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Equipment & Project Finance Bulletin

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April, 1998

WESTPAC COURTS MISS THE MARK ON §1110

Bankruptcy Courts are courts of equity. Occasionally, a Court's attempt to keep a debtor running (or, in this case, flying) or to preserve a debtor's property interest for the perceived benefit of the majority of the creditors undermines the rights of one creditor or a smaller class of creditors. Such, we believe, was the case in the recent decisions approving debtor-in-possession financing ("DIP Financing") and interpreting §1110 of the Bankruptcy Code in the Western Pacific Airlines ("WestPac") bankruptcy case *(In Re Western Pacific Airlines, Inc.* Case No. 97-24701 SBB in the United States Bankruptcy Court for the District of Colorado) where the Courts were attempting to protect WestPac's interest in "under market" leases. Fortunately, the appeal of the Bankruptcy Court's order approving the DIP Financing was decided on technical grounds not related to §1110. Further, the Colorado District Court appears to have missed the mark while overruling on appeal the same Bankruptcy Judge's more recent ruling in favor of aircraft lessors relating to a narrow §1110 issue of first impression. In any event, it appears that the unusual facts, narrow issues and strange interpretations of §1110 will not provide much, if any, precedent which is adverse to the aircraft finance industry, particularly outside of the bankruptcy courts in Colorado.

The DIP Financing Order

Facts: Following WestPac's filing for relief under Chapter 11 of the Bankruptcy Code, it requested bankruptcy court approval to obtain up to $30 million in additional DIP Financing from Energy Management Corporation and Sundance Venture Partners, L.P. II (the "Lenders") who also were potential purchasers of WestPac's operations. To secure the proposed DIP Financing, the Lenders would

receive a security interest in essentially all of the assets of WestPac.

Boullioun's Argument

Boullioun Aircraft Holding Company, Inc. and Boullioun Portfolio Finance I, Inc. (collectively "Boullioun"), the lessor of three Boeing 737s, did not object to the proposed DIP Financing *per se*. In fact, Boullioun was to be the direct recipient of at least $3 million of the DIP Financing to cure lease payment defaults. Boullioun filed a limited objection, however, to the following provision (the "Assignment Provision") in the proposed DIP Financing Order:

> If an Event of Default has occurred and is continuing, the Lenders shall have the following rights, among others:
>
> i. to direct the Debtor to assume and assign pursuant to §365(f) of the Bankruptcy Code any Aircraft Leasehold to an assignee designated by the Lenders;
>
> ii. to direct the Debtor to seek any consent (other than the consent of the lessor) necessary to the assumption and assignment or the assignment of any Aircraft Leasehold;
>
> iii. to collect any proceeds payable to the Debtor as a result of any disposition of the Aircraft Leasehold, including but not limited to any consideration payable by the assignees to the Debtor for the right to obtain the assignment or any reimbursement to the Debtor of security deposits or maintenance reserves resulting from the assignee's assumption and performance of the obligation to pay such deposits or reserves.

Specifically, Boullioun argued that the Assignment Provision was a default under the anti-lien and anti-assignment provisions of the Boullioun 737 leases. As a result, Boullioun asserted that such "defaults," if not cured,

violated the provisions of §1110 of the United States Bankruptcy Code, which in essence grants certain aircraft secured lenders and aircraft lessors special exceptions to the automatic stay and the right to repossess the aircraft unless:

A. before 60 days after the commencement of the bankruptcy case ("Sixty Day Period"), the debtor "agrees to perform all obligations of the debtor that become due" under the security agreement or lease after the commencement of the bankruptcy case (the "§1110 Agreement"); and

B. any default (other than one relating to the insolvency, financial condition or bankruptcy of the debtor) (i) that occurs before the commencement of the bankruptcy case is cured before the expiration of the Sixty Day Period; and (ii) that occurs after the commencement of the bankruptcy case is cured before the later of 30 days after the default or the expiration of the Sixty Day Period.

The Assignment Provision, Boullioun argued, violated the anti-assignment and anti-lien provisions of the subject aircraft leases and was not cured by WestPac as required under §1110. Therefore Boullioun argued that it had the right under §1110 to repossess the aircraft. In essence, Boullioun requested the Bankruptcy Court to approve the DIP Financing, but without the above-referenced Assignment Provision.

The Bankruptcy Court's DIP Financing Decision

The Bankruptcy Court first addressed the arguments of Boullioun (and other lessors) that the Assignment Provision of the DIP Financing Order violated the anti-lien provisions of their leases. The Court acknowledged that the Lenders, after the anti-lien issue first arose, agreed not to take an actual, direct assignment of the leasehold interests, but instead "in effect, a lien or priority in the Debtor's powers under §365(f) of the Bankruptcy Code," which grants a Debtor the right to assume and assign a lease notwithstanding anti-assignment provisions. As a result, the Court concluded, the Lenders merely were granted the right to direct the Debtor to assume and assign

the subject leases, "subject to all of the protections for lessors which are offered by §365(f)." The Court then noted, in equitable fashion, that significant value from the "under market" leases of WestPac would be dissipated without the curing of the lease payments with the DIP Financing.

The Court next addressed Boullioun's argument that §1110 "trumps" the Debtor's rights under §365(f) of the Bankruptcy Code. Section 365(f) provides a Debtor with the sometimes valuable right to assume and assign a lease, notwithstanding non-assignability provisions in a lease. If the Court followed Boullioun's argument enforcing the anti-assignment provision, WestPac would have been prevented from assuming and assigning the leases and the potential value of the under market aircraft leases would be lost to creditors. The Court concluded that "§365(f) is not overridden by §1110, but rather coexists with it. As a result, the Debtor has the authority to assume and assign aircraft leases under §365(f), even without the consent of the lessors." Again, in equitable fashion, the Court first noted that "the value to the estate of the aircraft leaseholds would be eliminated if no loan is made," and then approved the DIP Facility without modification and with the Assignment Provision.

The Appeal of the DIP Financing Order

The Lenders immediately disbursed funds to WestPac pursuant to the approved DIP Facility. WestPac then tendered, and Boullioun accepted, $1.7 million of the loan proceeds as cure payments under the subject leases. Other objecting lessors withdrew their objections to the DIP Financing upon disbursement of the funds. Without seeking a stay of the DIP Financing Order, Boullioun pursued the appeal, but in a somewhat unusual fashion. As noted by the Court,

> Boullioun contends its purpose on appeal is not to challenge the post-petition loan transaction itself (Bouilloun concedes it accepted its $1.7 million in loan proceeds) but to enforce its nonmonetary rights under 11 U.S.C. §1110 to prevent the assignments of leaseholds without its consent.

The Court then noted that Boullioun sought to alter and diminish the security upon which the Lenders had already relied to disburse the loans, including to Boullioun:

> The nature and risk of extending post-petition financing to a Chapter 11 debtor are such that no lender would be willing to do so without assurances that the collateralization provisions for which it bargained in good faith are secure in absence of a stay.

The Court concluded that Boullioun's attempt to alter the collateralization provisions of the DIP Financing Order without invalidating the loan itself and the $1.7 million already received by Boullioun "is an attempt to have its cake and eat it, too."

Accordingly, the District Court found that Boullioun's failure to seek or to obtain a stay of the Bankruptcy Court's DIP Financing Order rendered the appeal moot under §364(e) of the Bankruptcy Code, which specifically protects lenders' liens and advances from reversal or modification of financing orders on appeal, unless a stay pending appeal was obtained.

Boullioun Aircraft Returned

Shortly thereafter, the Boullioun/WestPac §1110 decision appeared to be much ado about nothing. WestPac ceased operations on February 5, 1998 and on February 23, 1998, the Bankruptcy Court entered an order approving the Motion of Boullioun for termination and rejection of the subject aircraft leases, releasing the aircraft to Boullioun. Two of the three aircraft were immediately sold by Boullioun to Southwest Airlines and a new lease was being negotiated for the third, when the next chapter of this unusual story developed.

Revived §1110 Issues After Shutdown

After the February 5, 1998 shutdown of operations, numerous other aircraft lessors [1] requested relief under §1110 from the Bankruptcy Court. WestPac had agreed in December, as required by §1110, to perform all obligations that become due after the commencement of the case (the "§1110 Agreement") and cured various defaults. WestPac, however, was now in default of various provisions under the leases and security agreements and the lessors argued that they were entitled to immediately repossess the aircraft pursuant to §1110. The Bankruptcy Judge, in his own words, described the *only* issue before him, and the only issue briefed by WestPac and the lessors

as follows:

> During the course of a reorganization and after an airline debtor-in-possession agrees to perform all its obligations pursuant to 11 U.S.C. §1110(a)(1)(A) and cures all its defaults under Section 1110(a)(1)(B) does it have a continuing 30-day period to cure any subsequent defaults? Put another way, does Section 1110 afford a Chapter 11 debtor a continuing, or rolling, 30-day period to cure any post-petition defaults, including a failure to make lease payments?

After hearing oral arguments and reviewing the briefs, the Bankruptcy Court ruled against WestPac and the DIP Financing Lenders, and in favor of the aircraft lessors by providing:

> This Court concludes that Section 1110(a)(1)(A) gives a debtor 60 days after the filing of the petition to decide if it will enter into a Section 1110 agreement. If a debtor enters into such an agreement, either implicitly or explicitly, it must (a) commit to perform all lease obligations that have come due after the petition, (b) agree to timely perform future obligations according to the lease terms, and (c) immediately cure all defaults that occurred within the initial 60 days of the case, except that a 30-day grace period is applicable to those payments coming due during the first 60 days of the case. *Any defaults that occur after the initial 60-day period must be cured according to the terms of the pre-bankruptcy lease, failing which the lessor is entitled to immediate possession of its aircraft.* (emphasis added)

The Debtor and the DIP Financing Lenders filed an appeal of the Bankruptcy Court decision to the Colorado District Court on an expedited basis. The only issue which was briefed on appeal was the one described by the Bankruptcy Court above. The District Court, however, found that the question presented and briefed by the parties — whether the 30-day provision of §1110 extends the 60-day period to 90 days or affords debtors a recurring 30-day period over the life of the bankruptcy to cure defaults — "is something of a red herring."

Without either the Debtor, DIP Financing Lenders or

aircraft lessors advocating any other reading of §1110 or any other issue, the District Court simply passed over the only issue presented to the Court — the 30-day cure/60-90-day issue — and concluded that:

- §1110 is satisfied if, within sixty days after the commencement of the case, the debtor cures defaults on its lease (potentially through the 90th day) and agrees to comply with the terms of the lease, which WestPac did in this case; and

- A lessor's right to repossession under §1110 terminates after the 60/90-day period (whatever it is) and "[i]ts lease may be subject to assumption and assignment by the trustee or debtor-in-possession, even if the debtor is in default."

The District Court reached the above conclusion even though it was not advocated by either WestPac or its DIP Facility Lenders and even though the Lenders admitted in their brief that "If a post-petition default is *not* cured within 30 days, the lessor is entitled to repossession."

The District Court decision appears to be incorrectly decided for a number of reasons. First, the issue was not advocated by any of the parties and therefore, not properly briefed. Accordingly certain relevant Federal Appellate Court authority was not considered by the Court. In particular, the Eleventh Circuit decision in *In re Airlift International, Inc.*, 761 F.2d 1503 (11th Cir. 1985) recognized a lender's continued §1110 rights after a debtor executed a §1110 agreement in the initial sixty day period and breached the §1110 agreement thereafter. The Eleventh Circuit overruled a bankruptcy court's decision which declined such post-Sixty Day Period §1110 rights and which granted only reasonable value as an administrative claim for the use of the aircraft, not the contractual amount agreed to in the §1110 agreement. The Court ruled that a lender's right to timely contractual payments and possession of the aircraft were preserved by §1110 after the Sixty Day Period:

> If the debtor wishes to stop the payment meter, he must return the aircraft; until that event occurs, the debtor is obligated to make payments as specified by the §1110 agreement.

Second, the decision just doesn't make much sense and is

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contrary to the legislative intent of §1110. Congress intended §1110 to "encourage new financing of ships and airplanes" through the special rights of uninterrupted repossession if the conditions of §1110 are not met by the debtor. Clearly, the financing of the aircraft industry would not be encouraged if the rights of §1110 are short-term and illusory, by allowing a lessee to avoid §1110 merely by making a superficial §1110 agreement on the 59th day, curing the initial defaults, and failing to make any post-petition payments thereafter.

Finally, the District Court appears to simply ignore the fact that the §1110 agreement by WestPac — to perform all obligations which become due after the commencement of the case — is a *post-petition* agreement. In fact, the District Court Judge appears to actually condone WestPac's post-petition defaults of its post-petition agreement in an attempt to preserve WestPac's interests in the under market leases. The integrity of all Chapter 11 reorganization cases, however, will be eroded if post-petition lessors, vendors, creditors and contracting parties believe, as a result of this decision, that post-petition agreements may very well be unenforceable if the Court later determines that such post-petition defaults are in the best interests of the debtor's estate. The likely result of such belief and erosion, is that there will be no successful Chapter 11 reorganizations.

Conclusion

On March 20, 1998, GATX Capital Corporation and Boullioun each filed Motions before the District Court for reconsideration and rehearing of the District Court's recent decision. We believe that there is a good chance that the decision will be vacated or overruled on appeal, once the issues are properly briefed and argued and fully addressed and considered by the Court. The original DIP Financing Order was based on unusual facts and issues, and eventually decided on technical grounds not related to §1110. The District Court's most recent decision related to narrow §1110 issues and appears simply to be contrary to the protections afforded aircraft lenders and lessors by Congress through §1110. In any event, the decisions are not binding beyond the Bankruptcy Courts in Colorado, and should not provide much, if any, precedent in other Courts.

If you have any questions regarding this bulletin, please

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[1] The Lessors include Wilmington Trust Company; Sunrock Aircraft Corporation Limited; GATX Capital Corporation; GATX Third Aircraft Corp.; B & A Leasing Corp.; KG Aircraft Leasing Co., Ltd.; Babcock & Brown Aircraft Management; Aircorp, Inc.; International Lease Finance Corporation; CIT Group/Equipment Financing, Inc.; Terandon Leasing Corporation; Willis Lease Financing Corp.; and General Electrica Capital Corporation.

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