unanimously reversed the holdings of the lower courts, finding that the purpose of the TIAs was to compensate the Owner Participants for their tax losses and that the lower courts’ interpretation of the exclusionary provisions defeated the intentions of the contracting parties. The Court interpreted three common variations of the exclusionary provisions in TIAs: those that barred recovery by the Owner Participant if Delta “pays” SLV, those that barred recovery if it is “required to pay” SLV, and those that barred recovery if it “pays SLV or an amount determined by reference thereto.” The Court found that in each case, the proper interpretation of the exclusionary provision was that the Owner Participant not be “double compensated” by receiving both its portion of SLV and amounts under the TIA – *not* that it be barred from recovery under the TIA when the airline paid some portion of SLV to the Indenture Trustee that did not compensate the Owner Participant at all.

The Court also rejected Delta's alternative argument that the claims should be disallowed because the SLV and TIA claims effectively amounted to double recovery for a single loss, finding that Delta either had contracted to pay duplicative claims or should have reduced the amounts to be paid to the Indenture Trustees as part of its agreed-upon allowance of those claims. On this point, the Court agreed with the bankruptcy court's view that if Delta contracted with separate parties and agreed to pay twice on the same loss, "so be it."² In so doing, the Court made it clear that it was rejecting Delta's public policy arguments based on principles of equality of treatment of creditors, relying instead on the enforcement on negotiated contracts among separate parties, even where one of the contracts, a settlement with Indenture Trustees, was negotiated post-petition.

III. Implications Of The Decision

This decision resolves an issue (in the Second Circuit, at least) that has resulted in significant litigation and conflicting decisions, including both in the Delta proceedings and in the Northwest Airlines proceedings, also in the Southern District of New York. Although Judge Hardin's 2007 opinion in the Delta proceedings was the first to address the issue, a subsequent 2008 opinion by Judge Gropper in the Northwest proceedings sided with the Owner Participants. (Other decisions, including in the United Airlines bankruptcy proceedings in the Northern District of Illinois, had previously addressed issues surrounding the proper calculation of Owner Participants' TIA claims, but did not specifically address the question of whether those claims were barred by payment of SLV claims.)

Beyond its immediate impact in the Delta case in opening the door to significant claims by the Owner Participants – the "test cases" at issue in the appeal alone accounted for approximately \$ 1 billion in asserted claims – the Second Circuit's decision is an important appellate precedent that will necessarily guide future litigation and negotiation among all parties to leveraged lease transactions in the insolvency context.

In addition, the Second Circuit made it clear that, at least in this context, general concepts of bankruptcy equity and fairness should not overturn the carefully negotiated contractual rights of sophisticated parties.

Please feel free to contact any of your regular contacts at the firm or any of our partners and counsel listed under Bankruptcy and Restructuring in the "Practices" section of our website (<http://www.clearygottlieb.com>) if you have any questions.

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² In re: Delta Air Lines, Inc., 2010 WL 2490021 at *9 (quoting In re: Delta Air Lines, Inc., 370 B.R. 552, 557 (Bankr. S.D.N.Y. 2008)).

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