In re Delta Air Lines Inc.: Leveraged-Lease Transactions in Airline Bankruptcies

Written by:
Vincent J. Roldan
DLA Piper LLP (US); New York
vincent.roldan@dlapiper.com

Contributing Editor:
Camisha L. Simmons
DLA Piper LLP (US); New York
camisha.simmons@dlapiper.com

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loss carry forwards or has large amounts of tax-exempt income, so the company chooses to lease the asset rather than outright own the asset. The leveraged-lease transaction is usually structured as a three-party transaction among a lessor, an owner trust (lessee) set up to own the aircraft and lease it to the lessee, and lenders.

Owner participants typically own an aircraft through an owner trust, and then lease the aircraft to a debtor/lessee. The owner trust is funded by equity funds of up to 20 to 40 percent of the purchase price to purchase the asset, the funds for which are provided by the owner participant (and beneficiary of the owner trust). The lessee generates income from use of the asset and makes periodic lease payments to the owner trust. A lender or group of lenders lends the remaining 60 to 80 percent of the purchase price to the owner trust. The lender(s) usually receive mortgage bonds secured by (1) a first lien on the asset, (2) an assignment of the lease, (3) an assignment of the lease payments and (4) sometimes a direct guarantee from the lessee or a third party. The lessee/owner reports the lease payments as gross income and uses various tax benefits resulting from the transaction.

On the Edge

Leveraged-Lease Transactions

Leveraged leases are tax-driven financing arrangements used to acquire assets, such as aircraft, that require huge capital outlays. A leveraged lease is the ideal financing arrangement for a company that is not able to use benefits associated with ownership, such as interest and accelerated depreciation. Usually, the company generates low profits, has large tax-1

About the Authors

Vincent Roldan is a senior associate and Camisha Simmons is a mid-level associate in the Financial Restructuring Group at DLA Piper LLP (US) in the firm’s New York office, where they represent debtors and creditors in restructuring both in and out of court.

Delta Air Lines Transactions

In Delta Air Lines, the debtor entered into a number of leveraged-lease transactions similar to the general structure described above. Equity investors/owner participants (OPs) created owner trusts to purchase certain aircrafts. The owner trusts purchased the aircrafts “with funds provided by (i) an equity contribution (of approximately 20 percent) from the Owner Trust’s beneficiary (the [OP]) and (ii) non-recourse borrowings (of approximately 80 percent) from lenders (the ‘Lenders’).”

For each separate leveraged-lease transaction, the owner trust leased the aircraft to Delta pursuant to a net lease (the “lease”). The lease provided that Delta was responsible for all operating expenses. The lease payments were calculated to amortize the amount due to the lenders (the “loan”). The debt owed under the loan was collateralized through the owner trust’s grant of a security interest in the aircraft and assignment of its interest in the lease to an indenture trustee, which served as agent for the lenders, pursuant to an indenture agreement (the “indenture”).

The indenture trustee made debt payments from lease payments and was to distribute any excess funds to the owner trust. Some of the lease transactions generated enough excess cash to provide a cash return to the OPs. The indenture trustee was also given the right to exercise all remedies available to the lenders in the case of a default under the lease.
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Owner Participants’ Bargained-for Protections

As discussed, leveraged-lease transactions are tax-driven. The OPs in Delta Air Lines were primarily motivated to enter into the leveraged-lease transactions to obtain benefits derived from the use of accelerated depreciation to reduce taxable income. To shield or insure each OP from the risk that certain events would prevent the OP from taking advantage of the tax deductions (such as lender foreclosure), the OP bargained for two protections. The first was a provision in each lease that permitted the lessor (or the indenture trustee as assignee) to demand that Delta pay the stipulated loss value (SLV) of the aircraft in the event of a default by Delta under the lease. SLV was calculated to provide for (i) the payment of the remaining debt with all interest due and (ii) the agreement among the OPs to the payment of all adverse tax consequences that would result from the default. The indemnity agreement (TIA) required Delta to compensate the OP in the event that, upon a foreclosure of the aircraft, the IRS required the OP to “recapture” deductions it had taken for accelerated depreciation. As the court in Delta Air Lines noted, because the SLV was calculated to be sufficient to compensate the OP for all adverse consequences of a lease default, if Delta was to pay the SLV in full and make full payment pursuant to the terms of the TIA, the OP would receive double compensation, at least to the extent of the tax loss suffered by the OP. Thus, each TIA contains an exclusionary provision, which provides, in essence, that if Delta pays the SLV under the lease, the OP is not entitled to collect under the TIA.

The TIAs analyzed by the court in Delta Air Lines contained three slightly different exclusionary provisions, each of which was designed to prevent the OP from receiving double compensation. The three exclusionary provisions at issue in Delta provided that (1) the OP “is limited in its ability to receive the SLV” if it “fails to request to have the SLV paid” and (2) “no amount is due under the TIA where Delta is required to pay the SLV.” and (3) the OP “is not entitled to any payment...in respect of any Loss...arising as a result of...[any event whereby] [Delta] pays Stipulated Loss Value...or an amount determined by reference there to.”

Delta Challenges Claims under the TIAs

In 2005, Delta filed for chapter 11 protection. The bankruptcy filing was an event of default under the leases and indenture. Thus, the indenture trustees were entitled to exercise various remedies available under the leases. Delta and an ad hoc committee of lenders entered into a term sheet that provided for the foreclosure of a number of aircraft subject to the leveraged-lease transactions, rejection of the applicable leases and execution of new post-petition leases with Delta. Pursuant to the term sheet, the indenture trustees’ rejection damages claims were calculated by subtracting the aggregate rent payments to be received under restructured leases and the expected residual value of the aircraft at the end of the restructured lease terms from the SLV, which was calculated as of the date of Delta’s bankruptcy filing. It was apparent that the indenture trustees were not being paid the SLV in full.

Certain OPs (the “claimants”) experienced tax losses when the indenture trustees foreclosed on certain aircraft. The foreclosure resulted in the claimants’ obligation to recapture prior tax deductions for accelerated depreciation. Consequently, the claimants filed proofs of claims (the “TIA claims”) for the tax liability. Delta filed objections to the TIA claims.

The bankruptcy court in Delta Air Lines upheld certain of Delta’s objections to the TIA claims. First, because the indenture trustees’ claims for the SLV were dischargeable in the bankruptcy case, the court concluded that the SLV had been “paid.” Thus the TIA claims could not also be asserted and paid. The court referred to the dictionary definitions of “pay” and “paid” to reach its conclusion that a discharge in bankruptcy results in “payment” of a debt. The court did not equate “paid” with payment in full. A second set of exclusionary provisions provided that Delta was not required to pay under the TIAs if Delta was paid less than the SLV. The court found that essentially, through a demand for payment of the SLV by the indenture trustee in the case, Delta was “required to pay” the SLV, consequently, the exclusionary provision barred payment under the TIA. Lastly, the court analyzed an exclusionary provision of a TIA that provided that Delta would not be obligated to pay under the TIA if the indenture trustee was paid an amount determined by reference to the SLV. The court concluded that if Delta paid a pro rata share of the SLV or lease rejection damages pursuant to the term sheet, it had paid an amount determined by reference to the SLV. Therefore, the court concluded that the claimants could not recover under the applicable TIAs.

The claimants appealed the bankruptcy court’s decision to the U.S. District Court for the Southern District of New York. The district court affirmed the bankruptcy court’s decision. The claimants then appealed to the Second Circuit.

Second Circuit’s Decision

The Second Circuit vacated the district court’s decision and remanded the case to the bankruptcy court with instructions to overrule Delta’s objections. The Second Circuit’s analysis centered on the intent of the contract parties. Accordingly, to understand the
TIAEs, the Second Circuit first looked to the purpose of the TIAEs and exclusionary provisions in the leases.\textsuperscript{46} The court recognized that the TIA was designed to remedy the loss of the tax benefit of accelerated depreciation by OPs due to a circumstance such as insolvency or default under the lease, which resulted in a foreclosure on the aircraft, by obligating Delta to compensate the OP for the loss.\textsuperscript{49}

Moreover, Delta’s default under the lease could simultaneously give rise to two obligations: (1) an obligation to pay the OP under the TIA and (2) an obligation to pay SLV to the indenture trustee.\textsuperscript{50} The court explained that “[t]he purpose of the exclusionary provisions was simply to ensure that an [OP] not receive double compensation for depreciation recapture.”\textsuperscript{53} The indenture waterfall, however, provided that OPs would not be paid until the lenders had been paid in full.\textsuperscript{52}

**Meaning of “Pay”**

The Second Circuit held that the bankruptcy court’s interpretation of “pay” and “paid” was erroneous because it defeated the purpose of the bargained-for protections provided by the TIA.\textsuperscript{53} “Adoption of the bankruptcy court’s construction of pay nullified Delta’s obligation to pay the [OP] under the TIA upon the occurrence most likely to call its provisions into play—Delta's bankruptcy.”\textsuperscript{54} The court reasoned that the bankruptcy court’s interpretation “treated Delta’s bankruptcy as simultaneously causing the [claimant’s] loss for which Delta owed compensation under the TIA and nullified Delta’s obligation to compensate the [claimant] for that loss. This was not a reasonable interpretation of the contract.”\textsuperscript{55}

Interestingly, the Second Circuit did not discuss the decision in *In re Northwest Air Lines Corp.*\textsuperscript{56} There, the bankruptcy court recognized that if “paid” means “paid in cash,” the TIA works effectively.\textsuperscript{57} The court in *Northwest* also rejected the debtor’s objection to an owner participant’s TIA claims and determined that “paid” had to be interpreted as requiring payment in full in cash.

**Meaning of “Required to Pay”**

The Second Circuit also rejected the bankruptcy court’s conclusion that Delta is “required to pay” the SLV whenever the indenture trustee makes a legally supported demand for payment of the SLV (regardless of whether any part of the SLV is actually paid to the indenture trustee).\textsuperscript{58} The court similarly found the bankruptcy court’s conclusion at odds with the intent of the parties in contracting for the TIA.\textsuperscript{59}

**Meaning of “Pay SLV or an Amount Determined by Reference Thereto”**

The Second Circuit likewise rejected Delta’s arguments that it had paid “an amount determined by reference [to the SLV]” because “it paid the Indenture Trustee either (1) a percentage of SLV net of the proceeds of the sale of the aircraft, or (2) a percentage of the stipulated lease rejection damages calculated under the [term sheet] using a formula that started from [the SLV].”\textsuperscript{60} The court believed the most likely interpretation of the clause was that the phrase “‘an amount determined by reference thereto,’ was intended to indicate that Delta could discharge its obligation under the TIAs by payment of the amount of [the SLV], reduced in accordance with certain lease-sanctioned offsets, such as those for fair-market value, sale proceeds, insurance revenues and government receipts, in a manner that would result in realization of the full value of [the SLV].”\textsuperscript{61} Further, the court reasoned that the claimants could not have intended that Delta’s payment to the indenture trustee would obviate Delta’s obligations under the TIAs, “so long as it was determined by reference to SLV, notwithstanding that such payment would in no way benefit the [claimant].”\textsuperscript{62}

**Conclusion**

The Delta Air Lines decision is a significant victory for owner participants in leveraged-lease transactions. Airline bankruptcies and foreclosures have led to significant tax-indemnity agreement claims from the resulting recapture of depreciation—more than $1 billion in *Delta Air Lines* alone. For the time being, owner participants seeking enforcement of their bargain-for-protections under tax-indemnity agreements in a court sitting in the Second Circuit can rest assured that their tax benefits will be protected in the context of a lessee bankruptcy, arguably, the case in which owner participants need the protection the most. When drafting new tax-indemnity agreements, however, owner participants likely should still clarify that the exclusivity provision is triggered when the lessor pays the SLV “in full.” Of course, in other contexts such as settlement agreements, plans of reorganization and other commercial agreements, the requirement that payment be made “in full,” where appropriate, may help avoid confusion and litigation over the meaning of “paid.”

The OP’s victory in *Delta Air Lines* resolves just one battle in a war between Delta and OPs. Delta has stated in bankruptcy court pleadings that it intends to object to TIA claims for other reasons. Specifically, Delta has indicated that it also object to the following premises: (1) “to the extent they include compensation for tax losses or tax liabilities that are attributable to a default or other event without taking into account all tax benefits that are attributable to the same default or event;” (2) “to the extent they include amounts that represent sums or values that the claimant expected to realize in the future and such future sums are not discounted to present value using an appropriate discount rate;” and (3) to the extent they include “gross-up” calculations based on the amount of the claim rather than the amount actually distributed with respect to such claim.\textsuperscript{58}

The bankruptcy court extended the claim objection deadline to Jan. 6, 2011.\textsuperscript{64} It remains to be seen whether these other objections will be successful. It will be interesting to see if other circuits follow the Second Circuit’s reasoning and conclusions with respect to these types of financing transactions.